

Portugal: First Review Under the Extended Arrangement

The following documents have been released and are included in this package:

- The staff report, prepared by a staff team of the IMF, following discussions that ended on August 12, 2011 with Portuguese officials on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 1, 2011, and discussed by the IMF Executive Board on September 12. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- Letter of Intent*
- Memorandum of Economic and Financial Policies*
- Technical Memorandum of Understanding*
- LOI & Memorandum of Understanding on specific Economic Policy Conditionality (European Commission and European Central Bank)*
- A Press Release summarizing the views of the Executive Board as expressed during its September 12, 2011 discussion of the Staff Report*
- A statement of the Executive Director for Portugal

* These documents will also be released separately and are also included in this report.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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PORTUGAL

First Review Under the Extended Arrangement

Prepared by the European Department in Consultation with Other Departments

Approved by Poul M. Thomsen and James Roaf

September 1, 2011

Executive Summary

Program status. On May 20, the IMF approved a SDR 23.7 billion (€26 billion) arrangement under the EFF as part of a joint financing package with the European Union worth €78 billion. The first tranche of SDR5.6 billion (€6.1 billion) was made available on May 24th. The available purchase, at completion of the first review, amounts to SDR3.5 billion (about €3.8 billion). All quantitative performance criteria and all but one structural benchmarks for the first review were met.

Recent developments. Macroeconomic developments are broadly in line with expectations: activity remains weak and the external adjustment is taking place. Despite expenditure slippages in 2011H1, caused in part by the electoral cycle, the end-June PC on the fiscal deficit was met. Recourse to the ECB financing has alleviated some of the pressures of the global financial crisis on banks' funding and so far there is no evidence of a severe contraction in credit to the economy.

Program discussions and recommendations. Additional, mostly one-off, fiscal measures have been announced to ensure that the end-year fiscal target is met. The main elements of the 2012 budget are still being discussed, but expenditure control and effective management of fiscal risks remain crucial. Discussions on the structural side focused on policies to restore growth and employment. In the financial sector, progress is being made in strengthening bank capital and liquidity safeguards, but credit developments warrant close monitoring.

Risks. The global market turmoil has heightened risk aversion with potential adverse consequences for funding, bank credit, and growth. Program safeguards help mitigate against these risks, while the recently announced policy actions by the European Council to strengthen the Euro area crisis management framework provide additional reassurances and significantly enhance prospects for the program's success.

Mission. Discussions took place during August 1–12 with the Minister of Finance, Governor of the Bank of Portugal (BdP), and other Cabinet Ministers; staff in the BdP, ministries and government agencies, and banks. The staff team comprised P. Thomsen (head), H. Samiei, P. Kunzel, S. Roudet, I. Vladkova Hollar, M. Zermeño (all EUR), S. Nardin (EXR), A. Lemgruber (FAD), Y. Liu (LEG), A. Piris (SPR), and O. Frecaut and M. Souto (MCM). Mr. Cardoso (OED) also participated in most of the meetings.

Contents	Page
I. Background and Program Design.....	3
II. Recent Developments and Performance Under the Program.....	4
III. Outlook and Risks.....	6
IV. Policy Discussions.....	8
A. Fiscal Policy.....	8
B. Structural Fiscal Reform.....	9
C. Financial Sector Policies.....	11
D. Corporate and Household Sectors.....	12
E. Structural Issues.....	13
V. Program Financing, New Measures, and Risks.....	15
VI. Staff Appraisal.....	16
Tables	
1. Selected Economic Indicators – Program Baseline.....	19
2. General Government Accounts.....	20
3. Public Sector Financing Requirements and Sources.....	21
4. Balance of Payments, 2008–16.....	22
5. External Financing Requirements and Sources, 2008–16.....	23
6. Selected Financial Indicators of the Banking System, 2005–11Q1.....	24
7. Monetary Survey, 2009–16.....	25
8. Public Sector Debt Sustainability Framework, 2007–16.....	26
9. External Debt Sustainability Framework, 2006–16.....	27
10. Access and Phasing Under the Extended Arrangement, 2011–14.....	28
11. Indicators of Fund Credit.....	29
Figures	
1. Background to the Program.....	30
2. High Frequency Activity Indicators.....	31
3. Financial Indicators.....	32
Boxes	
1. The Solvency and Deleveraging Assessment Framework.....	12
Appendices	
1. Public Debt Sustainability Analysis.....	33
2. Letter of Intent.....	36
A1. Memorandum of Economic and Financial Policies.....	38
A2. Technical Memorandum of Understanding.....	50
3. Letter of Intent (European Commission and European Central Bank).....	57
A1. Memorandum of Understanding on Specific Economic Policy Conditionality.....	59

I. BACKGROUND AND PROGRAM DESIGN

1. **Macroeconomic imbalances are large and structural problems deep-rooted.** In the decade prior to the crisis in Portugal, low interest rates and easy financing, associated with euro adoption, boosted private and public consumption, and indebtedness. Structural deficiencies persisted, exacerbating growth and competitiveness problems. Growth averaged only about 1 percent, and the per-capita income gap relative to the euro area average widened.

- Loss of competitiveness, with the ULC-based REER appreciating by about 14 percent between 1995 and 2010, and diversion of resources away from the tradable sector led to a significant rise in the current account deficit. In addition, expansion in primary expenditure raised public debt to 93 percent of GDP in 2010 from 48 percent of GDP in 2000. Fiscal risks intensified through the expansion of activities of state-owned enterprises (SOEs) and public-private partnerships (PPPs). Banks' loan-to-deposit ratio (over 150 percent) and the private sector's debt-to-GDP ratio (260 percent) increased to among the highest levels in the Euro area.
- On the structural side, restricted competition in the non-tradable sector promoted rent-seeking and discouraged activity in the tradable sector. Furthermore, inflexible labor markets contributed to high unemployment (nearly 30 percent among the youth) and low productivity growth, while sluggish and weak judicial process generated inefficiencies.

2. **The program agreed in May 2011 addresses these challenges.** A comprehensive program to revive growth and ensure fiscal and financial stability is being supported by €78 billion of assistance by the IMF and EU, with a view to restoring the government's access to medium- and long-term debt markets within two years.

- **Competitiveness and growth.** Boosting labor market flexibility, opening up the non-tradable sector, and enhancing productivity are critical elements of the program. Furthermore, in the absence of exchange rate policy, a fiscally-neutral reduction in social security contributions (fiscal devaluation) could play a significant role in improving competitiveness.
- **Fiscal sustainability.** The strategy combines a credible consolidation path to mitigate the impact on growth with appropriate confidence-building front-loaded measures and a focus on expenditure cuts. It maintains the SGP objectives of stabilizing debt and achieving a fiscal deficit of 3 percent of GDP by 2013—compared to 9.1 percent of GDP in 2010. Comprehensive fiscal structural reforms will support the consolidation effort.
- **Financial stability.** Under the program, banks are required to use market-based solutions to boost capital positions, which should help them regain access to wholesale market funding. The Bank of Portugal (BdP) will foster an orderly pace of deleveraging to avoid

a severe credit crunch. Amounts available for government guarantees for bank bond issuance and the capital support mechanism have been enhanced to provide additional safety nets for banks.

II. RECENT DEVELOPMENTS AND PERFORMANCE UNDER THE PROGRAM

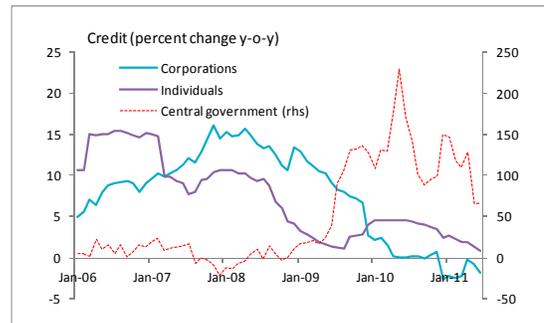
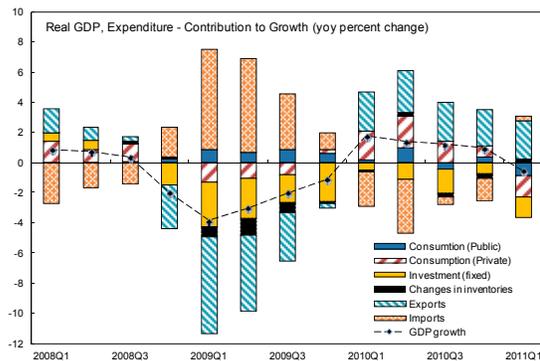
3. **The new government has signaled its strong support for the program.** Following its victory in the June 5 election, the PSD joined its traditional political ally, the CDS party, to form a majority government. Endorsements provided by both parties when the program was agreed and the new government's proactive policy stance to ensure program targets are met suggest strong commitment to the agreed policies. A new unit (ESAME) headed by the Secretary of State at the Prime Ministry has been formed to liaise with the Ministry of Finance (MoF), the Bank of Portugal (BdP), and other government agencies to ensure effective implementation of the program.
4. **The program is broadly on track.** All the end-June performance criteria (PCs) were met, and structural reform has made good progress, with all end-June and end-July benchmarks but one met, and several others met ahead of time. However, fiscal pressures have emerged.
 - **The end-June fiscal deficit target was met, but expenditure overruns and difficulties in SOEs require additional measures.** The new government faced larger expenditure commitments than anticipated, particularly regarding the wage bill, intermediate consumption, and support to SOEs. In addition, in spite of strong showing of VAT and CIT collections through July, revenue performance is expected to be weaker than expected, on account of shortfalls in some direct and non-tax revenues.
 - **The ambitious fiscal structural program is on track.** Progress has been made in public financial management and an FAD TA mission visited Lisbon in July. The authorities are on track to meet the end-August structural benchmarks—undertaking a survey of arrears and publishing the Medium-Term Fiscal Strategy (MTFS). On revenue administration, clearing tax cases above €1 million each has already started to reduce the large backlog (estimated at about 3.9 percent of GDP). The Fiscal Council statutes were approved by the Council of Ministers and have been sent to Parliament. Full implementation of the council is now envisaged for end-December (as opposed to end-September).
 - **Structural reforms are off to a good start.** The government abolished the State's special rights ("golden shares") in private companies (end-July benchmark) and amended the Privatization Law to ensure that no such rights are granted in the future. Labor market reform has started, with the submission of a law to reduce severance payments substantially for new contracts (end-July benchmark). The law is likely to enter into effect by September, and consultations with social partners regarding the next steps of the reform have started. However, the work on fiscal devaluation has been delayed and the

related end-July benchmark was missed. The authorities have published a study highlighting key design issues and a number of options for achieving the deficit-neutral reduction in labor taxes, but no political decision has yet been taken on the final calibration.

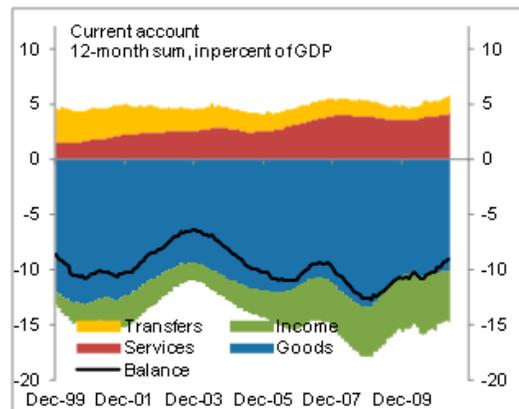
- **The financial sector agenda is progressing well.** The Bank Solvency Support Facility (BSSF) was augmented to €12 billion, as planned, and the amount of government guarantees for bank bond issuance, which can be used by banks for ECB refinancing purposes subject to approval of the Governing Council, was increased to €35 billion in early August. In addition, the program of special on-site inspections (SIP) has been developed (end-June benchmark), a new definition of nonperforming loans that improves transparency and facilitates international comparisons has been introduced, and the evaluation of the solvency and deleveraging assessment framework (SDAF) has been completed ahead of schedule (both end-September benchmarks). A buyer of the bankrupt bank, BPN, was selected in late July. Discussions to finalize the details of the transaction are under way.

5. Macroeconomic indicators are evolving broadly in line with expectations, but funding conditions (especially for banks) remain difficult, and markets volatile.

- **Activity remains weak** and, consistent with program projections, domestic demand subtracted about 3.7 percentage points from growth in the first quarter. Credit to the private sector is falling, broadly in line with program expectations. Inflation, at 3.2 percent y-o-y in July, is largely driven by VAT and tariff adjustments.



- **The external current account deficit narrowed** to 9.1 percent of GDP in May 2011, from a peak of 12.7 percent of GDP in early 2009, driven by an improvement in the goods trade balance. Growth in goods exports, averaging 17 percent y-o-y per month, has been consistently higher than imports.



- **Liquidity conditions remain fragile, but bank capital is improving.** Deposits have been fairly stable since the beginning of the year, but wholesale market funding conditions remains difficult, with access essentially limited to the short end. After falling to €44 billion in July, recourse to ECB financing has increased to €49 billion as of mid-August, reflecting significant pressures in global funding markets. At the same time, banks have managed to increase their capital levels, with the average Core Tier 1 ratio rising from 7.2 percent in September 2010 to 7.6 percent in March 2011.¹ Early indications point to a continuing trend in the second quarter of 2011, and several capital increase operations have successfully been completed.
- **Sovereign spreads have been volatile.** The downgrade by Moody's of Portugal's long-term government bond rating (to BB) and rising risk aversion in the Euro area and elsewhere pushed spreads up to record highs in July. While the July 21 European Council decision and reactivation of the ECB's Securities Market Program (SMP) have helped narrow spreads, foreign demand for government T-Bills has been weak and auctions have been supported to a large extent by domestic bank.
- **The European Council's decision to ease EFSF loans conditions could have sizeable impact on interest costs.** New terms have yet to be finalized and no interest savings are yet built into staff's fiscal projections. However, the savings could average around 0.3–0.5 percent of GDP per year over the next 3 years.

III. OUTLOOK AND RISKS

6. **Recent macroeconomic developments remain broadly consistent with program projections.** Real GDP is expected to contract by about 2 percent annually in 2011–12.² The envisaged pickup in growth after 2013 reflects a cyclical rebound, rather than the impact of reforms. The output gap does not close, and cumulative growth over 2009–16 is a mere 2½ percent (0.3 percent a year). Unemployment is expected to peak in 2013 and slowly recover starting in 2014, when firms begin hiring again, as credit constraints ease and near-term growth prospects solidify. Projections assume that interest spreads fall gradually over the medium term, but remain above pre-euro adoption levels until 2015.

¹ The recent EBA stress tests found that while under the adverse scenario core tier 1 capital of the four Portuguese banks included in the sample would remain above the 5 percent threshold, two banks would fall below 6 percent and the two others below 7 percent.

² However, Q2 flash estimate for GDP (released after the end of the mission) was higher than expected and the quarterly composition will have to be revised once Q2 numbers are finalized.

Portugal: Selected Macroeconomic Indicators, 2009-2016

	2009	2010	2011	2012	2013	2014	2015	2016
	(in percent of GDP, unless otherwise indicated)							
Real GDP (percent change)	-2.5	1.3	-2.2	-1.8	1.2	2.5	2.2	2.0
Consumer prices (percent change)	-0.9	1.4	3.4	2.1	1.5	1.5	1.6	1.6
Unemployment rate (percent)	9.5	10.8	12.2	13.4	13.5	12.5	11.2	10.3
General government balance	-10.1	-9.1	-5.9	-4.5	-3.0	-2.3	-1.9	-1.7
General government debt	83.0	92.9	106.0	111.8	114.9	114.6	112.5	110.5
Current account balance	-10.9	-9.9	-8.6	-6.1	-4.5	-4.0	-3.2	-2.5
Net IIP	-110.4	-107.4	-115.7	-121.2	-121.7	-120.1	-118.0	-115.5

Sources: Authorities and staff calculations

The unemployment rate series contains a structural break in 2011. Source: INE, Statistics Portugal.

7. **Improvements in the current account balance mainly reflect stronger demand in partner countries than in Portugal.** During 2010–16, GDP and imports increase by around 4–5 percent each cumulatively, while domestic demand in partner countries and exports rise substantially by around 40 percent. The assumed elasticities are in line with historical patterns. The real exchange rate remains largely unchanged, assuming conservatively that structural reform takes time to have a tangible impact.

8. **However, downside risks are significant, especially in the near term.** The global market turmoil has heightened risk aversion, and funding problems could intensify, especially for banks. In conjunction with rising borrowing costs, lending to the private sector could become more restricted. Furthermore, a significant drop in bank resources may endanger short-term financing needs of the government, including for SOEs, at a time when external financing is already being curtailed. While GDP growth surprised on the upside in Q2, risks in 2011H2 are clearly on the downside, given the weakening external demand and additional fiscal measures.

9. **Nevertheless these risks are manageable under the current strategy, and there is no need for major modifications to the program.**

- The program contains a number of important safeguards that mitigate risks: (i) disbursements under the program do not only cover medium- and long-term financing needs of the government for the next two years, but also half the stock of T-Bills, thus providing additional liquidity to the banking system; (ii) government guarantees for uncovered bank bonds for ECB refinancing, subject to approval by the Governing Council, provide additional liquidity buffers; and (iii) the solvency support facility can be tapped in the event market-based solutions for increasing capital fail.
- Furthermore, recent policy action by the European Council to strengthen the Euro area crisis management framework has tangibly reduced risks. In addition to the positive fiscal impact of lower interest rates and longer maturities, the Council's readiness to provide financing until market access has normalized—provided strong adjustment efforts—has increased the chances of success significantly. These decisions, in conjunction with the

reactivation of the ECB's Securities Market Program, have already lowered interest rates from their recent peaks.

IV. POLICY DISCUSSIONS

10. **Ongoing risks point to a need to ensure strong performance in all areas to instill confidence in the adjustment program.** Discussions focused on measures to offset fiscal slippages, structural fiscal reforms aimed at strengthening public financial management and reducing fiscal risks—particularly those arising from the SOE sector—and steps to strengthen the resilience of the financial sector and to boost competitiveness and growth.

A. Fiscal Policy

11. **Fiscal targets under the program remain unchanged, but there is a need to strengthen spending control and reduce wasteful expenditure.** The general government deficit is programmed to fall to 5.9 percent of GDP in 2011, 4.5 percent of GDP in 2012, and 3 percent of GDP in 2013—consistent with the EDP requirements. Achieving these targets will require addressing the fundamental causes of budget over-runs in the context of the 2012 budget and the planned medium-term fiscal strategy.

12. **Faced with expenditure slippages, the new government was proactive in announcing offsetting measures upon taking office.** The slippages reflected, in part, the electoral cycle and consisted of three main components (see text table): (i) lack of control over wage expenditures and the acquisition of goods and services; (ii) realization of fiscal risks (SOE support and a failed PPP); and (iii) shortfalls in nontax revenue. The government expressed its strong commitment to the targets under the program and announced measures amounting to 1.1 percent of GDP, including: a one-time PIT surcharge, sales of concessions, and using revenue from the ongoing phased transfer of banks' pension funds to the state social security system.

	Revenue	Expenditure	Total
Performance ^{1/}	0.2	0.9	1.1
Tax revenue	-0.2		
Non-tax revenue	0.4		
Compensation of employees		0.2	
Intermediate consumption		0.3	
Social transfers		0.1	
Fixed capital formation		-0.1	
Support to SOEs and PPPs		0.4	
Offsetting Measures	1.1		1.1
Advancing VAT rate increase	0.1		
One-time surcharge on PIT	0.5		
Additional sales of concessions	0.4		
Transfer of banks' pension funds, as previously planned	0.2		

^{1/} Magnitude of revenue under-performance and expenditure overruns. Negative numbers indicate over-performance.

13. **The authorities highlighted the constraints they faced in selecting these measures.** They agreed that one-off measures are unsatisfactory, but noted that some of the slippages also had a one-off nature and emphasized that expenditure cuts would only be credible if underpinned by structural changes, which would likely take time. The authorities, moreover, agreed that revenue from the ongoing phased transfer of banks' pension funds would only be used to meet the program target this year, but not in 2012 and beyond. They

pledged to strengthen commitment controls, particularly in ministries where slippages had occurred.

14. **The 2012 budget needs to take a much stronger and more balanced approach to adjustment.** The carry-over of the slippages will create a gap of about 0.6 percent of GDP next year. The authorities committed to cover this gap, in addition to measures of about 3 percent of GDP already specified at the time of the program request. They agreed that the additional fiscal effort will need to be of high quality and focused on permanent current expenditure cuts to ensure consistency with the program strategy to limit the tax burden on the economy and to streamline the functioning of the public sector. The budget should include an economically significant first step of the programmed fiscal devaluation. It was agreed that, in all these areas, EC, ECB, and IMF staff would assist the authorities during budget preparations in September.

B. Structural Fiscal Reform

15. **The program’s far-reaching fiscal reform agenda is crucial to underpin fiscal consolidation:**

- Sound Public Financial Management (PFM) is needed to support program implementation. The current fragmentation of the PFM system and weak compliance with legislation have led to a significant stock of arrears (about 2¼ percent of GDP) and expenditure overruns.³ Arrears are concentrated in local governments and hospitals (outside the general government). Following significant progress in assessing and monitoring arrears, the authorities recognized the need to put in place by end-September a two-pronged strategy to settle them and avoid new accumulation. In order to curb arrears accumulation, the program incorporates new structural measures on commitment controls, including two prior actions. The gradual clearance of the stock will demand a comprehensive medium-term strategy that will be discussed during the next review.
- Given the increasing concerns regarding fiscal risks arising from sub-national governments, notably in relation to their SOEs and PPPs, staff urged deepening the reform of regional and local public finances through better assessing fiscal risks and improving their budgetary frameworks.⁴ Such risks, identified in the May Staff Report, have started materializing in the Madeira region—which is under financial stress and has

³ Corresponding arrears clearance has not yet been incorporated in the program baseline, and will be discussed during the next review mission.

⁴ This reform consists of: (i) adapting the regional and local finance laws to the budgetary framework law; (ii) stopping the creation of SOEs and PPPs; (iii) designing a multi-tier system to prevent indebtedness; (iv) enhancing the revenue forecasting capacity; and (v) assessing regional and local government fiscal risks. Staff is discussing with the authorities ways to support effective implementation of these measures in a context of strong autonomy of regions.

over €1.5 billion in guaranteed debts. The regional authorities expressed commitment to fiscal consolidation, but the existing monitoring mechanism is weak and is in urgent need of reform.

- As per the program objective, the authorities are preparing to move ahead with the merger of the tax and customs administrations. Given the challenges caused by this merger during a time of fiscal consolidation, the authorities have requested technical assistance to help design and support the process. A TA mission will take place in September.
- Staff welcomed the steps already taken toward restructuring public administration. In particular, the government has launched a program for reforming and improving the central administration and has also initiated the debate on the administrative reform of local governments. During the discussions, staff encouraged the authorities to act swiftly and take bold steps, including through reducing the number of parishes.

16. **The SOE sector is posing increasing fiscal risks, requiring a forceful implementation of the revamped action plan that is being prepared.** The risks arise from three sources: operational losses, which are putting further pressure on the budget; roll-over needs, which for the August–December 2011 period amount to €3½ billion; and contingent liabilities (from SOEs’ guaranteed debt), which were close to 10 percent of GDP at end-2010. The problems are concentrated in a small number of large transport and infrastructure firms and the health sector. The authorities’ initial plans lacked sufficient detail, and a more comprehensive plan to overhaul the sector is being prepared.

- Initial efforts to reduce operational costs by 15 percent have had mixed success across sectors. In particular, the health sector is clearly underperforming. New cost reduction measures or tariff increases are being considered, as well as cuts to service provision (for example closing loss-making rail lines), and selling or winding down firms.
- A comprehensive strategy detailing how firms in many cases will be brought to operational balance by end-2012 will be prepared by end-September 2011.
- These plans will be used to seek longer-term commitment from SOE creditors while restructuring is underway.
- SOEs in the health sector face particular challenges. Budgetary allocations to hospitals are well below spending levels consistent with demand; even though co-payments will be raised, their impact is likely to be limited; and cost pressures in non-wage spending have not abated. This has led to the accumulation of arrears of about 1.1 percent of GDP, and structural pressures leading to new accumulation remain significant. The Memorandum of Understanding (MoU) lists detailed cost-saving measures designed to save

EUR 550 million annually (see MoU paragraphs 3.51–3.87). Further substantial spending cuts and efforts to clear arrears are also being considered.

C. Financial Sector Policies

17. **Progress on implementing the agenda has to be sustained to ensure continued financial stability and stem potential contagion effects.** Key areas include ensuring: (i) adequate system liquidity; (ii) an orderly deleveraging process; (iii) higher capital levels through market-based solutions; and (iv) enhanced regulation and supervision, and resolution frameworks.

18. **Maintaining the current channels of exceptional liquidity support from the Euro system is crucial to help ensure adequate funding.** The BdP and staff agreed that the amount available for government guarantees for bank bond issuance (€35 billion) and unused bank collateral (€28 billion) should be sufficient to cover banks' net market refinancing needs through year-end (€33 billion), even in the event of further sovereign rating downgrades.

19. **Credit developments require close monitoring.**

- Banks have delivered a first version of their medium-term deleveraging plans. Using the newly established framework for assessing bank deleveraging (Box 1), the BdP will continue to review banks' plans on a quarterly basis to ensure consistency with medium-term growth forecasts.
- The authorities are concerned about credit to the private sector, particularly SMEs. Staff shared this concern and noted that available information does not seem to suggest rapid deleveraging, but agreed that developments should be monitored closely and welcomed plans to focus on high frequency indicators. The authorities also shared some ideas on how to facilitate the sale of some SOE and real estate loans to foreign investors (for example, by creating an asset management agency) to provide room for banks to lend to other sectors. Staff argued against any schemes that would involve government guarantees with potentially large fiscal costs.

Box 1. The Solvency and Deleveraging Assessment Framework (SDAF)

The SDAF is a central tool used under the program for assessing banks' solvency and deleveraging and their consistency with credit developments and the macroeconomic framework. The framework links the evolution of banks' balance sheets to a model of the Portuguese economy, incorporating feedback effects between changes in the credit quality of banks loans and the macro model. The SDAF is also used for conducting stress tests of banks' balance sheets. The SDAF was reviewed by a team of experts from the ECB, EU, and IMF in June, which concluded that it was an appropriate tool for assessing bank solvency and deleveraging, its strength lying in the comprehensive macro-financial interaction. A set of recommendations to improve the framework further has been produced, which will be implemented mostly for the second and third reviews under the program.

20. **The BdP does not foresee any use of the Bank Solvency Support Facility (BSSF) in 2011.** All banks have capital plans to reach the targeted Core Tier 1 ratio of 9 percent by end-2011 through deleveraging and capital increases. This will also help address the weaknesses revealed by the July EBA stress-tests (see footnote 1). Maintaining proper capital levels will become more challenging next year, with higher capital requirements under the program (10 percent by end-2012) and as balance sheet adjustment progresses and nonperforming loans increase. For this review, however, no new amounts will be deposited into the dedicated account of the BSSF at the BdP. The BdP will continue with its regular stress tests to assess potential needs for precautionary capital increases on a quarterly basis.

21. **CGD, the large state-owned bank, is making considerable effort to strengthen its capital base through internal resources.** The authorities intend to have the insurance arm of the group taken over by a government entity as an intermediate step toward its eventual sale to a private owner. Staff stressed that the transfer price should be based on a new independent audit. A revised assessment of the capital augmentation plan of the banking arm of the CGD group will be conducted at the time of the second review.

22. **Efforts to strengthen banking regulation and supervision, and the early intervention and resolution framework are progressing well.** In addition to starting the SIP and introducing a new definition for nonperforming loans, the supervisory function of the BdP is being bolstered by increasing the number of banking supervisors and fine-tuning its internal bank evaluation system. The authorities are amending bank legislation to strengthen the resolution framework and the deposit guarantee legislation ahead of schedule in consultation with EC/ECB and IMF staff.

D. Corporate and Household Sectors

23. **The monitoring framework for the household and corporate sector is being enhanced and measures to provide financing to SMEs are being considered.** Benefiting from an IMF/EC/ECB TA mission, monitoring of SMEs is being stepped up and a quarterly

report will be produced starting at end-September. The Ministry of Economy is studying the implementation of measures to facilitate credit extension to the SME sector.

24. **The authorities are advancing the work to facilitate orderly and efficient corporate and household debt restructuring.** A comprehensive review of the corporate insolvency law is underway, and the authorities are engaged in an extensive consultation with stakeholders. The amendment of the law (structural benchmark) is now expected by end-December 2011. While reiterating their commitment to improve the personal insolvency regime, the authorities decided to review the relevant law as part of their wider efforts to prepare action plans to address the large household debt levels. Finally, the out-of-court restructuring framework is also being strengthened, including the preparation of voluntary guidelines in a consultative manner.

E. Structural Issues

25. **Tackling deep-rooted structural problems that impede growth and employment remains a key priority of the program.** To address these problems, the new government is keen to reduce structural rigidities and costly distortions, by fostering productivity and competition. Discussions focused on the following key areas:

- **Labor market.** Generous protection embedded in open-ended contracts has resulted in a disproportionate use of fixed-term contracts (at the expense of good firm-worker matches and investment in human capital) and a wage-setting mechanism disconnected from productivity developments. The authorities have started to modernize labor relations, and the landmark law to reduce severance payments for new contracts was submitted to parliament, as expected under the program. Staff urged the authorities to swiftly move ahead with the next steps of the reform, including through (i) preparing a draft law regulating the functioning of the employer-financed dismissal fund; (ii) broadening the employment protection reform to current contracts; and (iii) a gradual convergence to relevant EU countries' benchmarks.
- **Product market.** Policies aim at reducing barriers to entry, which raise rents and wage markups, thus hurting competitiveness. Staff welcomed the recent transposition of the Third EU Energy Package—although more time will be needed to transpose the provisions regarding the regulator's powers—into national legislation, the roadmap for phasing out regulated electricity tariffs, and submission to parliament of a draft law for the transposition of the EU “Better Regulation Directive” for telecoms. It stressed the crucial need to start implementing the various related provisions as soon as possible. Staff also urged the authorities to consider carefully the design of the spectrum auction to ensure a level playing field.
- **Privatization.** The authorities have planned to fully divest public sector shares in some energy companies (EDP, REN, and GALP) this year. Staff encouraged them to go

beyond this, if market conditions permit. As the government moves ahead with the privatization of large SOEs, it should also review the financing model for Parpublica, a holding company responsible for managing government assets, since its portfolio will be negatively impacted by privatization. Winding it down or consolidating its balance sheet with the general government are two possible options.

- **Housing market.** Inability to evict tenants for nonpayment has stifled the rental market and hampered labor mobility. Discussion focused on the appropriate measures to make this market more fluid. A reform proposal will be fleshed out by end-year, but constraints from the judicial system backlog are clear. Within these constraints, the authorities are considering an extrajudicial mechanism for evicting tenants in cases of nonpayment of rents. The possibility of setting a 15-year horizon for the termination of all existing open-ended contracts strengthens the commitments under the program.
- **Judicial system.** Recognizing the adverse impact of backlog cases, targeted measures are being developed on the basis of a June audit to resolve the backlog within two years. Implementation of the initial set of judicial reform measures is under way. However, the authorities indicated that the current financial and staff constraints may delay implementation of some measures. Understanding was reached that the authorities would focus on implementation of the measures critical to the efficiency of the judicial reform, including reforms to establish a more cost-efficient and effective enforcement regime, putting in place a sustainable court budget, promoting the use of alternative dispute resolution, and expediting resolution of backlog cases.

26. **The program envisages a boost to price competitiveness through a fiscal devaluation.** Discussions focused on the tradeoffs between fiscal risks related to the cut in the employers' social contributions and the size of the devaluation to ensure a meaningful change in relative prices.

- The authorities were concerned about the lack of margins for maneuver in the budget, in view of the ongoing fiscal consolidation and argued in favor of a cautious first step. They are considering a number of options and have not finalized their decision yet.
- One of their proposals is to target the devaluation initially only on employment-generating enterprises to reduce potential risks and amounts involved. Staff advised against such targeting on the grounds that its focus is on employment rather than competitiveness; it is not obvious that employment promotion is a good proxy for increased efficiency; the plan would be very difficult to implement, given the complicated design and potential loopholes; and it could significantly mitigate the positive impact of the exercise.
- Instead, staff recommended designing a simple and broad-based scheme, involving a bold cut in social security contributions (SSC) to bring about significant effects on growth and

exports—in line with the results of most simulations and empirical studies. This scheme would be accompanied by buffers (higher offsetting revenues/savings than the projected lower SSC revenues) to protect vulnerable consumers and to address adverse impacts on the fiscal balance. Staff also argued for a bold first step, noting the risk that a modest first step could be absorbed in firms' profit margins.

Fiscal Devaluation: Impact of a 1 Percent of GDP Shift in Revenues from SSC to VAT
(percentage deviation from baseline)

	Year 1	Year 2	Year 3	Year 4	Year 5
GDP	0.12	0.39	0.38	0.35	0.34
Employment	0.29	0.63	0.54	0.47	0.43
Exports	0.26	0.64	0.44	0.35	0.30

Impact shown is average impact across seven different simulations using different models

- It was agreed that the final calibration will be fully integrated within the ongoing fiscal consolidation plans and be prepared in consultation with EC, ECB, and IMF staff in time for the 2012 budget.

V. PROGRAM FINANCING, NEW MEASURES, AND RISKS

27. **The program remains adequately financed.** While additional pressures on the government's cash position have emerged, stemming principally from government financing of SOEs and outflows from long-term savings products for retail investors, access to the Treasury bill market has been maintained at a higher level than anticipated. Risks have increased: in particular shortening Treasury bill maturities means that increasingly large amounts—averaging €2.8 billion per month until December—must be rolled over. Building a prudential cushion over time will require implementation of program fiscal objectives and efforts to reduce SOEs financing needs.

28. **Staff maintains its view that exceptional access is justified.** Portugal should regain access to sovereign medium- and long-term debt markets by 2013, assuming a sustained track record of strong policy implementation. While turmoil in international capital markets has heightened contagion risks, revised staff projections suggest that public debt will still stabilize in 2013 (Appendix I), in line with original program projections.

29. **Program conditionality remains focused on ensuring fiscal and financial stability, and promoting growth.** Two prior actions for the first review focus on tightening expenditure control, in light of slippages. Structural benchmarks before the second review on completion of a comprehensive survey of arrears and a fiscal strategy document with a medium-term outlook similarly aim to facilitate fiscal control, as well as transparency. In the financial sector, the external evaluation of the SDAF provides reassurances over the framework used for assessing deleveraging and capital needs in the banking system, while a

new measure of nonperforming loans aligned with international practices increases transparency. A floor on the consolidated cash balance of the general government, a ceiling on the stock of its debt, and a continuous ceiling on the non-accumulation of external arrears remain as quantitative performance criteria. A continuous indicative target on the non-accumulation of domestic arrears will be monitored from end-August 2011, upon completion of the comprehensive survey of arrears currently underway.

30. Portugal's capacity to repay the Fund is expected to remain adequate.

Outstanding credit to Portugal is expected to peak in 2014 at over 14 percent of GDP, with debt service peaking in 2018 at 2¼ percent of GDP or a little over 5 percent of exports of goods and services. Lower rates and longer maturities on EU loans will ease the repayment burden in the post-program period.

31. Risks to the program have been mitigated by the recent European Council's policy decisions, but they remain elevated.

- Spillovers from the global market turmoil, if protracted, could further impinge upon funding prospects of the economy, and cause a credit crunch.
- Delayed fiscal implementation would undermine fiscal sustainability and confidence in the program.
- Sustained social and political support is necessary for the comprehensive structural reform program. Strong vested interests could weaken reforms, or reform fatigue could set in, and weaken growth prospects and the required adjustment in the economy.
- Even if domestic adjustment continues in line with commitments under the program, there could be disruptive spillovers from deepening problems in Greece.

32. The authorities are taking measures to reinforce governance structures to safeguard resources provided by the international community. While the safeguards assessment conducted by the IMF concluded that current safeguards are adequate, it recommended changes to the BdP law with prior consultation with the ECB to formalize BdP's autonomy and oversight over the Governor and the executive board in line with good governance practices. In addition, the supervisory responsibilities of the Audit Board will be extended to other tasks such as oversight of internal control functions, financial reporting, and audit. A review of Fund related transactions with the debt management agency (IGCP) is being finalized by the Court of Auditors.

VI. STAFF APPRAISAL

33. The ambitious program is broadly on track, and the new government's strong commitment is encouraging. Policy implementation has progressed well on many fronts and end-June PCs were met. Fiscal slippage so far in 2011, reflecting in part the electoral

cycle, is unfortunate, but the government is determined to achieve the 2011 targets—albeit with measures that are mostly one-off.

34. **Fiscal performance so far in 2011 demonstrates the need to refocus the fiscal strategy on strong expenditure control**, as envisaged under the program. It is critical that the 2012 budget and the planned medium-term fiscal strategy—with support from structural fiscal reforms—make important headways in this regard and aim to cut wasteful expenditure. Furthermore, regaining control over SOEs through restructuring and privatization, and transparent budgetary processes is essential for the success of the fiscal program, as is assessing PPPs' contingent liabilities and adequately managing associated fiscal risks going forward. Two prior actions for the first review focus on expenditure management.

35. **To support activity, it is crucial to prevent an excessively rapid deleveraging of the banking sector.** The overriding strategy under the program is to improve banks' funding imbalances while ensuring that the adjustment does not lead to excessive contraction in credit. Newly-prepared detailed banks' deleveraging plans are welcome and will be reviewed on a quarterly basis to ensure compatibility with the macroeconomic framework and to safeguard against a credit crunch. It is also essential that the ECB maintains current channels of exceptional liquidity support until the banking system has regained normal access to market funding. In this regard, the ECB's recent decision to relax conditions on collateral requirements for Portugal is a welcome development.

36. **Ultimately, the success of the program hinges on opening up the economy and improving competitiveness, including through a fiscal devaluation.** Policies need to aim at creating a level playing field to reduce the role of the state in economic activity, discourage rent-seeking behavior, and help dynamic enterprises. Staff welcomed the abolishment of the special rights of the State in private companies ahead of schedule and advances on privatization and labor market reforms. It is crucial that the next steps of these reforms are followed through and implemented. For fiscal devaluation to have a strong impact, significant tax changes would be required: a modest cut in social security contributions risks being absorbed in profit margins.

37. **Progress so far, however, should not divert attention from the major challenges and significant risks that lie ahead.** Market conditions remain very tight and fiscal risks high. Furthermore, the authorities' resolve to implement the measures agreed under the program, especially to promote competition and to provide more opportunities for dynamic enterprises and outsiders in the labor markets will be fiercely tested by opposition from vested interests. Successful implementation of the program will also be essential to protect against negative external shocks and contagion.

38. **In this regard, the European Council's renewed support enhances prospects for the program's success.** While existing safeguards under the program already mitigate risks,

the Council's readiness to extend adequate financing—assuming strong policy implementation—provides significant additional reassurances.

39. Staff supports the authorities' request for completion of the first review and bringing forward the availability debt for the second purchase under the EFF. The adjustment process will take time and require unwavering commitment to strong policy implementation given the severity of underlying macroeconomic imbalances and deep-rooted structural problems. However, staff is optimistic that the new government's resolve to implement comprehensive reforms, with the strong support of its European partners, provides Portugal with the best prospects for addressing underlying vulnerabilities, rebuilding market confidence, restoring growth, and raising the living standards of its people.

Table 1. Portugal: Selected Economic Indicators - Program Baseline
(Year-on-year percent change, unless otherwise indicated)

	2008	2009	2010	Projections						
				2011	2011	2012	2013	2014	2015	2016
				EBS/11/72	Prog.	Proj.				
Real GDP	0.0	-2.5	1.3	-2.2	-2.2	-1.8	1.2	2.5	2.2	2.0
Real domestic demand	0.8	-2.9	0.6	-5.8	-5.7	-4.6	-0.4	1.2	0.8	0.5
Private consumption	1.3	-1.1	2.3	-4.3	-4.6	-3.7	-0.2	0.9	0.8	0.5
Public consumption	0.4	3.6	1.2	-6.8	-4.0	-4.6	-3.0	-0.2	-0.2	-0.2
Gross fixed investment	-0.3	-11.3	-4.9	-9.9	-11.4	-9.2	2.2	4.0	2.3	1.0
Private	-0.9	-13.4	-7.6	-6.5	-7.7	-6.5	3.3	4.7	2.3	0.6
Government	4.3	3.1	10.8	-26.2	-29.0	-25.9	-6.1	-1.5	2.2	5.0
Exports	-0.1	-11.6	8.8	6.2	6.6	6.5	6.5	6.6	6.6	6.6
Imports	2.3	-10.6	5.1	-5.3	-4.9	-2.0	2.2	3.4	3.3	3.2
Contribution to Growth										
Total domestic demand	0.9	-3.2	0.7	-6.3	-6.1	-4.8	-0.4	1.2	0.8	0.5
Private consumption	0.9	-0.7	1.5	-2.9	-3.1	-2.5	-0.1	0.6	0.5	0.3
Public consumption	0.1	0.7	0.2	-1.4	-0.8	-0.9	-0.6	0.0	0.0	0.0
Gross fixed investment	-0.1	-2.5	-1.0	-1.9	-2.2	-1.6	0.4	0.7	0.4	0.2
Foreign balance	-1.0	0.7	0.6	4.1	4.0	3.0	1.6	1.3	1.4	1.5
Savings-investment balance (percent of GDP)										
Gross national savings	10.6	9.2	9.2	7.8	8.6	10.3	12.1	13.2	14.5	16.1
Private	11.9	16.1	15.8	11.1	12.0	13.0	13.4	13.9	14.8	16.1
Public	-1.3	-7.0	-6.6	-3.3	-3.4	-2.7	-1.3	-0.7	-0.3	0.0
Gross domestic investment	22.5	19.9	19.0	18.0	17.6	16.2	16.4	16.7	16.7	16.5
Private	19.6	16.9	15.7	15.5	15.1	14.4	14.7	15.0	15.1	14.8
Public	2.9	3.0	3.3	2.5	2.4	1.8	1.7	1.6	1.6	1.7
Resource utilization										
Potential GDP	1.1	-0.2	-0.6	0.0	0.0	0.5	1.0	1.5	1.6	1.6
Output Gap (% of potential)	-0.2	-2.5	-0.6	-2.8	-2.8	-5.1	-4.9	-4.0	-3.4	-3.0
Employment	0.5	-2.6	-1.5	-1.5	-1.5	-1.0	0.3	1.1	1.2	0.8
Unemployment rate (%) ¹	7.6	9.5	10.8	12.1	12.2	13.5	13.5	12.5	11.3	10.3
Prices										
GDP deflator	1.6	0.5	1.1	1.1	1.3	1.4	1.3	1.3	1.4	1.4
Consumer prices (harmonized index)	2.7	-0.9	1.4	3.5	3.4	2.1	1.5	1.5	1.6	1.6
Compensation per worker (whole economy)	3.4	1.4	1.4	-0.6	0.0	0.1	0.8	1.4	1.0	1.2
Labor productivity	-0.5	0.1	2.9	-0.7	-0.7	-0.8	0.8	1.4	1.0	1.2
Unit labor costs (whole economy)	4.7	3.4	-1.6	0.1	0.7	0.9	0.0	0.0	0.0	0.0
Money and credit (end of period, percent change)										
Private sector credit	8.7	3.4	-0.2	-1.3	-1.3	-1.8	-1.2	-0.3	0.5	1.9
Broad money	16.9	-3.3	-1.3	-1.1	-0.9	-0.4	2.5	3.8	3.6	3.5
Interest rates (percent)										
6-month interbank rate	3.8	1.7	0.8	1.7	1.7	2.6	3.1	3.4	3.7	3.9
Government bond rate, 10-year	4.5	4.2	5.4	7.8	9.9	6.3	5.4	5.3	5.2	5.3
Fiscal indicators (percent of GDP)										
General government balance (percent of GDP)	-3.5	-10.1	-9.1	-5.9	-5.9	-4.5	-3.0	-2.3	-1.9	-1.7
Revenues	41.1	39.7	41.5	41.8	42.2	42.3	42.5	42.6	42.5	42.4
Expenditures	44.6	49.8	50.6	47.7	48.0	46.8	45.5	44.9	44.4	44.1
Primary government balance (percent of GDP)	-0.5	-7.2	-6.1	-1.7	-1.7	0.3	2.0	2.8	3.1	3.4
Structural balance	-3.8	-9.3	-9.4	-4.2	-4.1	-1.4	0.0	0.0	0.0	-0.1
General government debt ²	71.6	83.0	92.9	106.4	106.0	111.8	114.9	114.6	112.5	110.5
External sector (percent of GDP)										
Trade balance (goods)	-13.4	-10.6	-10.4	-8.5	-8.9	-6.9	-5.8	-5.0	-4.2	-3.9
Current account balance	-12.6	-10.9	-9.9	-9.0	-8.6	-6.1	-4.5	-4.0	-3.2	-2.5
Net international investment position	-96.1	-110.4	-107.4	-116.9	-115.7	-121.2	-121.7	-120.1	-118.0	-115.5
Nominal effective rate: CPI based (2000=100)	109	109	107	107	108	109	110	111	112	113
REER based on CPI (2000=100)	114.4	113.6	111.3	111.5	116.7	118.0	117.4	117.0	116.5	116.1
(rate of growth)	0.9	-0.7	-2.1	0.8	4.9	1.1	-0.5	-0.4	-0.4	-0.4
Nominal GDP (billions of euro)	172.0	168.6	172.7	170.6	171.2	170.5	174.8	181.4	188.0	194.4

Sources: Bank of Portugal; Ministry of Finance; National Statistics Office (INE); Eurostat; and IMF staff projections.

¹ The unemployment rate series contains a structural break in 2011. Source: INE, Statistics Portugal.

² Includes Bank Solvency Support Facility.

Table 2. General Government Accounts

	EBS/11/72			Proj.					
	2009	2010	2011	2011	2012	2013	2014	2015	2016
	(millions of euros)								
Total revenues	66,967	71,664	71,258	72,220	72,127	73,861	76,725	79,460	81,948
Current receipts	65,390	67,150	69,093	69,782	69,957	71,639	74,419	77,069	79,475
Tax revenue	36,549	38,368	39,216	40,607	40,800	42,092	43,664	45,404	46,651
On goods and services	21,319	23,064	23,673	24,092	24,672	25,413	26,295	27,389	28,228
Direct taxes	15,231	15,304	15,543	16,515	16,129	16,680	17,369	18,016	18,423
Social security contributions	21,090	21,004	21,382	21,363	21,276	21,455	22,176	22,800	23,654
Other current revenues	7,750	7,778	8,496	7,812	7,881	8,092	8,580	8,865	9,170
Capital revenues	1,577	4,514	2,165	2,439	2,169	2,222	2,306	2,390	2,473
One-off transfer (Pension funds)		2,800		274					
Total expenditures	84,006	87,446	81,300	82,263	79,767	79,081	80,974	83,090	85,460
Primary expenditures	79,134	82,251	74,173	75,136	71,630	70,273	71,673	73,549	75,618
Compensation of employees	21,295	21,105	19,590	19,898	19,229	18,924	18,819	18,908	19,334
Intermediate consumption	8,322	8,858	7,278	7,861	7,255	7,029	7,250	7,574	7,835
Subsidies	1,342	1,293	1,183	1,183	871	794	912	936	969
Social transfers	36,950	37,707	37,506	37,684	37,335	37,523	38,555	39,843	40,991
Other	4,342	4,264	3,775	3,775	3,310	3,035	3,129	3,244	3,356
Interest payments	4,872	5,195	7,127	7,127	8,137	8,807	9,302	9,541	9,841
Capital expenditures	6,883	9,024	4,840	4,734	3,630	2,969	3,006	3,044	3,134
Fixed capital formation	4,961	5,653	4,341	4,161	2,918	2,376	2,330	2,394	2,551
Capital transfers	1,921	3,371	499	573	712	593	677	650	583
Net lending (+)/borrowing (-)	-17,039	-15,782	-10,042	-10,042	-7,641	-5,220	-4,249	-3,630	-3,512
	(percent of GDP)								
Total revenues	39.7	41.5	41.8	42.2	42.3	42.3	42.3	42.3	42.1
Current receipts	38.8	38.9	40.5	40.8	41.0	41.0	41.0	41.0	40.9
Tax revenue	21.7	22.2	23.0	23.7	23.9	24.1	24.1	24.2	24.0
On goods and services	12.6	13.4	13.9	14.1	14.5	14.5	14.5	14.6	14.5
Direct taxes	9.0	8.9	9.1	9.6	9.5	9.5	9.6	9.6	9.5
Social security contributions	12.5	12.2	12.5	12.5	12.5	12.3	12.2	12.1	12.2
Other current revenues	4.6	4.5	5.0	4.6	4.6	4.6	4.7	4.7	4.7
Capital revenues	0.9	2.6	1.3	1.4	1.3	1.3	1.3	1.3	1.3
One-off transfer (Pension funds)		1.6		0.2					
Total expenditures 1/	49.8	50.6	47.7	48.0	46.8	45.2	44.6	44.2	43.9
Primary expenditures	46.9	47.6	43.5	43.9	42.0	40.2	39.5	39.1	38.9
Compensation of employees	12.6	12.2	11.5	11.6	11.3	10.8	10.4	10.1	9.9
Intermediate consumption	4.9	5.1	4.3	4.6	4.3	4.0	4.0	4.0	4.0
Subsidies	0.8	0.7	0.7	0.7	0.5	0.5	0.5	0.5	0.5
Social transfers	21.9	21.8	22.0	22.0	21.9	21.5	21.2	21.2	21.1
Other	2.6	2.5	2.2	2.2	1.9	1.7	1.7	1.7	1.7
Interest payments	2.9	3.0	4.2	4.2	4.8	5.0	5.1	5.1	5.1
Capital expenditures 2/	4.1	5.2	2.8	2.8	2.1	1.7	1.7	1.6	1.6
Fixed capital formation	2.9	3.3	2.5	2.4	1.7	1.4	1.3	1.3	1.3
Capital transfers	1.1	2.0	0.3	0.3	0.4	0.3	0.4	0.3	0.3
Net lending (+)/borrowing (-)	-10.1	-9.1	-5.9	-5.9	-4.5	-3.0	-2.3	-1.9	-1.8
Memorandum items:									
Nominal GDP	168,587	172,699	170,582	171,222	170,471	174,777	181,435	187,970	194,448
Real GDP growth	-2.5	1.3	-2.2	-2.2	-1.8	1.2	2.5	2.2	2.0
Overall balance (ESA 95)	-17,039	-15,782	-10,042	-10,042	-7,641	-5,220	-4,249	-3,630	-3,512
Total revenue (ESA 95) 3/	66,967	71,664	71,258	72,680	72,127	73,861	76,725	79,460	81,948
Public debt 4/	139,945	160,470	181,546	181,547	190,557	200,812	207,861	211,491	215,003
Structural balance (percent of GDP)	-9.3	-9.4	-4.2	-4.1	-1.4	0.0	0.0	0.0	-0.2
Primary balance (percent of GDP)	-7.2	-6.1	-1.7	-1.7	0.3	2.1	2.8	3.1	3.3
Public debt (percent of GDP) 4/	83.0	92.9	106.4	106.0	111.8	114.9	114.6	112.5	110.6

Source: Ministry of Finance, and Fund staff projections

1/ Historical data include expenditure commitments that have given rise to arrears of the general government.

2/ In 2011, excludes the €460 million recapitalization of BPN in line with program definition. This recapitalization will be included in the ESA 95 expenditure.

3/ In 2011, includes an additional €460 million from the ongoing phased transfer of banks' pension funds to the state social security system.

4/ Includes Bank Solvency Support Facility.

Table 3. Portugal: Public Sector Financing Requirements and Sources
(In billion of euros)

	2009	2010	2011	2012	2013	2014	2015	2016
Gross borrowing need	38.8	42.3	53.3	38.0	31.4	32.2	25.7	40.3
Overall balance	17.0	15.8	10.0	7.6	5.2	4.2	3.6	3.5
Amortization	21.7	26.5	29.6	25.3	20.8	25.1	22.1	36.8
M<	7.2	7.3	9.5	12.8	9.8	14.2	10.6	9.8
Residents	1.8	2.9	3.8	5.1	3.9	5.7	4.2	3.9
Non-residents	5.4	4.4	5.7	7.7	5.9	8.5	6.4	5.9
ST	14.5	19.2	20.1	12.6	11.0	11.0	11.0	11.0
Residents	0.8	2.2	9.1	5.7	4.1	4.1	4.1	4.1
Non-residents	13.7	17.0	11.0	6.9	6.9	6.9	6.9	6.9
EU and IMF	0.0	0.0	0.0	0.0	0.0	0.0	0.5	16.0
Other 1/	0.0	0.0	13.6	5.0	5.4	2.8	0.0	0.0
Gross financing sources	38.8	42.3	15.2	13.0	21.4	27.0	25.7	40.3
Privatization receipts	0.0	0.9	2.0	2.0	1.0	0.0	0.0	0.0
Market access	38.8	41.4	13.2	10.9	20.3	27.0	25.7	40.3
M<	19.6	21.4	0.7	0.0	9.4	16.1	14.7	29.3
Residents	7.8	11.6	0.2	0.0	3.5	5.8	4.7	16.9
Non-residents	11.8	9.7	0.5	0.0	5.9	10.3	10.1	12.4
ST	19.2	20.1	12.6	11.0	11.0	11.0	11.0	11.0
Residents	2.2	9.1	5.7	4.1	4.1	4.1	4.1	4.1
Non-residents	17.0	11.0	6.9	6.9	6.9	6.9	6.9	6.9
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing gap	0.0	0.0	38.1	25.0	10.0	5.1	0.0	0.0
European Union	...	...	25.4	16.7	6.7	3.4	...	...
IMF	...	...	12.7	8.3	3.3	1.7	...	...
Net placement (market access-amortization)	17.0	14.9	-16.4	-14.4	-0.4	1.9	3.6	3.5
Residents	7.4	15.6	-7.0	-6.7	-0.4	0.1	0.4	13.0
M<	6.0	8.7	-3.6	-5.1	-0.4	0.1	0.4	13.0
ST (net increase)	1.4	6.9	-3.4	-1.6	0.0	0.0	0.0	0.0
Non-residents	9.7	-0.7	-9.3	-7.7	0.0	1.8	3.7	6.5
M<	6.4	5.3	-5.2	-7.7	0.0	1.8	3.7	6.5
ST (net increase)	3.3	-6.0	-4.1	0.0	0.0	0.0	0.0	0.0

Source: Portuguese authorities and Fund staff estimates.

1/ Includes the Bank Solvency Support Facility, bank restructuring costs and net financing from retail government securities programs.

Table 4. Portugal: Balance of Payments, 2008–16

	2008	2009	2010	Projections						
				2011	2012	2013	2014	2015	2016	
	(Billions of euro)									
Current account	-21.7	-18.4	-17.1	-14.8	-10.4	-7.9	-7.2	-6.0	-4.8	
Trade balance	-23.0	-17.8	-17.9	-15.2	-11.7	-10.1	-9.1	-8.0	-7.6	
Exports fob	39.2	32.0	36.9	41.0	44.3	47.7	51.6	55.8	60.3	
Imports fob	62.2	49.8	54.8	56.2	56.0	57.8	60.7	63.8	67.8	
Services, net	6.6	6.0	6.7	8.4	8.9	9.9	10.5	11.0	11.4	
Exports	17.9	16.3	17.6	18.9	19.4	20.7	21.9	23.0	24.2	
Imports	11.3	10.3	10.9	10.5	10.5	10.8	11.4	12.1	12.8	
<i>Of which:</i>										
Tourism	4.5	4.2	4.7	5.4	5.7	6.2	6.7	7.0	7.3	
Exports	7.4	6.9	7.6	8.2	8.4	9.1	9.7	10.2	10.7	
Imports	2.9	2.7	3.0	2.7	2.7	2.8	3.0	3.2	3.4	
Income, net	-7.8	-8.7	-8.0	-10.6	-10.6	-10.6	-11.4	-11.6	-11.4	
Current transfers, net	2.5	2.1	2.2	2.6	2.9	2.9	2.8	2.7	2.6	
Private remittances, net	2.6	2.1	2.2	2.7	2.8	2.7	2.7	2.6	2.6	
Official transfers, net	-0.2	0.1	0.0	0.0	0.1	0.2	0.1	0.1	0.0	
Capital account	2.6	1.4	1.9	2.1	1.9	1.9	2.0	2.1	2.1	
Financial account	19.1	15.7	15.6	-25.4	-16.5	-4.0	0.1	3.9	2.7	
Direct investment	1.3	1.4	7.6	4.5	0.8	0.9	1.4	1.4	1.4	
Portuguese investment abroad	-1.9	-0.6	6.5	3.4	-0.7	-1.1	-1.2	-1.2	-1.3	
Foreign investment in Portugal	3.2	1.9	1.1	1.1	1.5	2.0	2.6	2.6	2.7	
Portfolio investment, net	14.7	13.3	-9.6	-18.1	-10.8	-3.6	-3.9	1.4	-0.2	
Financial derivatives	0.3	0.2	0.3	0.0	0.0	0.0	0.0	0.0	0.0	
Other investment, net	3.0	0.8	18.3	-11.8	-6.5	-1.3	2.6	1.1	1.5	
Reserve assets	-0.1	0.1	-1.0	0.0	0.0	0.0	0.0	0.0	0.0	
Errors and omissions	-0.1	1.3	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	
Prospective financing	...	...	...	38.1	25.0	10.0	5.1	...	...
European Union (2/3 of total)	...	...	...	25.4	16.7	6.7	3.4	...	...
IMF (1/3 of total)	...	...	...	12.7	8.3	3.3	1.7	...	...
<i>Memorandum items:</i>										
Net international investment position 1/	-165.2	-186.2	-185.6	-198.2	-206.7	-212.7	-217.9	-221.8	-224.5	
Direct investment, net	-26.6	-32.1	-34.4	-38.9	-39.7	-40.6	-42.0	-43.4	-44.8	
Portfolio investment, net	-53.4	-70.0	-51.3	-71.3	-85.5	-91.9	-93.1	-94.5	-94.2	
Financial derivatives	0.2	-0.4	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	
Other investment, net	-93.9	-94.7	-114.4	-102.6	-96.1	-94.8	-97.4	-98.5	-100.1	
Reserve assets	8.6	11.1	15.7	15.7	15.7	15.7	15.7	15.7	15.7	
Nominal GDP	172.0	168.6	172.7	171.2	170.5	174.8	181.4	188.0	194.4	
	(Percent of GDP)									
Current account	-12.6	-10.9	-9.9	-8.6	-6.1	-4.5	-4.0	-3.2	-2.5	
Current account (including capital transfers)	-11.1	-10.1	-8.8	-7.4	-5.0	-3.4	-2.9	-2.1	-1.4	
<i>Of which:</i> Balance of goods and services	-9.5	-7.0	-6.5	-4.0	-1.6	-0.1	0.8	1.6	2.0	
Net international investment position 1/	-96.1	-110.4	-107.4	-115.7	-121.2	-121.7	-120.1	-118.0	-115.5	
Direct investment, net	-15.4	-19.0	-19.9	-22.7	-23.3	-23.2	-23.1	-23.1	-23.0	
Portfolio investment, net	-31.1	-41.6	-29.7	-41.6	-50.1	-52.6	-51.3	-50.3	-48.5	
Financial derivatives	0.1	-0.3	-0.6	-0.7	-0.7	-0.6	-0.6	-0.6	-0.6	
Other investment, net	-54.6	-56.2	-66.2	-59.9	-56.4	-54.2	-53.7	-52.4	-51.5	
Reserve assets	5.0	6.6	9.1	9.2	9.2	9.0	8.7	8.4	8.1	

Sources: Bank of Portugal; and IMF staff calculations.

1/ End-of-period data.

Table 5. Portugal: External Financing Requirements and Sources, 2008-16
(in billion of Euros)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
GROSS FINANCING REQUIREMENTS	169.4	172.8	186.0	211.9	199.0	184.3	169.9	156.6	167.0
Current account deficit	21.7	18.4	17.1	14.8	10.4	7.9	7.2	6.0	4.8
Medium- and long-term debt amortization	22.1	23.5	28.9	27.0	28.7	25.1	24.1	17.6	15.5
Public sector	7.3	5.4	4.4	5.7	7.7	5.9	8.5	6.4	5.9
Banks	11.4	14.5	20.5	17.2	17.2	12.7	10.1	7.5	5.6
Other private	3.4	3.7	4.0	4.1	3.8	6.6	5.5	3.8	4.0
Short-term debt amortization	125.6	130.9	140.0	170.1	159.9	151.3	138.5	132.5	130.7
Public sector	17.0	32.7	40.4	70.9	74.2	71.1	56.6	47.4	41.8
Central Bank	6.2	19.0	23.4	59.9	67.3	64.3	49.8	40.5	34.9
General government and SOEs	10.8	13.7	17.0	11.0	6.9	6.9	6.9	6.9	6.9
Banks	90.6	80.1	80.0	77.5	65.1	60.5	62.3	64.5	67.3
Other private	18.0	18.1	19.5	21.8	20.7	19.6	19.6	20.6	21.7
EU and IMF		0.0	0.0	0.0	0.0	0.0	0.0	0.5	16.0
SOURCES OF FINANCING	169.4	172.8	186.0	173.8	174.0	174.3	164.8	156.6	167.0
Capital account (net)	2.6	1.4	1.9	2.1	1.9	1.9	2.0	2.1	2.1
Foreign direct investment (net)	1.3	1.4	7.6	4.5	0.8	0.9	1.4	1.4	1.4
Inward	3.2	1.9	1.1	1.1	1.5	2.0	2.6	2.6	2.7
New borrowing and debt rollover	164.4	185.3	194.0	161.2	159.0	161.5	158.2	153.8	162.8
Medium and long-term borrowing	33.4	45.3	23.9	1.3	7.7	23.0	25.7	23.2	25.5
Public sector	14.1	11.8	9.7	0.5	0.0	5.9	10.3	10.1	12.3
Banks	15.4	26.2	5.6	-1.5	4.3	10.5	9.6	8.9	8.2
Other private	3.9	7.3	8.5	2.3	3.5	6.6	5.8	4.2	5.0
Short-term borrowing	131.0	140.0	170.1	159.9	151.3	138.5	132.5	130.7	137.3
Public sector	32.7	40.4	70.9	74.2	71.1	56.6	47.4	41.8	41.8
Central Bank	19.0	23.4	59.9	67.3	64.3	49.8	40.5	34.9	35.0
General government and SOEs	13.7	17.0	11.0	6.9	6.9	6.9	6.9	6.9	6.9
Banks	80.2	80.0	77.5	65.1	60.5	62.3	64.5	67.3	70.6
Other private	18.1	19.5	21.8	20.7	19.6	19.6	20.6	21.7	24.9
Other (includes asset operations)	1.0	-15.2	-17.6	6.0	12.3	9.9	3.2	-0.7	0.7
Of which: Net errors and omissions	-0.1	1.3	-0.5	0.0	0.0	0.0	0.0	0.0	0.0
FINANCING GAP	0.0	0.0	0.0	38.1	25.0	10.0	5.1	0.0	0.0
European Union (2/3 of total)	0.0	0.0	0.0	25.4	16.7	6.7	3.4	0.0	0.0
IMF (1/3 of total)	0.0	0.0	0.0	12.7	8.3	3.3	1.7	0.0	0.0
ROLLOVER RATES									
General government	153.7	150.4	96.7	44.0	47.3	100.0	111.8	128.2	149.8
Private	95.4	114.4	91.4	71.8	82.3	99.6	103.1	105.8	110.3
Banks	93.8	112.3	82.6	67.2	78.7	99.5	102.4	105.8	108.1
Non-financial corporates	102.8	123.5	128.9	88.8	94.2	100.0	105.0	105.8	116.6

Source: Bank of Portugal and staff estimates.

Table 6. Portugal: Selected Financial Indicators of the Banking System, 2005-2011Q1

	(Percent)						
	2005	2006	2007	2008	2009	2010	2011Q1
Capital Adequacy							
Regulatory capital to risk-weighted assets	12.5	11.8	10.4	9.4	10.5	10.3	10.5
Regulatory Tier 1 capital to risk-weighted assets	8.3	8.7	7.0	6.6	7.9	8.3	8.6
Capital to assets ^{1/}	6.2	6.6	6.5	5.8	6.5	6.7	6.8
Asset composition and quality							
Nonperforming loans net of provisions to capital ^{2/}	2.9	2.5	4.1	7.6	7.9	10.0	9.5
Nonperforming loans to total gross loans ^{2/}	1.5	1.3	1.4	1.8	3.1	3.3	3.6
Large exposures to capital ^{1/}	63.4	75.3	79.8	83.3	83.6	120.5	...
Sectoral distribution of loans							
Residents	81.2	80.2	83.7	83.7	83.6	83.3	83.9
Deposit-takers	5.5	5.2	6.2	6.2	5.8	5.5	5.1
Central bank	1.6	1.6	1.3	1.3	1.2	0.5	0.8
Other financial corporations	3.4	3.4	3.6	3.6	3.7	3.9	3.8
General government	1.8	1.7	1.6	1.6	1.7	2.9	3.3
Nonfinancial corporations	29.4	28.7	31.6	31.6	31.5	30.7	30.8
Other domestic sectors	39.5	39.7	39.5	39.5	39.6	39.9	40.2
Nonresidents	18.8	19.8	16.3	16.3	16.4	16.7	16.1
Earnings and profitability							
Return on assets	1.0	1.3	1.2	0.4	0.4	0.5	0.5
Return on equity	15.9	19.9	18.7	5.6	7.3	7.5	7.6
Interest margin to gross income	51.8	52.0	54.0	59.5	53.8	52.2	58.3
Noninterest expenses to gross income	58.5	53.9	55.4	58.0	58.3	58.8	61.0
Liquidity							
Liquid assets to total assets ^{3/}	14.8	13.5	11.2	12.8	13.2	18.0	17.6
Liquid assets to short-term liabilities ^{3/}	95.1	91.2	85.6	67.7	84.5	85.3	81.2
Loans to deposits ^{4/}							
banking system	...	...	...	...	161.5	157.8	156.7
eight largest banks	...	...	...	...	152.3	146.9	144.4
Foreign-currency-denominated liabilities to total liabilities ^{5/}	7.4	8.1	5.8	5.8	5.1	5.1	4.9

Sources: Bank of Portugal; and IMF staff estimates.

1/ On accounting basis; consolidated.

2/ On a consolidated basis.

3/ Three-month residual maturity.

4/ Loans to customers (net of impairments) and securitized non-derecognized credit to customers divided by resources from customers and other loans.

5/ Includes foreign currency deposits and deposit-like instruments of resident nonmonetary sector and claims of nonresident vis-à-vis resident monetary financial institutions (excluding Bank of Portugal).

Table 7. Portugal Monetary Survey, 2009–16
(In millions of euros, unless otherwise indicated; end of period)

	2009	2010	Projections					
			2011	2012	2013	2014	2015	2016
Aggregated Balance Sheet of Monetary Financial Institutions (MFIs)								
Assets	459,663	490,570	471,660	450,906	444,434	445,301	452,485	469,671
Cash	1,786	1,690	1,676	1,668	1,710	1,776	1,839	1,903
Claims on Bank of Portugal	8,771	4,921	3,659	3,643	3,735	3,877	4,017	4,156
Claims on other FIs	34,318	50,095	52,681	53,345	54,285	55,700	57,567	60,292
Claims on non MFIs	297,020	313,198	308,176	295,841	292,510	291,993	293,666	300,544
General government	16,715	33,485	32,196	24,714	24,593	24,819	25,088	26,735
Private sector	280,305	279,713	275,980	271,128	267,918	267,174	268,578	273,809
Claims on non-residents	111,926	114,117	100,423	91,385	87,044	86,609	89,857	97,045
Other assets	5,842	6,549	5,045	5,023	5,150	5,346	5,539	5,731
Liabilities	459,663	490,570	471,660	450,906	444,434	445,301	452,485	469,671
Liabilities to Bank of Portugal	16,503	41,936	49,300	46,255	31,761	22,487	16,887	16,947
Liabilities to other FIs	46,711	59,420	60,988	61,154	63,361	65,496	67,648	70,354
Deposits of non MFIs	154,009	162,771	166,811	167,215	173,171	179,039	184,947	192,303
General government	6,436	7,282	7,220	7,188	7,370	7,650	7,926	8,201
Private sector	147,573	155,489	159,591	160,027	165,802	171,389	177,021	184,102
Securities other than capital	67,867	62,593	47,150	30,707	25,162	21,846	21,222	21,875
Liabilities to non-residents	139,774	129,403	106,593	98,965	101,934	105,672	110,251	115,763
Other	-7,564	-8,229	-9,171	-9,130	-9,361	-9,717	-10,068	-10,416
Capital and reserves	42,378	42,673	49,990	55,740	58,406	60,477	61,597	62,845
Money and Credit								
Broad Money (M3)	177,139	174,748	173,257	172,496	176,853	183,591	190,204	196,794
Intermediate money (M2)	164,368	169,560	168,114	167,375	171,603	178,140	184,557	190,952
Narrow money (M1)	70,637	69,930	69,333	69,029	70,772	73,469	76,115	78,752
Private sector credit	280,305	279,713	275,980	271,128	267,918	267,174	268,578	273,809
Public sector credit	16,715	33,485	32,196	24,714	24,593	24,819	25,088	26,735
(percent of GDP)								
Broad Money	105.1	101.2	101.2	101.2	101.2	101.2	101.2	101.2
Private sector credit	166.3	162.0	161.2	159.0	153.3	147.3	142.9	140.8
Public sector credit	9.9	19.4	18.8	14.5	14.1	13.7	13.3	13.7
(percentage change)								
Broad Money	-3.3	-1.3	-0.9	-0.4	2.5	3.8	3.6	3.5
Private sector credit	3.4	-0.2	-1.3	-1.8	-1.2	-0.3	0.5	1.9
Public sector credit	64.1	100.3	-3.8	-23.2	-0.5	0.9	1.1	6.6
Memo items:								
Credit to deposits (%)	161.9	153.5	149.0	146.7	140.6	136.3	133.3	131.3
Deposits (% change)	6.1	10.6	2.6	0.3	3.6	3.4	3.3	4.0
Wholesale market funding (% change)	7.2	-8.2	-20.3	-17.0	-2.9	-0.3	2.9	4.6
Wholesale market funding (% assets)	39.6	34.0	28.2	24.5	24.1	24.0	24.3	24.5
Capital (% assets)	7.4	6.9	8.5	9.5	9.7	9.9	9.8	9.8

Sources: Bank of Portugal and staff estimates.

Table 8. Portugal: Public Sector Debt Sustainability Framework, 2007-2016
(In percent of GDP, unless otherwise indicated)

	Actual				Projections							Debt-stabilizing primary balance 9/
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016		
Baseline : Public sector debt 1/ o/w foreign-currency denominated	68.3	71.6	83.0	93.0	106.0	111.8	114.9	114.6	112.5	110.6	1.3	
Change in public sector debt	0.2	1.2	1.2	1.5	1.6	1.7	1.7	1.7	1.7	1.6		
Identified debt-creating flows (4+7+12)	4.3	3.3	11.4	10.0	13.0	5.8	3.1	-0.3	-2.1	-1.9		
Primary deficit	-0.3	2.5	11.6	9.5	13.0	5.8	3.1	-0.3	-2.1	-1.9		
Revenue and grants	0.2	0.5	7.2	6.1	1.7	-0.3	-2.1	-2.8	-3.1	-3.3		
Primary (noninterest) expenditure	41.1	41.1	39.7	41.5	42.2	42.3	42.3	42.3	42.3	42.1		
Automatic debt dynamics 2/	41.4	41.6	46.9	47.7	43.9	42.0	40.2	39.5	39.1	38.9		
Contribution from interest rate/growth differential 3/	-0.5	1.9	4.4	1.2	4.9	5.2	2.3	0.9	1.1	1.3		
Of which contribution from real interest rate	1.0	2.0	2.5	2.2	2.8	3.3	3.6	3.6	3.5	3.5		
Of which contribution from real GDP growth	-1.4	0.0	1.8	-1.1	2.0	2.0	-1.3	-2.7	-2.4	-2.2		
Contribution from exchange rate depreciation 4/	0.0	0.0	0.1	0.1	...	...	...	...	...	...
Other identified debt-creating flows	0.0	0.0	0.0	0.0	2.2	6.4	0.8	2.9	1.5	0.0		
Privatization receipts (negative)	0.0	0.0	0.0	-0.5	-1.1	-1.2	-0.6	0.0	0.0	0.0		
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	2.5	0.0	0.0	0.0	0.0	0.0	0.0		
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.2	7.6	2.0	3.5	1.5	0.0	0.0		
Residual, including asset changes (2-3) 5/	4.6	0.9	-0.2	0.5	0.0	0.0	0.0	0.0	0.0	0.0		
Public sector debt-to-revenue ratio 1/	165.9	174.1	209.0	223.9	251.4	264.2	271.9	270.9	266.2	262.4		
Gross financing need 6/ in billions of U.S. dollars	16.6	17.1	23.0	24.5	31.1	21.6	18.0	17.8	13.7	20.7		
	41.0	40.1	56.6	55.9	76.0	52.0	44.0	44.7	35.4	55.0		
Scenario with key variables at their historical averages 7/					106.0	108.9	113.9	117.7	120.1	122.4	1.9	
Scenario with no policy change (constant primary balance) in 2011-2016					106.0	113.8	120.7	124.9	127.8	131.0	1.5	
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	2.4	0.0	-2.5	1.3	-2.2	-1.8	1.2	2.5	2.2	2.0		
Average nominal interest rate on public debt (in percent) 8/	4.9	4.5	4.0	3.7	4.4	4.5	4.6	4.6	4.6	4.7		
Average real interest rate (nominal rate minus change in GDP deflator, in p	1.7	2.9	3.4	2.7	3.0	3.1	3.3	3.3	3.2	3.2		
Nominal appreciation (increase in US dollar value of local currency, in perc	9.2	7.4	-5.4	-4.7	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	3.2	1.6	0.5	1.0	1.5	1.4	1.3	1.3	1.4	1.4		
Growth of real primary spending (deflated by GDP deflator, in percent)	10.9	0.6	9.9	2.9	-9.9	-6.0	-3.2	0.7	1.2	1.4		
Primary deficit	0.2	0.5	7.2	6.1	1.7	-0.3	-2.1	-2.8	-3.1	-3.3		

1/ General government gross debt.
2/ Derived as $[(r - \pi)(1+g) - g + \alpha\epsilon(1+\pi)] / (1+g+\pi-g)$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ϵ = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the numerator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as $-g$.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\epsilon(1+\pi)$.

5/ For projections, this line includes exchange rate changes.

6/ Defined as general government deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table 9. Portugal: External Debt Sustainability Framework, 2006-2016
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Baseline: External debt	187.2	197.3	202.8	225.2	234.4	236.2	234.6	226.1	218.1	212.3	205.5
Change in external debt	10.9	10.1	5.5	22.4	9.2	1.8	-1.6	-8.5	-7.9	-5.9	-6.8
Identified external debt-creating flows (4+8+9)	2.4	1.9	5.1	13.2	0.3	11.3	9.0	0.0	-3.8	-4.3	-4.5
Current account deficit, excluding interest payments	5.1	3.2	4.7	4.8	4.6	2.5	-0.1	-1.4	-2.0	-2.9	-3.8
Deficit in balance of goods and services	-71.4	-73.0	-75.9	-64.4	-69.6	-74.0	-76.3	-78.5	-80.3	-82.3	-84.9
Exports	31.5	32.8	33.2	28.7	31.5	35.0	37.3	39.2	40.5	41.9	43.4
Imports	-39.9	-40.3	-42.7	-35.7	-38.0	-39.0	-39.0	-39.3	-39.8	-40.3	-41.4
Net non-debt creating capital inflows (negative)	-1.1	1.8	-4.5	-1.8	-4.3	-2.5	-1.5	-1.9	-2.4	-2.9	-2.9
Automatic debt dynamics 1/	-1.5	-3.1	4.8	10.2	-0.1	11.3	10.6	3.3	0.6	1.4	2.2
Contribution from nominal interest rate	5.7	6.9	7.9	6.1	5.3	6.1	6.3	6.0	6.0	6.1	6.3
Contribution from real GDP growth	-2.4	-4.2	0.0	5.2	-2.9	5.1	4.4	-2.7	-5.3	-4.6	-4.1
Contribution from price and exchange rate changes 2/	-4.8	-5.8	-3.1	-1.1	-2.4	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 3/	8.5	8.2	0.5	9.2	8.9	-9.4	-10.6	-8.5	-4.2	-1.5	-2.3
External debt-to-exports ratio (in percent)	594.2	602.0	611.2	785.4	743.1	675.1	628.3	577.4	538.3	506.3	473.2
Gross external financing need (in billions of US dollars) 4/				172.8	186.0	211.9	199.0	184.3	169.9	156.1	151.0
in percent of GDP				102.5	107.7	123.8	116.8	105.5	93.6	83.0	77.7
Scenario with key variables at their historical averages 5/						236.2	229.6	224.8	224.1	226.0	227.1
Key Macroeconomic Assumptions Underlying Baseline											
Real GDP growth (in percent)	1.4	2.4	0.0	-2.5	1.3	-2.2	-1.8	1.2	2.5	2.2	2.0
GDP deflator in US dollars (change in percent)	2.8	3.2	1.6	0.5	1.1	1.3	1.4	1.3	1.3	1.4	1.4
Nominal external interest rate (in percent)	3.4	3.9	4.1	3.0	2.4	2.6	2.6	2.6	2.7	2.9	3.1
Growth of exports (US dollar terms, in percent)	16.4	9.9	2.8	-15.3	12.7	10.0	6.2	7.5	7.4	7.2	7.2
Growth of imports (US dollar terms, in percent)	10.7	6.7	7.8	-18.1	9.2	1.6	-0.4	3.4	5.0	5.1	6.3
Current account balance, excluding interest payments	-5.1	-3.2	-4.7	-4.8	-4.6	-2.5	0.1	1.4	2.0	2.9	3.8
Net non-debt creating capital inflows	1.1	-1.8	4.5	1.8	4.3	2.5	1.5	1.9	2.4	2.9	2.9

1/ Derived as $[-g - r(1+g) + e\alpha(1+r)] / (1+g+r+g)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms;

g = real GDP growth rate; e = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-r(1+g) + e\alpha(1+r)] / (1+g+r+g)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($e > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

Table 10. Portugal: Access and Phasing Under the Extended Arrangement, 2011-14

Review	Availability date	Action	Purchase	
			In millions of SDRs	in percent of quota
		Board approval of Extended Arrangement		
First review	May 20, 2011	Observation of end-June 2011 performance criteria; completion of first review	5,611	544.9
Second review	September 9, 2011	Observation of end-September 2011 performance criteria; completion of second review	3,467	336.7
Third review	December 15, 2011	Observation of end-December 2011 performance criteria; completion of third review	2,425	235.5
Fourth review	March 15, 2012	Observation of end-March 2012 performance criteria; completion of fourth review	4,443	431.5
Fifth review	June 15, 2012	Observation of end-June 2012 performance criteria; completion of fifth review	1,197	116.2
Sixth review	September 15, 2012	Observation of end-September 2012 performance criteria; completion of sixth review	1,259	122.3
Seventh review	December 15, 2012	Observation of end-December 2012 performance criteria; completion of seventh review	724	70.3
Eighth review	March 15, 2013	Observation of end-March 2013 performance criteria; completion of eighth review	574	55.7
Ninth review	June 15, 2013	Observation of end-June 2013 performance criteria; completion of ninth review	806	78.3
Tenth review	September 15, 2013	Observation of end-September 2013 performance criteria; completion of tenth review	873	84.8
Eleventh review	December 15, 2013	Observation of end-December 2013 performance criteria; completion of eleventh review	803	78.0
Twelfth review	March 15, 2014	Observation of end-March 2014 performance criteria; completion of twelfth review	760	73.8
Total	May 15, 2014		800	77.7
			23,742	2,305.7

Source: Fund staff projections.

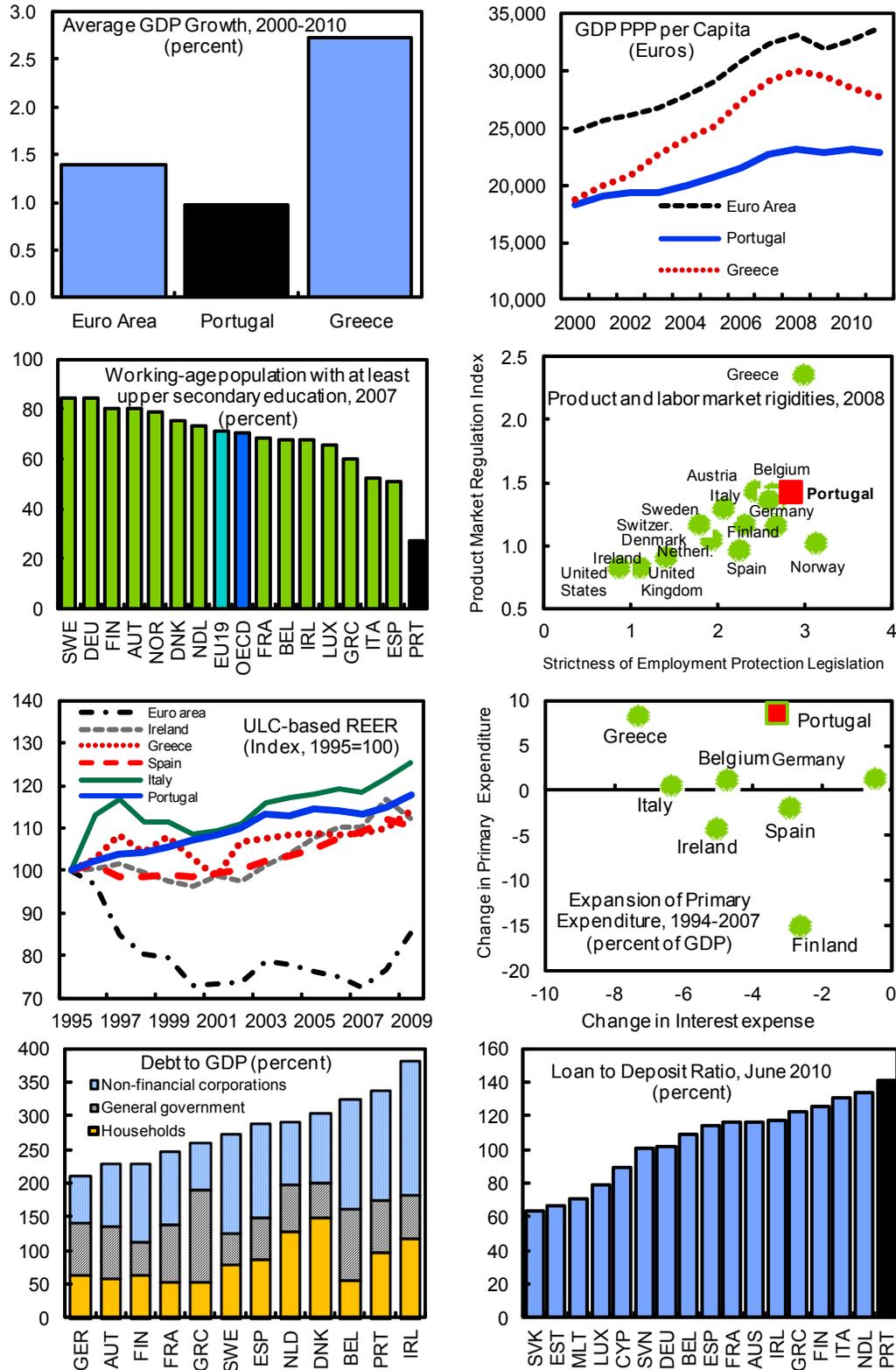
Table 11 Portugal: Indicators of Fund Credit
(In millions of euros, unless otherwise specified) 1/

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Disbursements (in percent of quota)	12,597	8,347	3,346	1,710	...	...	...	...	...
	1,125	740	297	152	...	...	...	...	...
(Projected debt service to the Fund, based on prospective drawings)									
Total	117	548	726	940	1,601	3,655	4,519	4,922	4,869
Interest and charges	117	548	726	940	1,089	1,040	902	731	536
Repayments	0	0	0	0	512	2,614	3,617	4,191	4,333
Total debt service, in percent of									
Exports of goods and services	0.2	0.9	1.1	1.3	2.0	4.3	5.0	5.1	4.8
GDP	0.1	0.3	0.4	0.5	0.9	1.9	2.2	2.3	2.2
(Projected level of credit outstanding based on prospective drawings)									
Outstanding stock	12,597	20,945	24,292	26,000	25,488	22,874	19,257	15,066	10,733
in percent of quota	1,117.1	1,857.4	2,154.2	2,305.7	2,260.3	2,028.5	1,707.7	1,336.1	951.8
in percent of GDP	7.4	12.3	13.9	14.3	13.6	11.7	9.5	7.2	4.9
Memorandum Items (in billions of euros)									
Exports of goods and services	60	64	68	74	79	84	90	96	101
GDP	171	170	175	181	188	195	202	210	219

Source: Fund staff projections.

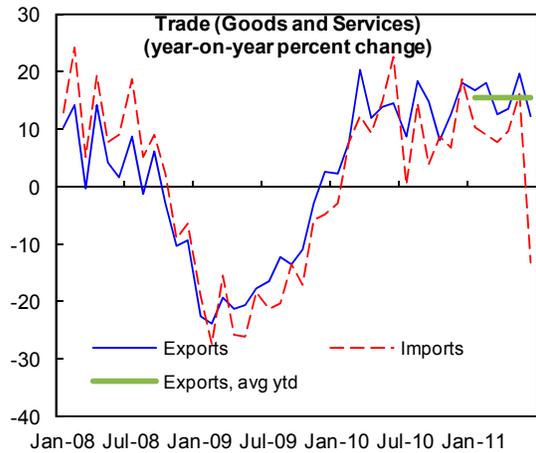
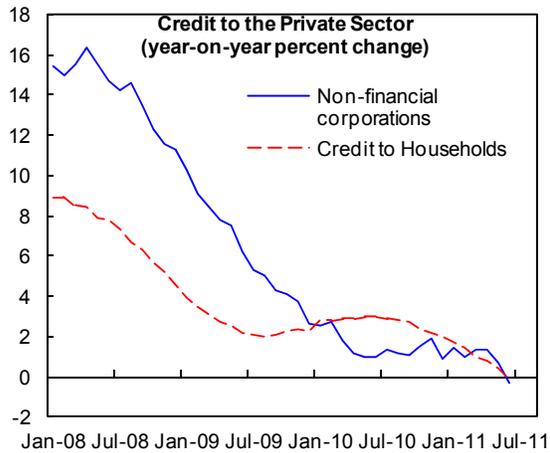
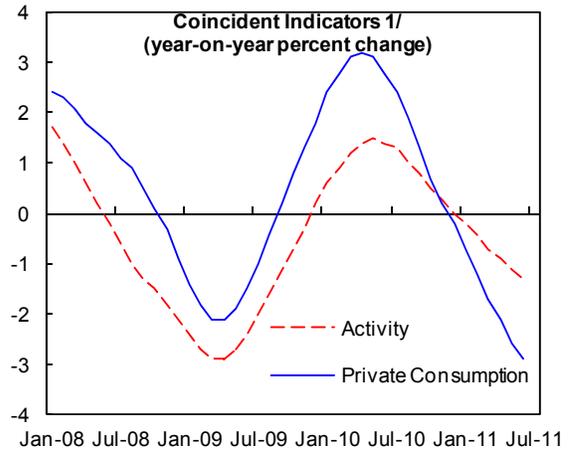
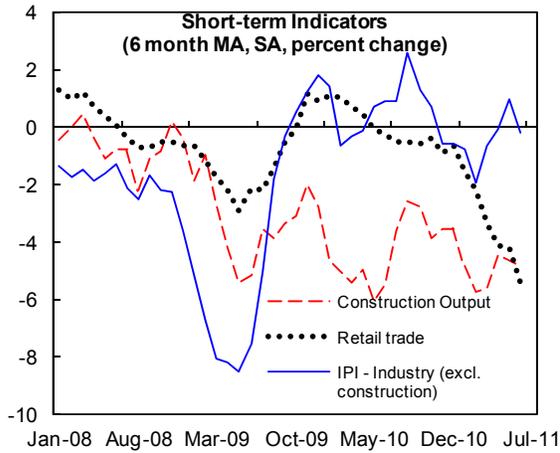
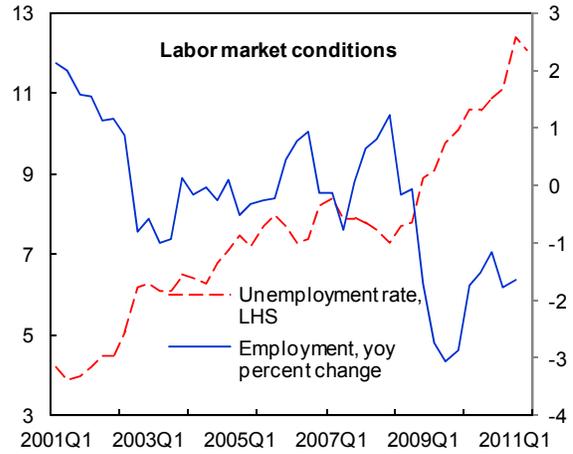
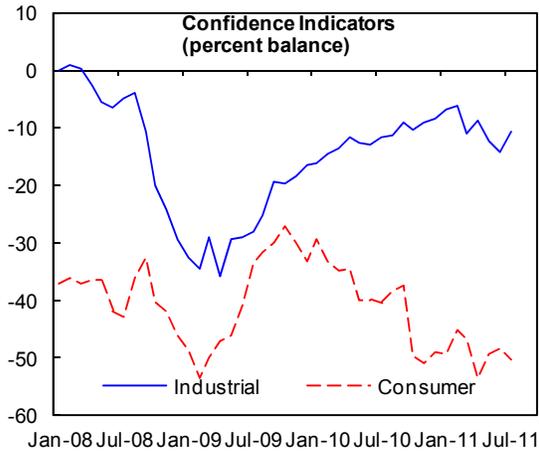
1/ An exchange rate of 1.09512 Euros per SDR was used.

Figure 1. Background to the Program



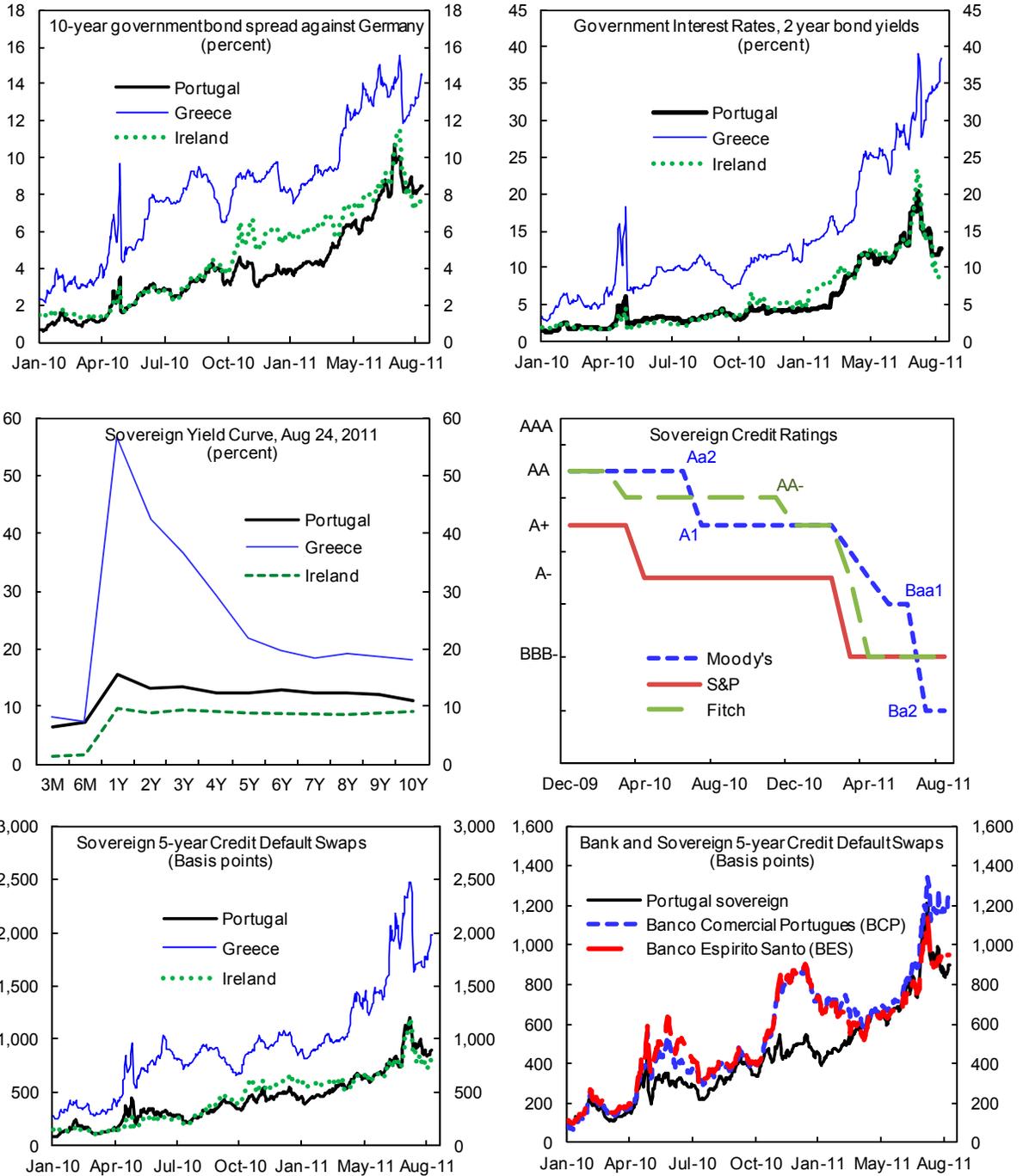
Sources: IMF, *World Economic Outlook*; OECD; Eurostat; and IMF staff calculations.

Figure 2. Portugal: High Frequency Activity Indicators



Source: Statistical Office of the European Communities; European Commission; Bank of Portugal; and Fund staff calculations.
1/ Calculated by the Bank of Portugal.

Figure 3. Portugal: Financial Indicators



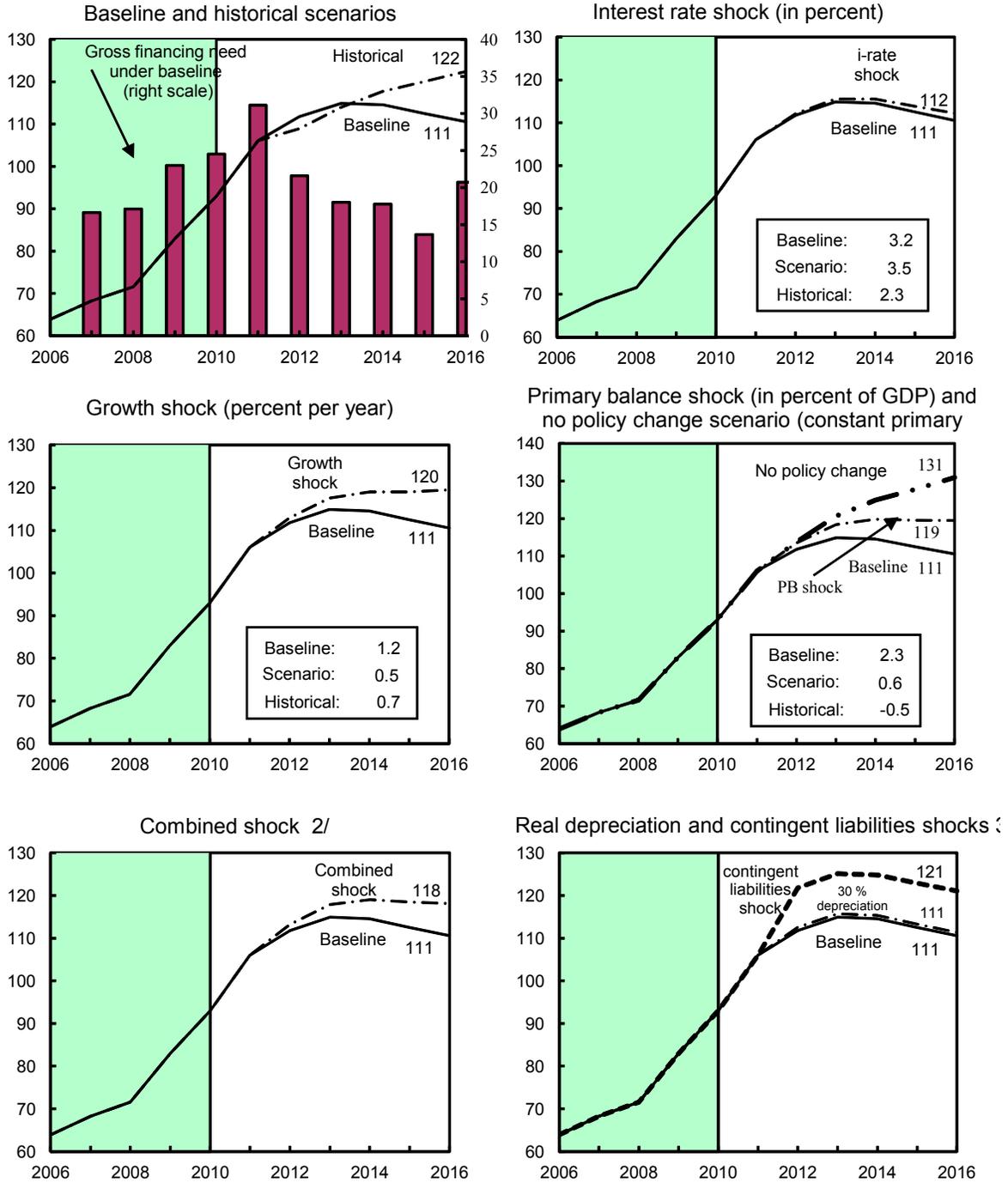
Sources: Bloomberg; and IMF staff calculations.

APPENDIX I. PUBLIC DEBT SUSTAINABILITY ANALYSIS

Public debt is sustainable under the baseline—peaking at 115 percent of GDP in 2013—but remains vulnerable to shocks. There is no substantial change in relation to the DSA presented in the May staff report. The debt level (almost double of the 60 percent of GDP EU's threshold) is high, and scope for assets sale seems small in the case of Portugal. Therefore, reducing debt over time depends mainly on (i) fiscal consolidation efforts; (ii) growth prospects; and (iii) interest rates. Sensitivity analysis confirms that the key threats to the baseline debt path are slippages in fiscal efforts and weaker growth. In addition to the standard shocks (Figure 1), this Appendix considers the following tailored shocks (Figures 2):

- A growth shock (at $\frac{3}{4}$ of the 10 year standard deviation) would bring the average growth rate to 0.9 percent over 2013–16 (or back to the low average growth of the past decade). In this scenario, debt would not stabilize and would reach 124 percent of GDP in 2016.
- In light of the recent expenditures overruns, risks of consolidation delays have increased. A shock to the primary balance (at $\frac{3}{4}$ of standard deviation or 2.6 percent of GDP) would also lead to unsustainable dynamics, with debt reaching 124 percent of GDP in 2016.
- In contrast, a shock to the interest rates leading to an average nominal interest rate of 5.3 percent in 2016 (rather than 4.7 percent under the baseline) would have a smaller impact on debt, which would reach 113.6 percent of GDP in 2016.
- Contingent liabilities continue to pose significant risks, as highlighted in the May staff report. A shock to contingent liabilities of 5 percent of GDP in 2011 and 10 percent of GDP in 2012 would lead debt to stabilize at 130 percent of GDP in 2013.

Figure 1. Portugal: Public Debt Sustainability: Standard Shocks Tests 1/
(Public debt in percent of GDP)

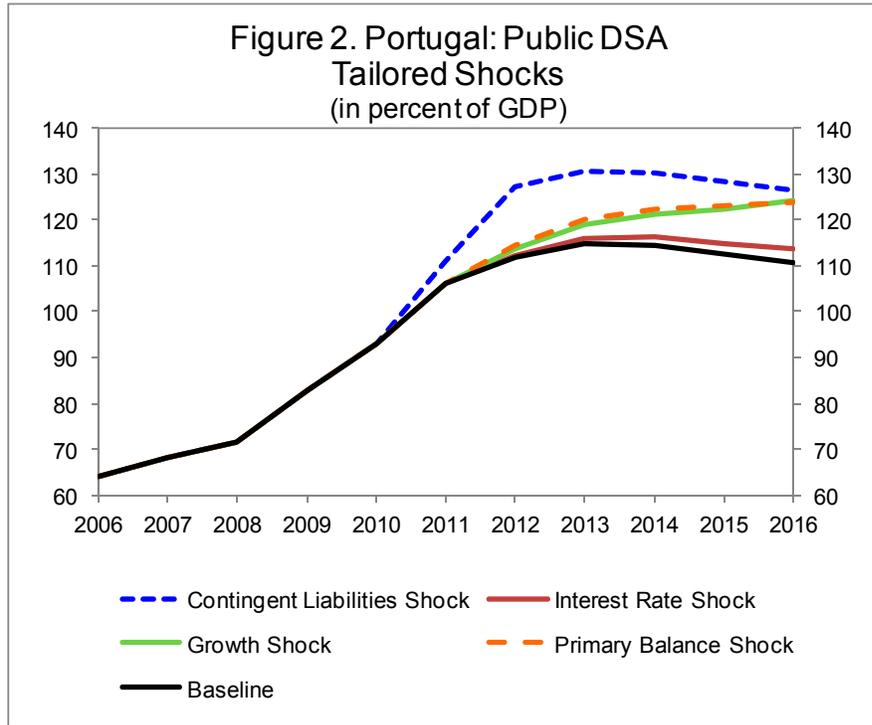


Sources: International Monetary Fund, country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).



APPENDIX II. PORTUGAL: LETTER OF INTENT

Lisbon, September 1, 2011

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Ms. Lagarde:

1. The Board of the IMF approved on May 20, 2011 a three-year Extended Arrangement (EFF) in support of our comprehensive adjustment and reform program, as laid out in the Memorandum of Economic and Financial Policies (MEFP) of May 17, 2011. The new government, which took office on June 21, 2011, is fully committed to policies and objectives of the MEFP. In the attached update we describe progress and additional policy steps towards meeting the objectives of our economic program.

2. Our policy implementation is mostly on track. All the quarterly quantitative performance criteria at end-June were met, along with the continuous criterion on external arrears. An inventory of domestic arrears is being completed (structural benchmark) and this will provide the quantitative basis for monitoring such arrears going forward. While tax revenue performance has been better than envisaged in the program, expenditure overruns occurred in the first semester, which will require additional fiscal measures in the remainder of the year. The overruns also reinforce the need for stronger control and a clearly defined strategy for addressing fiscal risks from State-Owned Enterprises (SOEs). Our measures to address these challenges in the remainder of the year are laid out in the attached MEFP.

3. We have made progress in strengthening competition, restoring competitiveness, and fostering growth. We have abolished all special rights of the State in private companies. We will withdraw from the shareholder agreement in GALP, by committing to sell the remaining shares in GALP held by the state-owned CGD. We have also submitted to Parliament legislation that brings about a substantial reduction in dismissal costs for new contracts. However, we have not yet finalized the calibration of the major reduction of social security contribution (SSC) toward a fiscal devaluation (end-July benchmark) and further discussion with the EC, ECB, and IMF is needed ahead of the finalization of the 2012 budget. These are only the first steps in the implementation of our comprehensive and ambitious plans for structural reforms.

4. The Bank of Portugal (BdP), in close cooperation with the ECB, stands ready to ensure sufficient liquidity in the banking system, while banks continue their orderly deleveraging process and strengthen capital buffers. In line with the program, we have

augmented the existing package of support measures, by approving the issuance of government guaranteed bank bonds in an amount of up to €35 billion. The BdP has directed all banking groups subject to supervision in Portugal to reach a core Tier 1 capital of 9 percent by end-2011 and 10 percent at the latest by end-2012. We have found a buyer for BPN, and are taking important steps in strengthening capital in the core banking arm of CGD using the group's internal resources. We are strongly committed to our financial sector reform program and are prepared to forcefully tackle the challenges that lie ahead.

5. On the basis of the policies defined in this letter, we request completion of the first review under the Extended Arrangement. We also request bringing forward the availability date for the second purchase under the EFF by four days, in case the Board date is brought forward. We are confident that the policies described in the May 17, 2011 MEFP, and in the attached update, are sufficient to achieve the objectives under the program. We stand ready to take additional measures that may be needed to meet the objectives of the economic program and will maintain a close policy dialogue with the IMF, the European Commission, and the ECB, and will consult in advance of any necessary revisions to the policies contained in this letter.

6. This letter is copied to Messrs. Juncker, Rehn, and Trichet.

Sincerely yours,

/s/

Vitor Gaspar
Minister of State and Finance

/s/

Carlos da Silva Costa
Governor of the Banco de Portugal

Attachments: 1. Memorandum of Economic and Financial Policies (MEFP)
2. Technical Memorandum of Understanding (TMU)

ATTACHMENT I: PORTUGAL—MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

September 1, 2011

A. Macroeconomic Outlook

1. **GDP growth and inflation for the year as a whole are expected to remain in line with the program framework.** Following two consecutive quarters of declines in growth, activity was flat in the second quarter. Exports have been relatively strong; consumer confidence indicators are steady, albeit at historical lows; credit developments have so far been consistent with a gradual deleveraging process; and employment has remained broadly stable. However, GDP is still expected to contract at an accelerated pace in 2011H2. In addition there are downside risks arising from the less favorable external environment than assumed even a few months ago. The path of inflation during 2011 is largely influenced by tax measures (VAT and tariff adjustments) in the context of the adjustment program.

B. Reducing Public Debt and Deficit

2. **We remain fully committed to our fiscal targets** of deficit-to-GDP ratios of 5.9 percent in 2011, 4.5 percent in 2012, and 3 percent in 2013. Achieving fiscal consolidation while protecting vulnerable groups remains a priority.

3. **Fiscal performance has so far been broadly in line with the program, but pressures have emerged.** While the end-June quantitative performance criterion on the general government cash balance was met, a number of developments during the first semester are threatening the achievement of the end-year fiscal target. These include support to several SOEs and Public-Private Partnerships (PPPs), and slippages in expenditure controls, mainly on employment costs and intermediate consumption. The projected shortfall for the year as a whole is expected to be about 1.1 percent of GDP.

4. **We commit to implement new measures to address this shortfall.**

- A one-time surcharge in the context of personal income tax has been introduced. We expect this new tax to generate 0.5 percent of GDP in 2011, with an adjustment yielding 0.1 percent of GDP in 2012.
- A number of measures initially scheduled for 2012 will be brought forward. Increases in the VAT rates for gas and electricity to the standard rate will be implemented starting on October 1, generating additional revenues of 0.1 percent of GDP in 2011.
- Additional sales of concessions (including an augmented spectrum auction) will raise 0.4 percent of GDP in 2011.

- The ongoing process of a phased transfer of banks' pension funds to the state social security system will exceptionally be used toward meeting the 2011 deficit target (see also the MoU).

5. **The 2012 budget, currently under preparation, will be fully consistent with the deficit target of 4.5 percent of GDP.** On current projections, the shortfalls in 2011 are projected to create a gap of about 0.6 percent of GDP in 2012. The budget will include measures to cover this gap, in addition to measures of about 3 percent of GDP specified in our May 2011 MEFP. In view of the already high tax burden, we are determined to focus this additional effort needed on expenditure cuts. The draft budget will be discussed with staff of the EC, ECB, and IMF before it is approved by the council of ministers.

C. Streamlining the Public Sector

Public Financial Management (PFM)

6. **We are committed to strengthening our PFM system.** We will implement all the measures defined in the May 2011 MEFP and the MoU. Our reform will be guided by an action plan determined in consultation with a recent IMF/EU technical assistance mission. We are working on a medium-term fiscal strategy document for the general government (structural benchmark), which will outline how some of the key reforms introduced by the amended 2011 budget framework law, in particular medium-term budgeting and the transition to accruals accounting, will be implemented over time. In order to support an improved assessment of fiscal risks starting with the 2012 budget, a definition of contingent liabilities was approved in July. Finally, the statutes of the independent fiscal council are expected to be approved in Parliament by September, and we are committed to making this council fully operational by end-December 2011.

7. **We will strengthen expenditure control and prepare a strategy to clear the stock of arrears over time.** Our preliminary survey, which was completed ahead of the schedule, has revealed a sizable stock of arrears as of end-June (about €3.8 billion), most of which is concentrated in the health sector and local governments. Our near-term priorities in this regard are to:

- Enhance, by end-September 2011 our survey of arrears, which will cover all entities within the general government and all transactions (e.g. employment costs, utilities, interest costs, transfers to local and regional governments, goods and services, capital expenditure, and transfers of withheld taxes and social contributions to respective responsible collection agencies and institutions);
- Prepare a strategy for the settlement of arrears for the entities of general government, as well as SOE hospitals, by end-September;

- Issue an instruction to general government units requiring that from January 1, 2012, (i) commitments must be controlled against available funds recorded in the accounting system and evidenced by authorized commitment documents (“*cabimento*”) bearing valid commitment numbers; (ii) all other commitments would be considered illegal and not eligible for payment; and (iii) any public official incurring such illegal commitment or expenditure will be subject to specified penalties in accordance with the budget framework law. (Prior Action)
- Issue an instruction to general government units to ensure that systems and procedures will comply, by end-December 2011, with the revised budget execution rule, as set out in the above instruction. (Prior Action)
- Carry out, through the Ministry of Finance, regular reviews of the commitment control systems of hospitals and local governments.

8. **The financial accountability and management functions of regions and municipalities will be strengthened.** In particular, given the sizeable risks to public finances, we will urge the two regional governments to adopt PFM reforms similar to those envisaged for the central government. Under the current commitments to revise the regional and local public finance laws, by end-December 2011 we will, in consultation with regional and local governments, endeavor to put a framework in place to: (i) require that their revenue projections be reviewed by the fiscal council; (ii) introduce a contingency reserve under their overall expenditure envelope as a buffer against genuine surprises; (iii) review the revenue-sharing mechanism between the State and the regions; (iv) strengthen the supervisory power of the State over the regions; and (v) apply tighter debt ceilings combined with the adoption of a multi-tiered monitoring system, as suggested by the July 2011 TA mission.

Revenue Administration

9. **We remain committed to the reforms set in the May 2011 MEFP.** An IMF/EC TA mission in early September will review our revenue administration reform agenda and provide inputs for fulfillment of our upcoming commitments, in particular: (i) the preparation of the strategic plan for 2012–14; (ii) the assessment of the current state of tax information systems; and (iii) the design of the new merged revenue administration structure. We are already improving the resolution process for tax appeals, and the number of outstanding cases above €1 million at the tax court has already fallen by 200. The new tax arbitration law has been implemented as planned.

Public Administration and its Perimeter

10. **The public administration is being streamlined.** A second phase of the restructuring program was launched for the central government. We are preparing a new set of organic laws aiming at reducing by at least 15 percent management positions and administrative units. The draft legislation will be submitted to the Council of Ministers by

end-October. As a key step to fulfill our commitments, we will submit to public discussion a White Book of administrative reform by end-September 2011. Starting with the 2012 budget, we will reduce the number of State Autonomous Funds. We will also aim to classify as general revenues, on a case by case basis, all own revenues of these funds that arise directly or indirectly from the use of the sovereign powers of the government (e.g. court fees, fines, fees for licenses or permits, and audit fees charged by the Court of Auditors).

SOEs

11. **We are committed to fundamentally overhauling the SOE sector.** We recognize that SOEs should not continue to act as off-budget arms of the state, but must focus on efficient provision of essential public services. Our strategy for firms with commercial operations rests on a combination of operational restructuring to restore financial balance and eliminate deficits and closure or divestiture of firms providing nonessential services or producing goods. Regarding noncommercial firms, in particular in the health sector, we will implement measures to improve efficiency and effectiveness, and generate saving, as detailed in the MoU.

12. **We will restore operational balance to most SOEs by the end of 2012.** We have implemented cost reduction measures across the SOE sector aiming at a 15-percent average reduction and raised tariffs on public transportation. Results have been mixed, in particular due to the underperformance of the health sector, which will need a longer period to adjust. We will take further new measures to ensure that all but the most problematic cases have a zero operational deficit by the end of 2012, preparing an SOE strategy document by end-September with numerical targets on cost reductions, including measures to realign wages or reduce employment, and further tariff increases as needed. A review of SOE operations and finances will be an input to the budget. We will impose progressively stricter limits on the SOEs' borrowing requirement from 2012 onwards. For the firms with the most entrenched financial and operational difficulties restructuring may take longer, and require a recomposition of their liabilities from debt to equity. Our strategy document will address these issues fully.

13. **Financial support for SOEs may be needed during the transition to long-term viability.** Some SOEs face significant difficulties rolling over amortizing debts. These debts are principally owed to the domestic and European banks, including the EIB, and our restructuring strategy will be a key tool in helping SOEs' roll over amortizing debt. While we have been largely successful in this policy, in some cases the central government has had to step in to provide resources and allowing SOEs to meet their commitments on time. Any such support will be provided within the agreed deficit target for the general government. The SOEs will urgently develop medium term restructuring plans with a view to reduce their indebtedness and restructure to ensure improved conditions for markets financing.

Privatization

14. **We are pushing ahead with privatization.** We will fully divest public sector shares in EDP, REN, and GALP (and if market conditions permit, TAP), by the end of the 2011. We will do this under the new framework law for privatization (see MEFP ¶ 27) and in accordance with EU competition and state aid rules. We have also decided to include Aguas de Portugal and RTP in privatization by end-2012 in addition to enterprises identified for sale under the broader strategy of comprehensive SOE restructuring.

15. **We will develop a strategic plan for Parpublica, whose sources of income would be affected by privatization.** The plan, which will be prepared before end-2011, will reconsider the role of Parpublica as a public company, including eliminating the obligation to remit the proceeds of the sale of assets to the Treasury in return for new assets, and considering the possibility of winding down the company or consolidating it with the general government. In the interim we will ensure that Parpublica will have sufficient income-generating assets to manage its debt and financing needs.

D. Protecting the Financial System amidst Deleveraging

16. **Bank liquidity remains under pressure.** We continue to encourage banks to strengthen their collateral buffers, and we have finalized the approval of the issuance of government guaranteed bank bonds in the amount of up to €35 billion.

17. **A balanced and orderly deleveraging of the banking sector remains critical to eliminating funding imbalances on a permanent basis.** The process has started, with banks having delivered a first version of their medium-term plans to achieve a stable market-based funding position. The funding plans target a reduction in the loan-to-deposit ratio to about 120 percent and a reduction of the reliance on Eurosystem funding during the duration of the program, while ensuring adequate support to the more productive sectors of the domestic economy, including SMEs. The BdP and the ECB will ask banks to revise their funding plans by end-September. These funding plans will be reviewed quarterly, starting with the second review of the program, with a view to ensuring, in particular, consistency with the macroeconomic framework—including the medium-term plans for the public sector that are under development (MEFP ¶12). The BdP will take appropriate action in case of deviations from the banks' funding plans. To facilitate quarterly reviews, we will develop high frequency indicators for credit to the main sectors of the economy.

18. **To bolster the resilience of the banking sector, banks have been asked to further strengthen their capital buffers, while we have augmented the bank solvency support facility.** Banks have presented plans to the BdP by which they intend to reach a core tier 1 capital ratio of at least 9 percent by end 2011 and 10 percent by end 2012 through internal means and market solutions. Banks will revise their capital plans on a quarterly basis. In the event that they cannot reach the targets on time through market based solutions, ensuring higher capital standards may temporarily require public provision of equity for the private

banks. In this regard we have increased the bank solvency support facility to €12 billion, as planned under the program. The banks benefitting from equity injections will be subjected to specific management rules and restrictions, and to a restructuring process in line with EU competition and state aid requirements.

19. **We have started to streamline the state-owned CGD group to increase the capital base of its banking arm as needed.** We plan to transfer the insurance arm of the group to a state entity, as a first step toward its eventual sale. Prior to the transfer, a new independent evaluation of its market value will be performed, to be completed by the time of the second review. On the basis of that evaluation, CGD's capital increase plan will be adjusted to ensure that all the necessary resources come from within the group, as it does not have recourse to the bank solvency support facility.

20. **The BdP has intensified its monitoring of the banking sector.** It stepped up the application of its Solvency and Deleveraging Assessment Framework (SDAF) for the system as a whole and for each of the eight largest banking groups. A joint team of experts from the EC, the ECB and the IMF completed an evaluation of the enhanced assessment framework in June 2011 and a timetable has been agreed upon for the implementation of most of the recommendations by the second and third reviews. The BdP will monitor the banks' potential capital needs on a quarterly basis, with a forward looking approach under stress conditions. The BdP has also launched a Special on-site Inspections Program (SIP) to validate the data on assets that banks provide as inputs to the SDAF. This process is overseen by a steering committee chaired by the BdP that comprises representatives from the EC, ECB and the IMF as well as from three euro area supervisory authorities, with participation from external consultants. The process should be completed by early 2012. In addition, disclosure of nonperforming loans is being improved by adding a new ratio aligned with international practices to the current ratio that covers only overdue loan payments.

21. **We have chosen a buyer for Banco Português de Negócios (BPN).** In order to conclude the deal, we understand that there are a number of issues to be cleared under EU competition and state aid rules. We will fully cooperate in these matters with the relevant authorities.

22. **Legislative amendments to strengthen the framework for early intervention, resolution, and deposit insurance will be adopted by end November 2011 (structural benchmark).** Amendments (prepared in consultation with the ECB, and EC and IMF staff) will grant the authorities adequate resolution tools (including recapitalization in accordance with the relevant EU framework and transfer of assets and liabilities) to orderly resolve banks under official control. To adequately fund such resolution, amendments will also (i) strengthen the availability of funding for the resolution by clarifying that the Deposit Guarantee Funds' (FGD and FGCAM) may contribute, if necessary, by funding the transfer of guaranteed deposits to another bank, up to the amount that would have to be paid out in liquidation (while removing their ability to recapitalize banks), and (ii) introduce a priority

insolvency ranking for guaranteed deposits. We will further examine the establishment of a resolution fund and the interaction between such a fund and the deposit guarantee funds in line with developing EU legislation in this area.

23. **The legal framework for corporate and household debt restructurings is being strengthened.** A review of the insolvency law is underway and the corporate insolvency law will be amended by end-December 2011 (structural benchmark) to better support early rescue of viable firms. The Ministry of Justice is taking the lead in preparing voluntary corporate out of court restructuring guidelines which will be issued by end-September 2011. Proposals to authorize the tax administration to use a wider range of restructuring tools are being prepared. Finally, we are developing an action plan to raise public awareness of the restructuring tools available for early rescue and re-organization of viable firms.

24. **We are intensifying the monitoring of the corporate and household sectors.** Following up on recommendations from a recent IMF-EC-ECB technical assistance mission, the quarterly monitoring of the corporate and household sectors is being enhanced and we have started to prepare action plans to deal with the large debt overhang of these sectors, based on the assessment of existing support programs and market-based funding alternatives.

E. Enhancing Competitiveness through Structural Reforms

Labor Markets

25. **The government remains committed to fostering job creation and wage flexibility through a well-functioning labor market.** We strive for a timely and effective implementation of the measures described in the May 2011 MEFP:

- We have submitted to Parliament legislation to reform severance payments for new hires, aligning the payments of open-ended contracts with those of fixed-term contracts, reducing dismissal costs to 20 days per year of service, eliminating the three month minimum payment, and capping payments at 12 months of pay. The law is expected to enter into force by September 2011.
- Following consultation with social partners, we will prepare a draft law regulating the functioning of the employer-financed dismissal fund by end-September 2011.
- In line with our commitment to a sweeping employment protection reform over the next few quarters, we are giving careful consideration to ways of (i) extending the severance pay adjustment to include current employees without reducing accrued-to-date entitlements, and (ii) benchmarking to the EU average.

Fiscal Devaluation

26. **A major fiscal devaluation remains a key element in our strategy to boost price competitiveness.** To this end, we will incorporate, in the context of the 2012 budget, a fiscally neutral cut in the employers' rate of social contributions (SSC). The offsetting measures will be integrated in the context of the ongoing fiscal consolidation, to avoid piecemeal changes to the tax system. These offsetting measures will take into account the need to protect vulnerable consumers, and will allow for a buffer to address cyclical volatility in the fiscal balance. The reform will be finalized after consultation with the IMF, EC, and ECB in September, ahead of the finalization of the 2012 budget.

Competition Framework

27. **To encourage competition, the State will strongly reduce its direct involvement in private sector activities.** We have effectively abolished involvement through controlling shares or special rights of the State, while ensuring consumer protection and a level-playing field.

- Legislation adopted by Parliament in end-July eliminated “golden shares” of the government in publicly quoted companies. Going beyond our commitment in the MoU, we have amended the Framework Law of Privatization by repealing all provisions which allow for special rights of the State or other public bodies in the corporate management or control of private companies.
- To encourage entry of strategic investors, we have also amended the articles of the Privatization Law which gave the State power to set caps on the acquisition or voting rights in privatized companies. We have eliminated voting caps, and commit not to set acquisition caps beyond the initial privatization transaction. In EDP, where such provisions already exist, we have proposed increasing voting caps for any individual shareholder from 5 percent to 20 percent.
- The State or any public entity will not conclude shareholder agreements whose intention or effect is to hinder the free movement of capital. We commit to sell the remaining shares held by CGD in GALP, thereby withdrawing from the last remaining such agreement.
- We are preparing a new draft Competition Law, clearly separating rules on competition enforcement procedures and penal procedures and harmonized with the EU competition legal framework, which we expect to present for public consultation by end-September, and approve by end-December 2011. A new specialized Court on Competition, Regulation, and Supervision was established at end-June, to start functioning by end-March 2012.

- To strengthen the independence of regulators, we are preparing the terms of reference for an independent report by internationally recognized specialists on the main National Regulatory Authorities (NRAs), on the basis of which we will consider further changes to the regulatory framework. We will launch a call for a tender by end-October 2011, which would produce a report by end-March 2012.

28. We are taking bold steps to address excessive profits in non-contested markets and reduce the scope for rent-seeking behavior.

Telecommunications

- The spectrum auction rules will ensure that potential new entrants are not placed at a competitive disadvantage, by carrying out an assessment of possible distortions and anti-competitive behavior, and creating a level playing field in terms of access to national roaming and taking other measures, as detailed in the updated MoU.

Energy markets

- We will continue to press forward with measures described in the MoU to foster competition and to rationalize the additional costs associated with the production of electricity under the ordinary and special regimes.
- Beyond exploring measures to put downward pressure on policy costs, we remain committed to a rigorous analysis of the costs and consequences for energy prices of all future investments in renewables. Through these and other measures we will ensure the sustainability of the national electricity system, and avoid further unfavorable developments in the deficit in the energy sector.
- As to the Third EU Energy package, we commit to take the required steps to implement the provisions of the package, in particular concerning the powers of the regulator, by end-March 2012, as detailed in the MoU.

Services and regulated professions

- We will continue with reforms that facilitate the establishment and cross-border provision of services, allowing for a more integrated and competitive market. Following the recently approved legislation for the construction and real estate sectors, we will analyze the need for further amendments to the sectoral legislation to ensure that all unjustified restrictions are lifted.

Judicial Reforms

- 29. We recognize the urgent need to make the judicial system more effective.** To achieve our goal of resolving the backlog of cases within 2 years, we have

developed targeted measures based on the June 2011 audit. Given the pivotal role of enforcement agents in the debt enforcement process, as a new measure, we will strengthen the legal and institutional framework in line with international practice with a particular focus on the financing structure and authority of the oversight body, including adopting a decree law by end-2011 to ensure the body's full access to the enforcement case files.

30. **We are advancing with reforms to improve efficiency of the court system.** We will, by end-2011, conduct an assessment of court management with a view to speeding up court proceedings and improving cost efficiency. The new Courts on Competition Matters and Intellectual Property Rights will now become operational by end-March 2012. We have accelerated a comprehensive review of the Code of Civil Procedure and are now preparing a proposal in a consultative manner by end-2011 (structural benchmark) to analyze the experience with the new experimental regime, and building on such experience, to address the key areas for refinement. We are also strengthening alternative dispute resolution framework to facilitate out of court settlement. Finally, we have decided not to continue with planned extensions of experimental civil procedure regime to more courts, given the fiscal costs (May MEFP, Para 46).

31. **We are committed to putting in place a more sustainable and transparent budget for the judiciary.** In particular, we will publish, by end-January 2012, an annual plan for 2012 on the allocation of resources based on court by court performance data. Quarterly reports on recovery rates, duration and costs of corporate insolvency and tax cases for the third quarter of 2011 are being prepared and will now be published by end-October 2011.

F. Safeguard Assessment

32. **In line with the recommendations of an IMF safeguard mission, the BdP's governance structure will be reinforced.** We are committed to managing the resources provided by the international community in a transparent and prudent manner. To strengthen the Board's role in supervising the activities of its executive members, we will seek amendment of the BdP's organic law in order to codify independent oversight in line with new corporate governance models. The BdP will adopt internal regulations extending the supervisory responsibilities of the Audit Board to other tasks such as oversight of internal control functions, financial reporting, and audit.

33. **We will also conduct a review of Fund related transactions with the debt management agency (IGCP).** We have asked the Court of Auditors to conduct a special review of the IGCP's internal controls over foreign exchange transactions related to program disbursements. In addition, the IGCP has, at the request of the IMF, updated its investment policy which now requires that all in transactions related to Fund disbursements be undertaken with investment grade counterparties.

Table 1. Portugal: Quantitative Performance Criteria
(In billions of Euros, unless otherwise specified)

	Performance Criteria (unless indicated otherwise)							
	Jun-11		Sep-11	Dec-11	Indicative Targets			
	Program	Actual			Mar-12	Jun-12	Sep-12	Dec-12
1. Floor on the consolidated General Government cash balance (cumulative) 1/	-5.4	-5.1	-6.7	-10.3	-1.7	-3.9	-5.9	-7.6
2. Ceiling on accumulation of new domestic arrears by the General Government (continuous indicative target) 2/	...	...	0	0	0	0	0	0
3. Ceiling on the overall stock of General Government debt	175.9	167.9	175.9	175.9	189.4	189.4	189.4	189.4
4. Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by the general government. 3/	0	0	0	0	0	0	0	0

1/ Corresponds to an overall deficit of the General Government of €10,042 million on ESA 95 basis. Cumulative from January 1, 2011 for 2011, and cumulative from January 1, 2012 for 2012.

2/ Applies on a continuous basis. The indicative target will start applying with the end-September arrears data, to be compared to the end-August arrears data.

3/ Applies on a continuous basis from June 15 onwards.

Table 2. Portugal: Structural Conditionality

Measure	Timing	Status
Prior Actions		
1 Issue an instruction to general government units requiring that from January 1, 2012, (i) commitments must be controlled against available funds recorded in the accounting system and evidenced by authorized commitment documents ("cabimento") bearing valid commitment numbers; (ii) all other commitments would be considered illegal and not eligible for payment; and (iii) any public official incurring such illegal commitment or expenditure will be subject to specified penalties in accordance with the budget framework law.		
2 Issue an instruction to general government units to ensure that systems and procedures will comply, by end-December 2011, with the revised budget execution rule, as set out in the above instruction.		
Structural Benchmarks		
A. Strengthen financial stability and enhance banking sector monitoring:		
3 Design a program of special on-site inspections to validate the data on assets that banks provide as inputs to the solvency assessment.	End-Jun. 2011	Met
4 Seek evaluation of the enhanced solvency and deleveraging assessment framework by a joint team of experts from the EC, the ECB and the IMF.	End-Sep. 2011	Met
5 Improve disclosure on non-performing loans by adding a new ratio aligned with international practices to the current ratio that covers only overdue loan payments.	End-Sep. 2011	Met
6 Amend relevant legislation in consultation with the EC, the ECB and the IMF to strengthen the early intervention framework, introduce a regime for restructuring of banks as a going concern under official control and strengthen deposit insurance framework	End-Nov. 2011	
7 Amend the Insolvency Law to better facilitate effective rescue of viable firms	End-Dec. 2011	
B. Enhance competitiveness:		
8 Eliminate "golden shares" and all other special rights established by law or in the statutes of publicly quoted companies that give special rights to the state.	End-Jul. 2011	Met
9 Submit to Parliament a law, already agreed with social partners, to align and reduce severance payments on all new contracts (fixed term and open-ended).	End-Jul. 2011	Met
10 Finalize calibration of fiscal reform to reduce unit labor costs via deficit-neutral reduction in labor taxes.	End-Jul. 2011	Not met 1/
11 Submit to Parliament legislation revising the Competition Law, making it as autonomous as possible from the Administrative Law and the Penal Procedural Law and more harmonized with the European Union competition legal framework.	End-Dec. 2011	
12 Review the efficiency of support schemes for co-generation and renewables and propose possible options for reducing the implicit subsidy.	End-Dec. 2011	
13 Review the Code of Civil Procedure and prepare a proposal addressing the key areas for refinement.	End-Dec. 2011	
14 Take all necessary legal, administrative, and other steps to make arbitration fully operational.	End-Feb. 2012	
C. Strengthen public financial management and reduce fiscal risks:		
15 Publish a fiscal strategy document for the general government which will specify 4-year medium-term economic and fiscal forecasts, supporting analysis and underlying assumptions, and 4-year costings of new policy decisions.	End-Aug. 2011	
16 Conduct and publish the results of a survey of arrears of general government entities and SOEs for all categories of expenditure as at end-June 2011.	End-Aug. 2011	
17 Based on assessment from EU/IMF technical assistance on the budgetary implications of main PPP programs, recruit a top tier international accounting firm to complete a more detailed study of PPPs and identify areas for deeper analysis by an international consulting firm.	End-Dec. 2011	
18 Prepare a report on SOEs based on forecast financial statements assessing their financial prospects, potential government exposure, and scope for orderly privatization.	End-Feb. 2012	

1/ A study highlighting key design issues and a number of options for achieving a reduction in labor taxes has been published. Further discussion with the EC, ECB, and IMF is needed ahead of the finalization of the 2012 budget.

ATTACHMENT II: PORTUGAL—TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

September 1, 2011

1. This Technical Memorandum of Understanding (TMU) sets out the understandings regarding the definitions of the indicators subject to quantitative targets (performance criteria and indicative targets), specified in the tables annexed to the Memorandum of Economic and Financial Policies. It also describes the methods to be used in assessing the Program performance and the information requirements to ensure adequate monitoring of the targets. We will consult with the EC, the ECB, and the IMF before modifying measures contained in this letter or adopting new measures that would deviate from the goals of the Program, and provide the EC, the ECB, and the IMF with the necessary information for Program monitoring.
2. For Program purposes, all foreign currency-related assets, liabilities, and flows will be evaluated at “Program exchange rates” as defined below, with the exception of the items affecting government fiscal balances, which will be measured at spot exchange rate (i.e., the rate for immediate delivery) prevailing on the date of the transaction. The Program exchange rates are those that prevailed on May 5, 2011. In particular, the exchange rates for the purposes of the Program are set €1 = 1.483 U.S. dollar, €1 = 116.8390 Japanese yen, €1.09512 = 1 SDR.
3. For reporting purposes, the MoF and BdP will employ the reporting standards and templates considered to be appropriate given the transmission of data covered by this TMU, unless otherwise stated or agreed with the EC, the ECB and the IMF.

General Government

4. **Definition:** For the purposes of the Program, the General Government, as defined in the Budget Framework Law, Law No. 91/2001 of August 20, amended by Law 22/2011 of May 20, includes:
 - 4.1. The Central Government. This includes:
 - 4.1.1. The entities covered under the State Budget, which covers the budgets of the Central Administration, including the agencies and services that are not administratively and financially autonomous, agencies and services that are administratively and financially autonomous (*Serviços e Fundos Autónomos* – SFA).
 - 4.1.2. Other entities, including Incorporated State-owned enterprises (ISOE), or extra-budgetary funds (EBF) not part of the State Budget, but which are, under the European System of Accounts (ESA95) and ESA95 Manual on Government

Deficit and Debt rules, classified by the National Statistical Institute (INE) as part of the Central Government.

- 4.2. Regional and Local Governments, that include:
 - 4.2.1. Regional Governments of Madeira and Azores and Local Governments (*Administrações Regionais and Locais*);
 - 4.2.2. Regional and local government-owned enterprises or companies, foundations, cooperatives and other agencies and institutions, which are, under the ESA95 and ESA95 Manual on Government Deficit and Debt rules, classified by the INE as Local Government.
- 4.3. Social Security Funds comprising all funds that are established in the general social security system.
- This definition of General Government also includes any new funds, or other special budgetary and extra budgetary programs or entities that may be created during the Program period to carry out operations of a fiscal nature and which are, under the ESA95 and ESA95 Manual on Government Deficit and Debt rules, classified by the INE in the correspondent subsector. The MoF will inform the EC, ECB, and IMF of the creation of any such new funds, programs, entities or operations at the time of its creation or statistical re-classification or, in the case of Regional and Local Governments, at the time the Government acknowledges its creation.
- The General Government, as measured for purposes of Program monitoring in 2011, shall not include entities nor operations that are re-classified into General Government during the remainder of 2011.¹ In 2012, it shall not include entities or operations (including pension funds) that are re-classified into General Government during 2012, but shall include those reclassified in 2011.²

5. **Supporting material**

- 5.1. Data on cash balances of the State Budget will be provided to the EC, the ECB and the IMF by the MoF within three weeks after the end of the month. Data will

¹ An operation refers to part of a legal entity that is involved in the production or delivery of goods and services—including government services provided on a nonmarket basis. As such, it does not include transactions relating to the assets or liabilities of an entity. For example, should an entity handle a number of PPPs, reclassifying only one PPP would be considered as reclassifying an operation. In contrast, taking over part of an entity's debt by the government would not qualify for the exclusion.

² On this issue, see also paragraph 13.

include detailed information on revenue and expenditure items, in line with monthly reports that are published by the MoF.

- 5.2. Data on the cash balances of the other parts of General Government as defined in paragraph 4³ will be provided to the EC, the ECB and the IMF by the MoF within seven weeks after the end of the month. Data will include detailed information on revenue and expenditure items. Data will also include detailed information on PPP-related revenues and expenditures for those PPP reclassified within the General Government sector according to ESA 95, and called guarantees.
- 5.3. Data on domestic and external debt redemptions (securities), new domestic and external debt issuance (securities), change in the domestic and foreign currency assets and liabilities of the Central Government at the BdP and other financial institutions will be provided to the EC, the ECB, and the IMF by the BdP within 40 days after the closing of each month.
- 5.4. BdP will provide to the EC, the ECB, and the IMF detailed monthly data on the financing of the General Government, as defined in ESA95, within seven weeks after the closing of each month.

QUANTITATIVE PERFORMANCE CRITERIA, INDICATIVE CEILINGS, AND CONTINUOUS PERFORMANCE CRITERIA: DEFINITIONS AND REPORTING STANDARDS

A. Floor on the Consolidated General Government Cash Balance (Performance Criterion)

6. **Definition:** The consolidated General Government cash balance (CGGCB) is defined as the sum of the cash balances of the entities covered by the State Budget, the ISOE, the Regional and Local Governments, and the Social Security Funds, and other entities and EBFs, as defined in paragraph 4. Privatization receipts will be excluded from cash receipts. In 2012, revenues from the reclassification of pension funds into the general government will not be accounted for as cash revenues for the purpose of the calculation of the consolidated general government cash balance. The net acquisition of financial assets for policy purposes, including loans and equity participation will be recorded as cash expenditures, except for transactions related to the banking sector support and restructuring strategy under the Program. Called guarantees (excluding those related to the banking sector support and restructuring strategy), where entities of the General Government make cash payments on

³ In 2011, data exclude regional and local government-owned enterprises or companies, foundations, cooperatives and other agencies and institutions, which are, under the ESA95 and ESA95 Manual on Government Deficit and Debt rules, classified by the INE as Local Government, i.e., entities referred in paragraph 4.2.2.

behalf of entities that are not part of the General Government, will be recorded as cash expenditures.

6.1. The cash balance of the State Budget. The cash balance of the State Budget will be measured from above the line, based on budget revenues (recurrent revenue plus nonrecurrent revenue, including EU revenues, minus tax refunds) minus budget expenditures of the State Budget as published monthly on the official website of the DGO of the MoF, and in line with the corresponding line items established in the State Budget. Budget expenditures will exclude amortization payments but include salaries and other payments to staff and pensions; grants to Social Security Funds, medical care and social protection; operational and other expenditure, interest payments; cash payments for military equipment procurement; and EU expenses.

6.2. The cash balance of the Regional and Local Governments, Social Security Funds, ISOE and other entities or EBFs. The cash balance of each of these parts of the General Government will be measured from above the line, based on revenues minus expenditures as it will be provided by the DGO of the MoF in the monthly General Government budget execution report (see Para 5), and in line with the corresponding line items established in their respective budgets. All entities including ISOE that prepare accrual-based financial statements will submit monthly cash flow statement in accordance with form and content specified by the MoF. The reporting by Local Government will be phased as set out in paragraph 8 below.

6.3. The change in the stock of arrears of all entities of the General Government. The stock of arrears, defined according to the definition below, as at June 30, 2011 will be measured through a survey and the results of the survey will be published by end-August 2011. From September 2011 onwards monthly report of arrears of the General Government will be published referring to the end of the period stock. Data will be in line with the monthly publications of State Budget arrears, published on the MoF website.

Other provisions

7. For the purpose of the program, the expenditure of the central government that is monitored excludes payments related to bank support, when carried out under the program's banking sector and restructuring strategy. However, any financial operation by central government to support banks, including the issuance of guarantees or provision of liquidity, will be immediately reported to the EC, ECB, and IMF.

8. Quarterly consolidated accounts for the General Government on a cash basis will be reported for internal, EC, ECB, and IMF monitoring 7 weeks after the reference period, starting with the first quarter of 2012. The reports will be published externally starting with December 2011 data. SOEs will be consolidated with the general government accounts starting with the first quarter 2012. The larger municipalities (defined as those with a population of 100,000 voters or more) are required to provide monthly reports under current

arrangements, and their cash balance will be included in the calculation of the monthly cash General Government balance. The cash balance of the smaller municipalities, i.e. those with a population of under 100,000 voters, will be excluded until any necessary legal changes requiring them to provide monthly reports have been put in place. In this transitory period, the MoF will provide a monthly estimate of the cash balance of these smaller municipalities excluded from the General Government reports to the EC, the ECB, and the IMF.

9. **Supporting material**

9.1. Data on cash balances of the State Government, ISOEs, Regional and Local Government and Social Security Funds will be provided to the EC, the ECB and the IMF by the MoF within seven weeks after the end of each month. The information provided will include general government net acquisitions of financial assets for policy purposes, including loans and equity participations, as well as called guarantees where entities that are part of the General Government make cash payments on behalf of entities that are not part of the General Government.

9.2. The MoF will submit quarterly data on General Government accounts determined by the INE in accordance with ESA 95 rules, showing also the main items of the transition from cash balances to the General Government balances in national accounts. The reconciliation will be accompanied by necessary explanatory materials for any indication of potential deviation of the annual general government cash target from the annual general government accrual target determined in accordance with ESA 95 rules.

B. Non-Accumulation of New Domestic Arrears by the General Government (Continuous Indicative Target)

10. **Definitions.** Commitment, liabilities, payables/creditors, and arrears can arise in respect of all types of expenditure. These include employment costs, utilities, transfer payments, interest, goods and services and capital expenditure. Commitments are explicit or implicit agreements to make payment(s) to another party in exchange for that party supplying goods and services or fulfilling other conditions. Commitments can be for specific goods and services and arise when a formal action is taken by a government agency, e.g., issuance of a purchase order or signing a contract. Commitment can also be of a continuing nature that require a series of payments over an indeterminate period of time and may or may not involve a contract, e.g. salaries, utilities, and entitlement payments. Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources (usually cash) embodying economic benefits or service potential. In relation to commitment, the liability arises when a third party satisfies the terms of the contract or similar arrangement. Payables/creditors are a subset of liabilities. For the purposes of the program payables/creditors exclude provisions and accrued liabilities. Arrears are a subset of payables/creditors. For the purposes of the Program domestic arrears are defined as payables/creditors that have remained unpaid for 90 days or more beyond any

specified due date (regardless of any contractual grace period). In case no due date is specified, arrears are defined as payables/creditors that have remained unpaid for 90 days or more after the date of the invoice or contract. Data on arrears will be provided within seven weeks after the end of each month. The continuous indicative target of non-accumulation of new domestic arrears requires that the total arrears at the end of any month are not greater than the corresponding total at the end of the previous month. Furthermore, in line with quantitative targets to be established at the time of the first review, the existing stock of arrears will be settled or otherwise reduced. This also includes arrears that are being accumulated by the SOEs not included in the General Government under ESA95 and ESA95 Manual on Government Deficit and Debt rules classification.

11. **Supporting material.** Starting in September 2011, the MoF will provide consistent data on monthly expenditure arrears of the General Government, as defined above. Data will be provided within seven weeks after the end of each month and will include total arrears classified by the different constituent sectors of the General Government sub-sector as defined in paragraph 4. The indicative target will start applying with the end-September arrears data, to be compared to the end-August arrears data—based on the same perimeter with respect to the entities covered.

C. Ceiling on the Overall Stock of General Government Debt (Performance Criterion)

12. **Definition.** The overall stock of General Government debt will refer to the definition established by Council Regulation (EC) No 479/2009 of 25 May 2009 on the application of the Protocol on the Excessive Deficit Procedure annexed to the Treaty establishing the European Community. For the purposes of the Program, the stock of General Government debt will exclude: (i) debt contracted for bank restructuring, when carried out under the Program's banking sector support and restructuring strategy; (ii) IGCP deposits; and (iii) (from end-September 2011) the *'prepaid margin'* on all EFSF loans.

13. **Adjusters.** For 2011, the ceiling of the overall stock of General Government debt will be adjusted upward (downward) by the amount of any upward (downward) revision to the stock at end-December 2010 general government debt of EUR160.47 billion. From 2012 onwards, the ceiling of the overall stock of General Government debt will be adjusted upward (downward) by the amount of any upward (downward) reclassification of entities or operations that affects the stock at end-December of the previous year.

14. **Supporting material.** Quarterly data on the total stock of General Government debt as defined in paragraph 12 will be provided to the EC, ECB and IMF by the BdP no later than 90 days after the end of each quarter, as reported to the ECB and the Eurostat. Monthly estimates will be provided to the EC, ECB and IMF by BdP no later than seven weeks after the end of each month.

D. Non-Accumulation of New External Debt Payments Arrears by the General Government (Continuous Performance Criterion)

15. **Definition.** For the purposes of the Program, the definition of debt is the same as in paragraph 12. An external debt payment arrear will be defined as a payment on debt to nonresidents, contracted or guaranteed by the general government, which has not been made within seven days after falling due (taking into account any applicable contractual grace period). The performance criterion will apply on a continuous basis throughout the Program period.

16. **Supporting material.** Any external debt payment arrears of the General Government will be immediately reported by the MoF.

E. Bank Solvency Support Facility

17. €1 billion has been provided in cash and is made available in a separate dedicated account to be set up at the Bank of Portugal by end-June 2011. Future amounts for the bank support fund will be deposited into the dedicated account to the extent that there is a need for bank capital.

F. Overall Monitoring and Reporting Requirements

18. Performance under the Program will be monitored from data supplied to the EC, the ECB, and the IMF by the MoF and BdP. The authorities will transmit to the EC, ECB, and IMF any data revisions in a timely manner.

19. Concerning the Central Administration, and Regional and Local Administrations owned companies not classified by INE within the General Government, the MoF will provide by end-September 2011 data on the 2010 financial statements reported under the Simplified Business Information framework, to be reported by end-June 2011.

APPENDIX III. LETTER OF INTENT

Lisbon, September 1, 2011

Mr Jean-Claude Juncker
President
Eurogroup

Mr. Jan Vincent Rostowski
Minister of Finance
Poland

Mr Olli Rehn
Commissioner
European Commission

Mr Jean-Claude Trichet
President
European Central Bank

Dear Sir

1. The Council granted financial assistance to Portugal (Council Implementing Decision 2011/344/EU of 17 May 2011) in support of our comprehensive adjustment and reform programme as laid down in the Memorandum of Economic and Financial Policies (MEFP) and in the Memorandum of Understanding on Specific Economic Policy Conditionality (MoU). The new government, which took office on 21 June 2011, is fully committed to the policies and objectives of the programme. In the attached update we describe progress and additional policy steps towards meeting the objectives of our economic programme.

2. Our policy implementation is mostly on track. All the quarterly quantitative performance criteria at end-June were met, along with the continuous criterion on external arrears. An inventory of domestic arrears is being completed (structural benchmark) and this will provide the quantitative basis for monitoring such arrears going forward. While tax revenue performance has been better than envisaged in the programme, expenditure overruns occurred in the first semester, which will require additional fiscal measures in the remainder of the year. The overruns also reinforce the need for stronger control and a clearly defined strategy for addressing fiscal risks from State-Owned Enterprises (SOEs). Our measures to address these challenges in the remainder of the year are laid out in the attached MEFP and MoU.

3. Structural benchmarks to strengthen competition, restore competitiveness, and foster growth have been met. We have abolished all special rights of the State in private companies. We will withdraw from the shareholder agreement in GALP, by committing to sell the remaining shares in GALP held by the state-owned CGD. We have also submitted to Parliament legislation

that brings about a substantial reduction in dismissal costs for new contracts. However, we have not yet finalised the calibration of the major reduction of social security contributions (SSC) towards a fiscal devaluation (end-July benchmark) and further discussion with the EC, ECB, and the IMF is needed ahead of the finalisation of the 2012 budget. We are also making progress on the other structural reforms foreseen in the programme, including of the energy, telecommunication and services sector and of the judicial system. We remain committed to an ambitious and frontloaded structural reform agenda to support the rebalancing of the economy. These are only the first steps in the implementation of our comprehensive and ambitious plans for structural reforms.

4. The Bank of Portugal (BdP), in close cooperation with the ECB, stands ready to ensure sufficient liquidity in the banking system, while banks continue their orderly deleveraging process and strengthen capital buffers. In line with the programme, we have augmented the existing package of support measures, by approving the issuance of government guaranteed bank bonds in an amount of up to €35 billion. The BdP has directed all banking groups subject to supervision in Portugal to reach a core Tier 1 capital of 9 percent by end-2011 and 10 percent at the latest by end-2012. We have found a buyer for BPN, and are taking important steps in strengthening capital in the core banking arm of CGD using the group's internal resources. We are strongly committed to our financial sector reform program and are prepared to forcefully tackle the challenges that lie ahead.

5. On the basis of the policies defined in this letter, we request completion of the first review of the Economic Adjustment Programme. We are confident that the policies described in the 17 May MEFP and MoU and in the attached updates are sufficient to achieve the objectives under the programme. We stand ready to take additional measures that may be needed to meet the objectives of the economic programme and will maintain a close policy dialogue with the IMF, the European Commission, and the ECB. We will consult in advance of any necessary revisions to the policies contained in this letter.

6. This letter is copied to Ms. Lagarde.

Sincerely yours,

/s/

Vítor Gaspar
Minister of State and Finance

/s/

Carlos da Silva Costa
Governor of the Banco de Portugal

Attachments: 1. Memorandum of Understanding (MoU);
2. Memorandum of Economic and Financial Policies (MEFP);
3. Technical Memorandum of Understanding (TMU)

**ATTACHMENT I. PORTUGAL: MEMORANDUM OF UNDERSTANDING ON
SPECIFIC ECONOMIC POLICY CONDITIONALITY**

First Review Update – 1 September 2011

With regard to Council Regulation (EU) n° 407/2010 of 11 May 2010 establishing a European Financial Stabilisation Mechanism (EFSM), and in particular Article 3(5) thereof, this Memorandum of Understanding details the general economic policy conditions as embedded in Council Implementing Decision 2011/344/EU of 17 May 2011 on granting Union financial assistance to Portugal.¹²

The first disbursement of financial assistance from the EFSM took place following the entry into force of the Memorandum of Understanding on specific economic policy conditionality (MoU) and of the Loan Agreement.

The Council Implementing Decision specifies that the release of further instalments is conditional on a positive conclusion of the reviews of conditionality that will take place throughout the three-year duration of the programme. These reviews will assess progress made with respect to the policy criteria in the Council Implementing Decision and specified in the MEFP and in this MoU, as well as Council Recommendations in the context of the Excessive Deficit Procedure.

The first quarterly review was carried out in August 2011. It assessed compliance with the conditions to be met by end-July and the need and scope for additional policy steps. This update of the MoU reflects the findings of the first review. The following reviews taking place in any given quarter will assess compliance with the conditions to be met by the end of the previous quarter.

If targets are missed or expected to be missed, additional action will be taken. The authorities commit to consult with the European Commission, the ECB and the IMF on the adoption of policies that are not consistent with this Memorandum. They will also provide the European Commission, the ECB and the IMF with all information requested that is available to monitor progress during programme implementation and to track the economic and financial situation. Prior to the release of the instalments, the authorities shall provide a compliance report on the fulfilment of the conditionality.

¹ The current version includes some limited changes made during the internal Commission approval process relative to the version agreed between the staff level mission team and the Portuguese authorities on 11 August.

² On 8 April 2011, Eurogroup and ECOFIN Ministers issued a statement clarifying that EU (European Financial Stabilisation Mechanism) and euro-area (European Financial Stability Facility) financial support would be provided on the basis of a policy programme supported by strict conditionality and negotiated with the Portuguese authorities, duly involving the main political parties, by the Commission in liaison with the ECB, and the IMF. Further to the EU support from the EFSM, loans from the European Financial Stability Facility (EFSF) will contribute to the financial assistance. The Loan Facility Agreement on the EFSF financing contribution specifies that the disbursements there under are subject to the compliance with the conditions of this Memorandum.

1. Fiscal policy

Objectives

Reduce the Government deficit to below EUR 10,068 million (equivalent to 5.9% of GDP based on current projections) in 2011, EUR 7,645 million (4.5% of GDP) in 2012 and EUR 5,224 million (3.0% of GDP) in 2013 by means of high-quality permanent measures and minimising the impact of consolidation on vulnerable groups; bring the government debt-to-GDP ratio on a downward path as of 2013; maintain fiscal consolidation over the medium term up to a balanced budgetary position, notably by containing expenditure growth; support competitiveness by means of a budget-neutral adjustment of the tax structure.

Fiscal policy in 2011

1.1. The Government will achieve a general government deficit of no more than EUR 10,068 millions in 2011. **[Q4-2011]**

1.2. Within the year, progress will be assessed against the (cumulative) quarterly ceilings for the consolidated General Government cash balance in the Memorandum of Economic and Financial Policies (MEFP), as defined in the Technical Memorandum of Understanding (TMU), without prejudice to full-year ESA-95 deficit targets. **[Q3 and Q4-2011]**

1.3. Over the remainder of the year, the government will rigorously implement the Budget Law for 2011 and the additional consolidation measures the government has announced since then.

1.4. With the information available as of early August, the Government has identified a projected shortfall for the year 2011 as a whole of about 1.3 percent of GDP, due in particular to (i) government support to several SOEs and Public-Private Partnerships (PPPs), and (ii) slippages in expenditure controls, mainly on employment costs and intermediate consumption. The recapitalisation costs related to the sale of Banco Português de Negócios (BPN) will add another 0.2 percent of GDP to the headline deficit. Excluding these recapitalisation costs, the shortfall is about 1.1 percent of GDP. To address this shortfall, the Government will take new measures as follows:

- i. A one-time surcharge in the context of the personal income tax in 2011 has already been approved. This new tax is projected to generate 0.5 percent of GDP in 2011, with an adjustment yielding 0.1 percent of GDP in 2012.
- ii. The increases in the VAT rates for natural gas and electricity to the standard rate which were foreseen for 2012 will be brought forward to 1 October 2011, generating additional revenues of 0.1 percent of GDP in 2011. These measures are still subject to Government approval. The Government will also endeavour to adopt other consolidation measures of a permanent nature and/or frontload other measures planned for next year.
- iii. Additional sales of concessions (including an augmented spectrum auction) will raise 0.4 percent of GDP in 2011.

- iv. The ongoing process of a phased transfer of banks' pension funds to the State social security system will exceptionally be used towards meeting the 2011 deficit target. The Government is committed not to use the acquired assets of these pension funds in a way which would undermine long-term sustainability.

Fiscal policy in 2012 and fiscal devaluation

1.5. The government will achieve a general government deficit of no more than EUR 7,645 millions in 2012. **[Q4-2012]**

1.6. Throughout the year, the government will rigorously implement the Budget Law for 2012. Within the year, progress will be assessed against the (cumulative) quarterly ceilings for the consolidated General Government cash balance in the Memorandum of Economic and Financial Policies (MEFP), as defined in the Technical Memorandum of Understanding (TMU), without prejudice to full-year ESA-95 deficit targets. **[Q1, Q2, Q3 and Q4-2012]**

1.7. The measures listed below, worth about 3 percent of GDP, will be carried out with the 2012 Budget Law **[Q4-2011]**, unless otherwise specified. Further measures, mostly on the expenditure side, will be taken to fill the gap arising from the shortfalls in 2011, and which could be about 0.6 percent of GDP. The Government will prepare an updated assessment of the budgetary situation and prospects in view of the discussion of the 2012 Budget with the European Commission, the IMF and the ECB before its approval by the Council of Ministers.

1.8. A major fiscal devaluation remains a key element in the Government's strategy to boost competitiveness. To this end, the 2012 budget will include a major fiscally neutral cut in the employers' rate of social contributions (SSC). The offsetting measures will be integrated in the context of the ongoing fiscal consolidation, to avoid piecemeal changes to the tax system, and will take into account the need to protect vulnerable consumers, and will allow for a buffer to address cyclical volatility in the fiscal balance. The reform will be finalised after consultation with the IMF, EC, and ECB in September, ahead of the finalisation of the 2012 budget **[October 2011]**.

Expenditure

1.9. Improve the working of the central administration by eliminating redundancies, increasing efficiency, reducing and eliminating services that do not represent a cost-effective use of public money. This should yield annual savings worth at least EUR 500 million. Detailed plans will be presented by the Portuguese authorities and will be assessed **by Q1-2012**; the budgetary impacts will spread to 2014. To this end, the government will:

- i. reduce the number of services while maintaining quality of provision;
- ii. create a single tax office and promoting services' sharing between different parts of the general government;
- iii. reorganise local governments and the provision of central administration services at local level;

- iv. regularly assess the value for money of the various public services that are part of the government sector as defined for national accounts purposes;
- v. promote mobility of staff in central, regional and local administrations;
- vi. reduce transfers from the State to public bodies and other entities;
- vii. revise compensation schemes and fringe benefits in public bodies and entities that independently set their own remuneration schemes;
- viii. reduce subsidies to private producers of goods and services.

1.10. Reduce costs in the area of education, with the aim of saving EUR 195 million by rationalising the school network by creating school clusters; lowering staff needs; centralising procurement; and reducing and rationalising transfers to private schools in association agreements.

1.11. Ensure that the aggregate public sector wage bill as a share of GDP decreases in 2012 and 2013 [**Q2-2012** for assessment; **Q2-2013** to complete process]:

- i. Limit staff admissions in public administration to achieve annual decreases in 2012-2014 of 1% per year in the staff of central administration and 2% in local and regional administration. [**Q3-2011**]
- ii. Freeze wages in the government sector in nominal terms in 2012 and 2013 and constrain promotions.
- iii. Reduce the overall budgetary cost of health benefits schemes for government employees schemes (ADSE, ADM and SAD) lowering the employer's contribution and adjusting the scope of health benefits, with savings of EUR 100 million in 2012.

1.12. Control costs in health sector on the basis of detailed measures listed below under 'Health-care system', achieving savings worth EUR 550 million.

1.13. Reduce pensions above EUR 1,500 according to the progressive rates applied to the wages of the public sector as of January 2011, with the aim of yielding savings of at least EUR 445 million.

1.14. Suspend application of pension indexation rules and freeze pensions, except for the lowest pensions, in 2012.

1.15. Reform unemployment insurance on the basis of detailed measures listed below under 'Labour market and education', yielding medium-term savings of around EUR 150 million.

1.16. Reduce transfers to local and regional authorities by at least EUR 175 million with a view to having this subsector contributing to fiscal consolidation.

1.17. Reduce costs in other public bodies and entities by at least EUR 110 million.

1.18. Reduce costs in State-owned enterprises (SOEs) with the aim of saving at least EUR 515 million by means of:

- i. sustaining an average permanent reduction in operating costs by at least 15%;
- ii. tightening compensation schemes and fringe benefits;

- iii. rationalisation of investment plans for the medium term;
- iv. increase their revenues from market activities.

1.19. Permanently reduce capital expenditure by EUR 500 millions by prioritising investment projects. Make more intensive use of funding opportunities provided by EU structural funds, while preserving the basic competitiveness approach agreed with the European Commission in the context of the current National Strategic Reference Framework (NSRF).

Revenue

1.20. Introduction of a standstill rule to all tax expenditure, blocking the creation of new items of tax expenditure and the enlargement of existing items. The rule will apply to all kinds of tax expenditure, of a temporary or permanent nature, at the central, regional or local level.

1.21. Reduction of *corporate* tax deductions and special regimes, with a yield of at least EUR 150 million in 2012. Measures include:

- i. abolishing all reduced corporate income tax rates;
- ii. limiting the deductions of losses in previous years according to taxable matter and reducing the carry-forward period to three years;
- iii. reducing tax allowances and revoking subjective tax exemptions;
- iv. curbing tax benefits, namely those subject to the sunset clause of the Tax Benefit Code, and strengthening company car taxation rules;
- v. proposing amendments to the regional finance law to limit the reduction of corporate income tax in autonomous regions to a maximum of 20% vis-à-vis the rates applicable in the mainland.

1.22. Reduction of *personal income tax* benefits and deductions, with a yield of at least EUR 150 million in 2012. Measures include:

- i. capping the maximum deductible tax allowances according to tax bracket with lower caps applied to higher incomes and a zero cap for the highest income brackets;
- ii. applying separate caps on individual categories by (a) introducing a cap on health expenses; (b) eliminating the deductibility of mortgage principal and phasing out the deductibility of rents and of mortgage interest payments for owner-occupied housing; eliminate interest income deductibility for new mortgages (c) reducing the items eligible for tax deductions and revising the taxation of income in kind;
- iii. proposing amendments to the regional finance law to limit the reduction of personal income tax in autonomous regions to a maximum of 20% vis-à-vis the rates applicable in the mainland.

1.23. Apply personal income taxes to all types of cash social transfers and ensure convergence of personal income tax deductions applied to pensions and labour income with the aim of raising at least EUR 150 million in 2012.

1.24. Changes in property taxation to raise revenue by at least EUR 250 million by reducing substantially the temporary exemptions for owner-occupied dwellings. Transfers from the central to local governments will be reviewed to ensure that the additional revenues are fully used for fiscal consolidation.

1.25. Raise VAT revenues, including through an increase in the efficiency of the VAT structure, to achieve a yield of at least EUR 410 million by:

- i. reducing VAT exemptions;
- ii. moving categories of goods and services from the reduced and intermediate VAT tax rates to higher ones;
- iii. proposing amendments to the regional finance law to limit the reduction of VAT in the autonomous regions to a maximum of 20% vis-à-vis the rates applicable in the mainland.

1.26. Increase excise taxes to raise at least EUR 250 million in 2012. In particular by:

- i. raising car sales tax and cutting car tax exemptions;
- ii. raising taxes on tobacco products;
- iii. indexing excise taxes to core inflation;
- iv. introducing electricity excise taxes in compliance with EU Directive 2003/96.

1.27. Increase efforts to fight tax evasion, fraud and informality to raise revenue by at least EUR 175 million in 2012.

Fiscal policy in 2013

1.28. The government achieves a general government deficit of no more than EUR 5,224 million in 2013. **[Q4-2013]**

1.29. Throughout the year, the government will rigorously implement the Budget Law for 2013. Within the year, progress will be assessed against the (cumulative) quarterly ceilings for the consolidated General Government cash balance in the Memorandum of Economic and Financial Policies (MEFP), as defined in the Technical Memorandum of Understanding (TMU), without prejudice to full-year ESA-95 deficit targets. **[Q1, Q2, Q3 and Q4-2013]**

1.30. The measures listed below will be carried out with the 2013 Budget Law **[Q4-2012]**, unless otherwise specified:

Expenditure

1.31. Further deepening of the measures introduced in the 2012 Budget Law with a view of reducing expenditure in the area of:

- i. central administration functioning: EUR 500 million. Detailed plans will be presented and assessed before Q3-2012;
- ii. education and school network rationalization: EUR 175 million;
- iii. wage bill: annual decreases of 1% per year in headcounts of central administration and 2% in local and regional administrations;
- iv. health benefits schemes for government employees: EUR 100 million.
- v. health sector: EUR 375 million;
- vi. transfers to local and regional authorities: EUR 175 million;
- vii. costs in other public bodies and entities, and in SOEs: EUR 175 million;
- viii. capital expenditure: EUR 350 million;
- ix. maintain the suspension of pension indexation rules except for the lowest pensions in 2013.

1.32. In addition, the government will extend the use of means testing and better target social support achieving a reduction in social benefits expenditure of at least EUR 350 million.

Revenue

1.33. Further deepening of the measures introduced in 2012 Budget Law, leading to extra revenue in the following areas:

- i. broaden corporate tax bases and reduce tax benefits and tax deductions: EUR 150 million;
- ii. personal income tax benefits and tax deductions: EUR 175 million;
- iii. taxation of all types of cash social transfers and convergence of personal income tax deductions for pensions and labour income: EUR 150 million;
- iv. excise taxes: EUR 150 million.

1.34. Update the notional property value of real estate assets for tax purposes to raise revenue by at least EUR 150 million in 2013. Transfers from the central to local governments will be reviewed to ensure that the additional revenues are fully used for fiscal consolidation.

Fiscal policy in 2014

1.35. The government will aim at achieving a general government deficit of no more than EUR 4,521 millions in 2014. The necessary measures will be defined in the 2014 Budget Law. **[Q4-2013]**

1.36. Within the year, progress will be assessed against the (cumulative) quarterly ceilings for the consolidated General Government cash balance in the Memorandum of Economic and Financial Policies (MEFP), as defined in the Technical Memorandum of Understanding (TMU), without prejudice to full-year ESA-95 deficit targets. **[Q1 and Q2-2014]**

1.37. With the 2014 Budget Law, the Government will further deepen the measures introduced in the 2012 and 2013 with a view in particular to broadening tax bases and moderating primary expenditure to achieve a declining ratio of government expenditure over GDP.

2. Financial sector regulation and supervision

Objectives

Preserve financial sector stability; maintain liquidity and support a balanced and orderly deleveraging in the banking sector; strengthen banking regulation and supervision; bring closure to the Banco Português de Negócios case and streamline state-owned Caixa Geral de Depósitos; strengthen the bank resolution framework and reinforce the Deposit Guarantee Fund and the Guarantee Fund for Mutual Agricultural Credit Institutions; reinforce the corporate and household insolvency frameworks.

Maintaining liquidity in the banking sector

2.1. Encourage banks to strengthen their collateral buffers and monitor the issuance of the government guaranteed bank bonds, which has been authorised up to EUR 35 billion in line with the EU State aid rules.

Deleveraging in the banking sector

2.2. Monitor the implementation of the medium-term plans in order to achieve a stable market-based funding position. Funding plans target a reduction in the loan-to-deposit ratio to about 120 percent and a reduction of the reliance on Eurosystem funding during the duration of the program, while ensuring adequate support to the more productive sectors of the domestic economy, including SMEs. The BdP and the ECB will ask banks to revise their funding plans by **end-September**. These funding plans will be reviewed ahead of the second review of the program with a view to ensure, in particular, consistency with the macroeconomic framework— including the medium-term plans for the public sector that are under development. The BdP will take appropriate action in case of deviations from the plans. Such reviews will be conducted quarterly in the future.

Capital buffers

2.3. BdP will follow closely the plans the banks presented to reach a core Tier 1 capital ratio of 9 percent by **end-2011** and 10 percent at the latest by **end-2012**. Banks will revise their capital plans on a quarterly basis. If needed, using its Pillar 2 powers, the BdP will also require some banks, based on their specific risk profile, to reach these higher capital levels on an accelerated schedule, taking into account the indications of the solvency assessment framework described below.

2.4. In the event that banks cannot reach the capital requirement thresholds on time, might temporarily require public provision of equity for the private banks through the established EUR 12 billion bank solvency support facility. The banks benefitting from equity injections will be subjected to specific management rules and restrictions, and to a restructuring process in line with EU competition and state aid requirements, that will provide the incentive to give priority to market-based solutions.

Caixa Geral de Depósitos (CGD)

2.5. The state-owned CGD group will be streamlined to increase the capital base of its core banking arm as needed. The insurance arm of the group will be transferred to a state entity, as a first step toward its eventual sale. Prior to the transfer, a new independent evaluation of its market value will be performed to be completed by the time of the **second review**. On the basis of that evaluation, CGD's capital increase plan will be adjusted to ensure that all the necessary resources come from within the group, as it does not have recourse to the bank solvency support facility.

Monitoring of bank solvency

2.6. The BdP will implement by the **second and third reviews** most recommendations on its Solvency and Deleveraging Assessment Framework (SDAF) formulated by a joint IMF, EC and ECB technical assistance mission in June 2011.

2.7. The BdP will complete the Special on-site Inspections Program (SIP) to validate the data on assets that banks provide as inputs to the SDAF. This process is overseen by a steering committee chaired by the BdP that comprises representatives from the EC, ECB and the IMF as well as from three euro area supervisory authorities with the participation of external consultants. The process and should be completed by **early 2012**.

2.8. The BdP will monitor quarterly banks' potential capital needs with a forward looking approach under stress conditions.

Banking regulation and supervision

2.9. BdP will ensure that the disclosure of non-performing loans is improved by adding a new ratio aligned with international practices to the current ratio that covers only overdue loan payments.³[Q3-2011]

Banco Português de Negócios

2.10. The authorities complete the process of selling Banco Português de Negócios (BPN) after clearance from EU competition and state aid authorities.

³ Structural benchmark in the Memorandum of Economic and Financial Policies.

2.11. Once the deal is concluded, the CGD's state guaranteed claims on BPN and all related special purpose vehicles will be taken over by the state according to a timetable to be defined at that time.

Bank resolution framework

2.12. The authorities are amending legislation concerning credit institutions in consultation with the EC, the ECB and the IMF before **end-November 2011** to, inter alia, impose early reporting obligations based on clear triggers and penalties. BdP will be authorised to take remedial measures to promote implementation of a recovery plan. Credit institutions with systemic risks will be required to prepare contingency resolution plans subject to regular review.⁴

2.13. The amendments will introduce a regime for the resolution of distressed credit institutions as a going concern under official control to promote financial stability and protect depositors.⁵ The regime will set out clear triggers for its initiation, and restructuring tools for the resolution authorities shall include recapitalization without shareholder pre-emptive rights in accordance with the relevant EU framework, transfer of assets and liabilities to other credit institutions and a bridge bank.

The deposit guarantee funds and resolution fund

2.14. The authorities amend the legislation on the Deposit Guarantee Fund (FGD) and on the Guarantee Fund for Mutual Agricultural Credit Institutions (FGCAM) and establish a resolution fund with a view to strengthen depositor protection and adequately fund resolution of distressed credit institutions, in consultation with EC, the ECB and the IMF, **by end-November 2011**.⁶ FGD and FGCAM's functions will be re-examined to strengthen protection of guaranteed depositors. These funds should retain the ability to contribute to funding, if necessary, the resolution of distressed credit institutions and in particular the transfer of guaranteed deposits to another credit institution, while removing their ability to recapitalise banks. Such financial assistance shall be capped at the amount of guaranteed deposits that would have to be paid out in liquidation. This should be permissible only if it does not prejudice their ability to perform their primary function.

2.15. The relevant legislation will be amended **by end-November 2011** to provide that guaranteed depositors and/or the funds (either directly or through subrogation) will be granted a higher priority ranking over unsecured creditors in the insolvent state of a credit institution.

⁴ Structural benchmark in the Memorandum of Economic and Financial Policies.

⁵ Structural benchmark in the Memorandum of Economic and Financial Policies.

⁶ Structural benchmark in the Memorandum of Economic and Financial Policies.

Corporate and household debt restructuring framework

2.16. To better facilitate effective rescue of viable firms, the Insolvency Law will be amended by **end-December 2011** with technical assistance from the IMF, to, inter alia, introduce fast track court approval procedures for restructuring plans.⁷

2.17. General principles on voluntary out of court restructuring in line with international best practices will be issued by **end-September 2011**.

2.18. The authorities will also take the necessary actions to authorise the tax and social security administrations to use a wider range of restructuring tools based on clearly defined criteria in cases where other creditors also agree to restructure their claims, and review the tax law with a view to removing impediments to voluntary debt restructuring.

2.19. The personal insolvency procedures will be amended to better support rehabilitation of financially responsible individuals, which will balance the interests of creditors and debtors.

2.20. The authorities will launch a campaign to raise public and stakeholder awareness of the restructuring tools available for early rescue of viable firms through, e.g., training and new information means.

Monitoring of corporate and household indebtedness

2.21. The authorities will prepare quarterly reports on corporate and household sectors including an assessment of their funding pressures and debt refinancing activities. The authorities will assess guarantee programmes currently in place and evaluate market-based financing alternatives. A task force will be constituted to prepare contingency plans to efficiently deal with the challenges posed by high corporate and household sectors indebtedness. These enhanced monitoring actions will put be in place by the **end of the second review** in consultation with the EC, the IMF and the ECB.

3. Fiscal-structural measures

Objectives

Improve the efficiency of the public administration by eliminating redundancies, simplifying procedures and reorganising services; regulate the creation and functioning of all public entities (e.g. enterprises, foundations, associations); streamline the budgetary process through the newly approved legal framework, including by adapting accordingly the local and regional financial legal frameworks; strengthen risk management, accountability, reporting and monitoring of all parts of the general government. Government action will build on the

⁷ Structural benchmark in the Memorandum of Economic and Financial Policies.

recommendations provided by the IMF/EU technical assistance mission that took place in July 2011.

Public Financial Management framework

To strengthen the public financial management framework the Government is taking the following measures:

Reporting

3.1. Apply the recently approved standard definition of arrears and commitments at all levels of government (central, local and regional). **[Ongoing]**.

3.2. Conduct and publish a comprehensive survey of arrears by **end-August 2011** covering all categories of expenditure payables as at the end of June 2011.⁸ All general government entities and SOEs classified outside the general government will be covered by this survey. The survey will be further enhanced by **September 2011** to include all transactions (including employment costs, utilities, interest costs, transfers to local and regional governments, goods and services, capital expenditure, and transfers of withheld taxes and social contributions to respective responsible collection agencies and institutions). Prepare a strategy for the settlement of arrears for the entities of general government, as well as SOE hospitals, **by end-September 2011**.

3.3. Enhance the existing monthly reporting on budgetary execution on a cash basis for the general government, including on a consolidated basis. The monthly reporting perimeter currently includes the State, Other public bodies and entities, Social Security, regional and local governments and it will be progressively expanded to include all SOEs and PPPs reclassified within the general government, regional and local governments. **[Q3-2011]**

3.4. Following the inventory on tax expenditures of June, the existing annual report on tax expenditures will be improved by **end-October**, starting with the 2012 budget, in line with international best practices. The report will cover central, regional and local administrations. Technical assistance may be provided if necessary.

3.5. Develop intra-annual targets, and corrective measures in case of deviation from targets, for **[Q3-2011]**:

- i. internal monthly cash balance, expenditure, revenue targets for the general government as defined in national accounts;
- ii. public quarterly balance targets for the general government as defined in national accounts.

3.6. Implement any changes to the budget execution rules and procedures necessary to align with the standard definition of arrears and commitments. Meanwhile, existing commitment control procedures will be enforced and where necessary strengthened for all types of

⁸ Structural benchmark in the Memorandum of Economic and Financial Policies.

expenditure across the general government including the regional and local administration. In particular:

- i. an instruction will be issued by **mid-September 2011** to general government units requiring that from January 1, 2012:⁹
 - o commitments must be controlled against available funds recorded in the accounting system and evidenced by authorized commitment documents (“*cabimento*”) bearing valid commitment numbers;
 - o all other commitments will be considered illegal and not eligible for payment; and
 - o any public official incurring such illegal commitment or expenditure will be subject to specified penalties in accordance with the budget framework law;
- ii. an instruction will be issued by **mid-September 2011** to general government units to ensure that systems and procedures will comply, by end-December 2011, with the revised budget execution rule, as set out in the above instruction;¹⁰
- iii. the Inspeção-Geral de Finanças (IGF) will ensure that the commitment control is operating effectively by **Q4-2011**.

3.7. Following the survey, prepare a consolidated monthly report on arrears for the general government sector. The general government perimeter will be defined as in national accounts. **[Q3-2011]**

3.8. Publish quarterly accounts for State-Owned Enterprises (SOEs) at the latest 45 days after the end of the quarter. It should start with the 30 largest SOEs that are consolidated in the general government but as a general rule all SOEs should follow the same reporting standards. **[Q4-2011]**

3.9. Publish information on: number of general government staff on a quarterly basis (no later than 30 days after the end of the quarter); stock and flows over the relevant period per Ministry or employment entity (i.e. new hiring, retirement flows, and exit to other government service, private sector or unemployment); average wage, allowances and bonuses. The regional and local administration will transmit the necessary information. Information on employment in SOEs (central, local and regional) and other public entities and/or bodies will also be compiled. **[Q1-2012]**

Monitoring

3.10. Apply the approved standard definition of contingent liabilities at all levels of government (central, local and regional). **[Ongoing]**

⁹ Prior action for the second disbursement in the Memorandum of Economic and Financial Policies.

¹⁰ Prior action for the second disbursement in the Memorandum of Economic and Financial Policies.

3.11. Publish a comprehensive report on fiscal risks each year as part of the budget, starting with the 2012 budget. The report will outline general fiscal risks and specific contingent liabilities to which the general government may be exposed, including those arising from Public-Private Partnerships (PPPs), SOEs and explicit guarantees to the banks. **[Q3-2011]**

Budgetary framework

3.12. Publish a fiscal strategy document for the general government by **end-August 2011** and annually thereafter in April for the Stability Programme. The document will specify 4-year medium-term economic and fiscal forecasts and 4-year costs of new policy decisions. Budgets will include a reconciliation of revisions to the 4 year fiscal forecasts attributable to policy decisions and parameter revisions e.g. policy decisions, changes in the macroeconomic environment.¹¹

3.13. Following the recommendations of the July technical assistance mission, ensure full implementation of the Budgetary Framework Law adopting the necessary legal changes:**[Q3-2011]**

- i. The general government perimeter will cover the State, Other public bodies and entities, Social Security, SOEs and PPPs reclassified within the general government and local and regional administrations.
- ii. Define in detail the proposed characteristics of the medium-term budgetary framework, including medium-term fiscal strategy, decision-making and prioritisation process, carry over rules, commitment controls; and appropriate contingency reserves and related access rules. **[Q3-2011]**

3.14. The budgetary frameworks at local and regional levels will be considerably strengthened, in line with recommendations by the IMF/EC technical assistance mission:

- i. A proposal to revise the local and regional finance laws will be submitted to Parliament, in consultation with regional and local governments, in order to fully adapt the local and regional financing framework to the principles and rules in the recently revised Budgetary Framework Law, namely in what concerns (i) the inclusion of all relevant public entities in the perimeter of local and regional government; (ii) the multi-annual framework with expenditure, budget balance and indebtedness rules, and programme budgeting; and (iii) the interaction with the function of the Fiscal Council. The revision will also foresee that: (i) the Fiscal Council reviews local and regional governments own revenue projections and multi-annual fiscal plans and (ii) a contingency reserve is included under the overall current expenditure envelope as a buffer against negative revenue surprises or erroneous expenditure planning. **[Q4-2011]**
- ii. The revision of the regional and local finance laws will also strengthen fiscal accountability, in particular by: i) tighter financial requirements for regional

¹¹ Structural benchmark in the Memorandum of Economic and Financial Policies.

and local SOEs and other regional and local public bodies; ii) a revision of the regime of transfers between the State and the regions and the local authorities; iii) strengthening the supervisory power from the State on budgetary execution and iv) apply tighter debt ceilings combined with the adoption of a multi-tiered monitoring system as suggested by the July technical assistance mission. This reform should follow international best practices. **[Q4-2011]**

3.15. The forecast underpinning the preparation of the budget and of the fiscal strategy document will be published, including supporting analysis and underlying assumptions. **[Q4-2011, Q3-2011]**

3.16. Adopt the Statutes of the Fiscal Council. **[Q3-2011]** The Fiscal Council will be operational by **[Q4-2011]**.

Public Private Partnerships

The Government will:

3.17. Avoid engaging in any new PPP agreement before the completion of the reviews on existing PPPs and the legal and institutional reforms proposed (see below). **[Ongoing]**

3.18. Following the recommendations of the July technical assistance mission, perform an initial assessment of at least the 20 most significant PPP contracts, including the major *Estradas de Portugal* PPPs, covering a wide range of sectors. **[end-August 2011]**

3.19. The Government will recruit a top tier international accounting firm to undertake a more detailed study of PPPs in consultation with INE and the Ministry of Finance.¹² The review will identify and, where practicable, quantify major contingent liabilities and any related amounts that may be payable by the Government. It will assess the probability of any payments by Government in relation to the contingent liabilities and quantify such amounts. The study, to be completed by **end-March 2012**, will assess the feasibility to renegotiate any PPP or concession contract to reduce the Government financial obligations. All PPPs and concession contracts, including those undertaken by regional authorities, will be available for these reviews. **[Q4-2011]**

3.20. Put in place a strengthened legal and institutional framework, within the Ministry of Finance, for assessing fiscal risks *ex-ante* of engaging into PPP, concessions and other public investments, as well as for monitoring their execution. The Court of Auditors must be informed of this *ex-ante* risk assessment. Technical assistance may be provided if necessary. **[Q1-2012]**

3.21. Enhance the annual PPP and concessions report prepared by the Ministry of Finance in July with a comprehensive assessment of the fiscal risks stemming from PPPs and concessions. The report will provide information and analysis at sectoral level. The annual review of PPPs and concessions will be accompanied by an analysis of credit flows channelled to PPPs through banks (loans and securities other than shares) by industry and an

¹² Structural benchmark in the Memorandum of Economic and Financial Policies.

impact assessment on credit allocation and crowding out effects. This particular element will be done in liaison with the Bank of Portugal. **[Q2-2012]**

State-owned enterprises¹³

3.22. A report on concrete plans to reduce the overall operating costs of central government 10 State-owned enterprises (SOEs) posing the largest potential fiscal risks to the State by at least 15% over the 2009 levels and on a planned review of the tariff structure was presented in May. Measures taken in relation to SOEs will respect EU competition and State aid rules.

3.23. Implement ongoing plans to reduce operational costs of central government SOEs outside the health care sector by at least 15% on average compared with 2009 by the end of 2011. **[Q4 2011]**. For local and regional government SOEs equivalent company-specific cuts of 15 % of operational costs will be presented by **end-September 2011**.

3.24. All but the most problematic SOEs will reach an operational balance by **end-2012**. To this end the government will prepare a comprehensive SOEs strategy document by **end-September 2011** reviewing the tariff structure and service provision of central, local and regional government SOEs, with numerical targets on cost reductions, including measures to realign wages or reduce employment, and further tariff increases as needed. The review of SOEs operations and finances will be an input to the 2012 budget.

3.25. The government will prepare a plan to tighten borrowing requirements for central, regional and local SOEs from 2012 onwards by **September 2011**.

3.26. Prepare a plan to strengthen governance of SOEs in accordance with international best practices. The plan will review the existing shareholder approach, giving the Ministry of Finance a decisive role in financial matters of the enterprises, including in regional and local SOEs. **[Q4-2011]**

3.27. Prepare a report reviewing the operations and finances of SOEs at central, regional and local government levels. The report will assess these companies' business financial prospects, the potential exposure of the government and scope for orderly privatisation. The government will adopt the necessary legal changes to fulfil this requirement. Technical assistance will be provided.¹⁴ **[Q1-2012]**

3.28. No additional SOEs at central, regional and local government level will be created until this review is completed. **[Ongoing]**

3.29. The Government will submit to Parliament a draft law to regulate the creation and the functioning of SOEs at the central and local levels. The law will enhance the monitoring powers of the central administration over all SOEs. In addition, the timing and content of financial and operational reporting will be defined. The decisions adopted at central level to improve the efficiency of the enterprises while reducing their financial burden will be implemented at all SOEs, taking into account their specificities. The government will

¹³ State-owned enterprises comprise those pertaining to central, local and regional administration.

¹⁴ Structural benchmark in the Memorandum of Economic and Financial Policies.

promote the initiatives needed so that the same objective is achieved by the regions. **[Q4-2011]**

3.30. MoF will prepare a complement to the annual SOEs report published in July on local SOEs by **end-October 2011**. A separate report on regional SOEs will be prepared by each region by **end-October 2011**. As of next year, the annual SOEs report prepared by the MoF **in July** will include all SOEs (at central, local and regional levels) and a comprehensive fiscal risk analysis of all liabilities (explicit and implicit). **[July-2012]**

Privatisation

3.31. The Government is pushing ahead with its privatisation programme. Public sector shares in EDP, REN, GALP and, if market conditions permit, TAP, will be sold **by the end of the 2011**. The divestments will be done under the new framework law for privatisation). Aguas de Portugal and RTP have been included for privatization **by end-2012**, in addition to enterprises identified for sale under the broader strategy of comprehensive SOE restructuring. The privatisation plan through 2013, covers also Aeroportos de Portugal, the freight branch of CP, Correios de Portugal and Caixa Seguros, as well as a number of smaller firms. The plan targets front-loaded proceeds of about €5 billion through the end of the program.

3.32. By **end-2011**, a strategic privatisation plan for Parpublica will be prepared, given that its sources of income will be affected by privatisation. The plan will reconsider the role of Parpublica as a public company, including eliminating the obligation to remit the proceeds of the sale of assets to the Treasury in return for new assets, and considering the possibility of winding down the company or consolidating it with the general government. In the interim, the government will ensure that Parpublica will have sufficient income-generating assets to manage its debt and financing needs.

3.33. Prepare an inventory of assets, including real estate, owned by municipalities and regional governments, examining the scope for privatisation. **[Q2-2012]**

Revenue administration

3.34. The Government will merge the tax administration, customs administration and the information technology service DGITA in a single entity **[complete design of the new structure by Q4-2011 and implement it by Q4-2012]** and study the costs and benefits of including the revenue collection units of the social security administration in the merge. **[Q3-2011]** It will proceed with the broader merge if the assessment is favourable **[Q1-2012]**;

3.35. Further comprehensive reform plans will be prepared by **October 2011**, including the following elements: **[Q4-2011]**

- i. Establishing special chambers within the tax tribunals, specialised to handle large cases and assisted by a specialised technical staff pool; **[Q1-2012]**
- ii. Reducing the number of municipal offices by at least 20% per year in 2012 and 2013; **[Q4-2012 and Q4-2013]**
- iii. Increase in the resources devoted to auditing in the tax administration to at least 30% of the total staff, mostly through reallocations of staff within the tax

administration and other parts of the public administration. The threshold should be attained by **Q4-2012**.

3.36. The Government will address the bottlenecks in the tax appeal system by:

- i. Reviewing the assessment of audit performance based on both qualitative and quantitative indicators; **[Q3-2011]**
- ii. Applying interest charges on the outstanding debt over the whole appeal period using an interest rate above market levels. Impose a special statutory interest on non-compliance with a tax court decision; **[Q4-2011]**
- iii. Implement the new tax arbitration law by **Q3-2011**;
- iv. Establishing an integrated IT system between the revenue administration and the tax courts; **[Q4-2011]**
- v. Clearing cases worth above EUR 1 million by **Q4-2012** with the support of the tax court judges.

3.37. The Government will submit to Parliament a law to strengthen the auditing and enforcement powers of the central tax administration to exercise control over the whole territory of the Republic of Portugal including currently exempt tax regimes and to reserve to the central administration the power to issue interpretative rulings on taxes with national scope in order to ensure its uniform application. **[Q4-2011]**

3.38. Prepare a report assessing the current state of the information systems in the tax administration and proposing reforms. **[Q3-2011]**

3.39. The tax administration will prepare a comprehensive strategic plan for 2012-2014. The plan will include concrete actions to combat tax fraud and evasion, to strengthen audit and enforce collection based on risk management techniques. **[end-October 2011]**

Public administration

The Government will take the following measures to increase the efficiency and cost-effectiveness of the public administration:

Central, regional and local administration

3.40. Reduce management positions and administrative units by at least 15% in the central administration. **[Q4-2011]** The draft legislation will be submitted to the Council of Ministers by **end-October 2011**.

3.41. In view of improving the efficiency of the central administration and rationalising the use of resources, implement a second phase of the public administration restructuring programme (PREMAC). **[Q4-2011]**

3.42. In view of improving the efficiency of local administration and rationalising the use of resources, the Government will submit to Parliament a draft law by **Q4-2011** so that each municipality will have to present its plan to attain the target of reducing their management positions and administrative units by at least 15% by the end of 2012. **[Q2-2012]** In what

concerns regions, the Government will promote the initiatives needed so that each region will present its plan to attain the same target. **[Q4-2011]**

3.43. In conjunction with the review of SOEs (see above), prepare a detailed cost/benefit analysis of all public and quasi-public entities, including foundations, associations and other bodies, across all levels of government. **[Q4-2011]** Based on the results of this analysis, the administration (central, regional or local) responsible for the public entity will decide to close or to maintain it in respect of the law (see below). **[Q1-2012]**

3.44. Regulate by law the creation and the functioning of foundations, associations, and similar bodies by the central and local administration. This law, which will also facilitate the closure of existing entities when warranted, will be prepared in coordination with a similar framework to be defined for SOEs. The law will define the monitoring and reporting mechanisms and evaluation performance. Starting with the 2012 Budget, the number of SFAs will be reduced. The law will also aim at classifying as general government revenues, on a case-by-case basis, all own revenues of these funds that arise directly or indirectly from the use of the sovereign powers of the government (e.g. court fees, fines, fees for licenses or permits, and audit fees charged by the Court of Auditors). In addition, the Government will promote the initiatives needed so that the same objective is achieved by the regions. **[Q4-2011]**

3.45. Reorganise local government administration. There are currently 308 municipalities and 4,259 parishes. By **July 2012**, the government will develop a consolidation plan to reorganise and significantly reduce the number of such entities. The Government will implement these plans based on agreement with EC and IMF staff. These changes, which will come into effect by the beginning of the next local election cycle, will enhance service delivery, improve efficiency, and reduce costs.

3.46. Carry out a study to identify potential duplication of activities and other inefficiencies between the central administration, local administration and locally-based central administration services. **[Q4-2011]** Based on this analysis, reform the existing framework to eliminate the identified inefficiencies. **[Q2-2012]**

Shared services

3.47. Develop the use of shared services in the central administration by fully implementing the ongoing projects and by regularly assessing the scope for further integration:

- i. Fully implement the strategy of shared services in the area of financial (GeRFIP) and human resources (GeRHup). **[Q2-2012]**
- ii. Rationalise the use of IT resources within the central administration by implementing shared services and reducing the number of IT entities in individual Ministries or other public entities. **[Q4-2012]**

3.48. Reduce the number of local branches of line ministries (e.g. tax, social security, justice). The services should be merged in citizens' shops covering a greater geographical area and developing further the e-administration over the duration of the programme. **[Q4-2013]**

Human resources

3.49. Prepare a comprehensive plan to promote flexibility, adaptability and mobility of human resources across the administration, including by providing training where appropriate. **[Q4-2011]**

3.50. Limit staff admissions in public administration to achieve annual decreases in 2012-2014 of 1% per year in the staff of central administration and 2% in local and regional administrations. The Government will submit to Parliament a draft law to implement this measure at local administration level and will promote the initiatives needed so that each region will present its plan to achieve the same target. **[Q3-2011]**

Health care system

Objectives

Improve efficiency and effectiveness in the health care system, inducing a more rational use of services and control of expenditures; generate additional savings in the area of pharmaceuticals to reduce the public spending on pharmaceutical to 1.25 per cent of GDP by end 2012 and to about 1 per cent of GDP in 2013 (in line with EU average); generate additional savings in hospital operating costs and devise a strategy to eliminate arrears.

The Government will take the following measures to reform the health system:

Financing

3.51. Review and increase overall NHS moderating fees (*taxas moderadoras*) through:

- i. a substantial revision of existing exemption categories, including stricter means-testing in cooperation with Minister of Social Security; **[by September-2011]**
- ii. increase of moderating fees in certain services while ensuring that primary care moderating fees are lower than those for outpatient specialist care visits and lower than emergency visits; **[by September-2011]**
- iii. legislate automatic indexation to inflation of NHS moderating fees. **[Q4-2011]**

3.52. Cut substantially (by two thirds overall) tax allowances for healthcare, including private insurance by **end-October**.

3.53. In the light of the urgency and size of the savings needed in the health sector to address large arrears and budget limitations plans to achieve a self sustainable model for health-benefits schemes for civil servants will be accelerated. The current plan foresee that the overall budgetary cost of existing schemes – ADSE, ADM (Armed Forces) and SAD (Police Services) - will be reduced by 30% in 2012 and by further 20% in 2013 at all levels of general government. The system would become self-financed by 2016. The budgetary costs

of these schemes will be reduced by lowering the employer's contribution and adjusting the scope of health benefits. **[Q4-2011]**

3.54. Produce a health sector strategic plan, in the context of and consistent with the medium-term budget framework. **[Q4-2011]**

Pricing and reimbursement of pharmaceuticals

3.55. Set the maximum price of the first generic introduced in the market to 50% of the branded product with same active substance. **[Q3-2011]** Reduce automatically prices of drugs when their patent expires. **[Q4-2011]**

3.56. Move the responsibility of pricing medicines to the Ministry of Health (for example to the Infarmed). **[Q4-2011]**

3.57. Revise the existing reference-pricing system based on international prices by changing the countries of reference to the three EU countries with the lowest price levels or countries with comparable GDP per capita levels. **[Q4-2011]**

Prescription and monitoring of prescription

3.58. Make electronic prescription for medicines and diagnostic covered by public reimbursement fully compulsory for physicians in both the public and private sector. **[Q3-2011]**

3.59. Improve the monitoring system of prescription of medicines and diagnostic and set in place a systematic assessment by individual doctor in terms of volume and value, vis-à-vis prescription guidelines and peers The assessment will be done through a dedicated unit under the Ministry of Health such as the Centro de Conferência de Facturas. Sanctions and penalties will be envisaged and enforced as a follow up to the assessment. **[Q3-2011]** . Feedback is to be provided to each physician on a regular basis (e.g. quarterly), in particular on prescription of costliest and most used medicines, starting from **Q4-2011**.

3.60. Induce physicians at all levels of the system, both public and private, to prescribe generic medicines and the less costly available branded product. **[Q3-2011]**

3.61. Establish clear rules for the prescription of drugs and the realisation of complementary diagnostic exams (prescription guidelines for physicians) on the basis of international prescription guidelines. **[Q4-2011]**

3.62. Remove all effective entry barriers for generic medicines, in particular by reducing administrative/legal hurdles in order to speed up the use and reimbursement of generics. **[Q4-2011]**

Pharmacies sector

3.63. Effectively implement the existing legislation regulating pharmacies. **[Q4-2011]**

3.64. Change the calculation of profit margin into a regressive mark-up and a flat fee for wholesale companies and pharmacies on the basis of the experience in other Member States. The new system should ensure a reduction in public spending on pharmaceuticals and encourage the sales of less expensive pharmaceuticals. The aim is that lower profits will contribute at least EUR 50 million to the reduction in public expense with drugs distribution. **[Q4-2011]**

3.65. If the new system of calculation of profit margin will not produce the expected savings in the distribution profits, introduce a contribution in the form of an average rebate (pay-back) which will be calculated on the mark-up. The rebate will reduce the mark-up by at least 3 percentage points. The rebate will be collected by the Government on a monthly basis through Centro de Conferência de Facturas, preserving the profitability of small pharmacies in remote areas with low turnover. **[Q1 -2012]**

Centralised purchasing and procurement

3.66. Set up the legislative and administrative framework for a centralised procurement system for the purchase of medical goods in the NHS (equipments, appliances, pharmaceuticals), through the recently created Central Purchasing Authority (SPMS), in order to reduce costs through price-volume agreements and fight waste. **[Q3-2011]**

3.67. Finalise the uniform coding system and a common registry for medical supplies developed by the INFARMED and SPMS based on international experience. Regularly update the registry. **[Q4-2011]**

3.68. Take measures to increase competition among private providers and reduce by at least 10 per cent the overall spending (including fees) of the NHS with private providers delivering diagnostic and therapeutical services to the NHS by end 2011 and by an additional 10% by end 2012. **[Q4-2011]**

3.69. Implement the centralised purchasing of medical goods through the recently created Central Purchasing Authority (SPMS), using the uniform coding system for medical supplies and pharmaceuticals. **[Q1-2012]**

3.70. Introduce a regular revision (at least every two years) of the fees paid to private providers with the aim of reducing the cost of more mature diagnostic and therapeutical services. **[Q1-2012]**

3.71. Assess compliance with European competition rules of the provision of services in the private healthcare sector and guarantee increasing competition among private providers **[Q1-2012]**

Primary care services

3.72. The Government proceeds with the reinforcement of primary care services so as to further reduce unnecessary visits to specialists and emergencies and to improve care coordination through:

- i. increasing the number of USF (*Unidades de Saúde Familiares*) units contracting with regional authorities (ARSs) using a mix of salary and performance-related payments as currently the case. Make sure that the new system leads to reduction in costs and more effective provision; **[Q3-2011]**
- ii. set-up a mechanism to guarantee the presence of family doctors in needed areas to induce a more even distribution of family doctors across the country. **[Q4-2011]**

Hospital services

3.73. Set out a strategy and a binding timetable to clear all arrears in the health sector. The strategy will include the introduction of standardised and tight control procedures for all health sector entities to prevent the re-emergence of arrears. In addition, a mechanism is put in place to ensure strong coordination between the Ministry of Health and the Ministry of Finance for the application of the same monitoring and control criteria to all types of hospitals. **[Q3-2011]**

3.74. Hospitals SOEs will swiftly change the existing accounting framework and adopt accounting standards in line with the requirements for private companies and other SOEs. This will help improving the management of the enterprises and the quality of the financial oversight by the general government. **[Q4-2012]**

3.75. Provide detailed description of measures aimed at achieving a reduction of at least EUR 200 million in the operational costs of hospitals in 2012 (EUR 100 million in 2012 in addition to savings of over EUR 100 million already in 2011). This is to be achieved through the reduction in the number of management staff, concentration and rationalisation in state hospitals and health centres and annual ceilings to PPP contracts. **[Q3-2011]**

3.76. Continue the publication of clinical guidelines and set in place an auditing system of their implementation. **[Q3-2011]**

3.77. Improve selection criteria and adopt measures to ensure a more transparent selection of the chairs and members of hospital boards. Members will be required by law to be persons of recognised standing in health, management and health administration. **[Q4-2011]**

3.78. Set up a system for comparing hospital performance (benchmarking) on the basis of a comprehensive set of indicators and produce regular annual reports, the first one to be published by end 2012. Indicators are to include financial indicators. **[Q1-2012]**

3.79. Ensure full interoperability of IT systems in hospital, in order for the ACSS to gather real time information on hospital activities and to produce monthly reports to the Ministry of Health and the Ministry of Finance. **[Q1-2012]**

3.80. Continue with the reorganisation and rationalisation of the hospital network through specialisation and concentration of hospital and emergency services and joint management (building on the Decree-Law 30/2011) joint operation of hospitals. These improvements will deliver additional cuts in operating costs by at least 5 per cent in 2013. A detailed action plan is published by 30 November 2012 and its implementation is finalised by the first quarter

2013. Overall, from 2011 to 2013, hospital operational costs must be reduced by at least 15% compared to 2010 level. [Q2-2012]

3.81. Move some hospital outpatient services to primary care units (USF). [Q2-2012]

3.82. Annually update the inventory of all practising doctors by specialty, age, region, health centre and hospital, public and private sector so as to be able to identify practising, professional and licensed physicians and current and future staff needs by the above categories by **October 2011**. The inventory will subsequently be extended to other categories of staff. It will also include figures for the autonomous regions of Madeira and Azores. [Q1-2012]

3.83. Prepare regular annual reports presenting plans for the allocation of human resources in the period up to 2014. The Report specifies plans to reallocate qualified and support staff within the NHS. [Q3-2011]

3.84. Introduce rules to increase mobility of healthcare staff (including doctors) within and across health regions. Adopt for all staff (including doctors) flexible time arrangements, with a view of reducing by at least 20% spending on overtime compensation in 2012 and another 20% in 2013. Implement a strict control of working hours and activities of staff in the hospital. [Q1-2012]

Regional health authorities

3.85. Improve monitoring, internal control and fiscal risks management systems of the Administrações Regionais de Saude by **Q4-2012**.

Cross services

3.86. Finalise the set-up of a system of patient electronic medical records. [Q2-2012]

3.87. Reduce costs for patient transportation by one third. [Q3-2011]

4. Labour market and education

Labour market

Objectives

Revise the unemployment insurance system to reduce the risk of long-term unemployment while strengthening social safety nets; reform employment protection legislation to tackle labour market segmentation, foster job creation, and ease the transition of workers across occupations, firms, and sectors; ease working time arrangements to contain employment fluctuations over the cycle, better accommodate differences in work patterns across sectors and firms, and enhance firms' competitiveness; promote labour cost developments consistent with job creation and enhanced competitiveness; ensure good practices and appropriate resources to Active Labour Market Policies to improve the employability of the young and disadvantaged categories and ease labour market mismatches.

Address early school leaving and improve the quality of secondary education and vocational education and training, with a view to raise the quality of human capital and facilitate labour market matching.

Reforms in labour and social security legislation will be implemented after consultation of social partners, taking into account possible constitutional implications, and in respect of EU Directives and Core Labour Standards.

Unemployment benefits

4.1. The Government will prepare by **Q4-2011** an action plan to reform along the following lines the unemployment insurance system, with a view to reduce the risk of long-term unemployment and strengthen social safety nets:

- i. reducing the maximum duration of unemployment insurance benefits to no more than 18 months. The reform will not concern those currently unemployed and will not reduce accrued-to-date rights of employees;
- ii. capping unemployment benefits at 2.5 times the social support index (IAS) and introducing a declining profile of benefits over the unemployment spell after six months of unemployment (a reduction of at least 10% in the benefit amount). The reform will concern those becoming unemployed after the reform;
- iii. reducing the necessary contributory period to access unemployment insurance from 15 to 12 months;
- iv. presenting a proposal for extending eligibility to unemployment insurance to clearly-defined categories of self-employed workers providing their services to a single firm on a regular basis. The proposal will take into account the risks of possible abuses and will contain an assessment of the fiscal impact of extending benefits under several scenarios concerning eligibility criteria (namely the involuntary character of unemployment) and requirements for increased social security contributions for firms making use of these arrangements.

4.2. This plan will lead to draft legislation to be adopted by the Government by **Q1-2012**.

Employment protection legislation

4.3. The Government will carry out reforms in the employment protection system aimed at tackling labour market segmentation, fostering job creation, and easing adjustment in the labour market:

4.4. Severance payments.

- i. The Government submitted end-July 2011 legislation to Parliament to implement a reform in the severance payments for new hires in line with the

March 2011 Tripartite Agreement.¹⁵ The reform aligns severance payments of open-ended contracts with those of fixed-term contracts. The reform re-designs the system for severance payment entitlements as follows:

- total severance payments for new open-ended contracts are reduced from 30 to 10 days per year of tenure (with 10 additional days to be paid by an employers' financed fund) with a cap of 12 months and elimination of the 3 months of pay irrespective of tenure;
 - total severance payments for fixed-term contracts are reduced from 36 to 10 days per year of tenure for contracts shorter than 6 months and from 24 to 10 days for longer contracts (with 10 additional days to be paid by an employers' financed fund);
 - implementation of the fund agreed in the March Tripartite Agreement to partly finance the cost of dismissals for new hires will be done through a law regulating the functioning of the fund, as well as a description of technical details concerning its operation and a planned time frame for its implementation **by end-September 2011**.
- ii. By **Q4-2011**, the Government will present a proposal to align severance payment entitlements for current employees in line with the reform for new hires, (taking into account the revised link between entitlement and seniority and the cap to total entitlements) without reducing accrued-to-date entitlements. This plan will lead to draft legislation to be submitted to Parliament by [**Q1-2012**].
- iii. By **Q1-2012**, the Government will prepare a proposal aiming at:
- aligning the level of severance payments to that prevailing on average in the EU;
 - allowing the severance pay entitlements financed from the fund agreed in the Tripartite agreement to be transferable to different employers by means of the creation of notional individual accounts.

On the basis of this proposal, draft legislation will be submitted to Parliament no later than **Q3-2012**.

4.5. Definition of dismissals. The Government will prepare by **Q4-2011** a reform proposal aimed at introducing adjustments to the cases for fair individual dismissals contemplated in the Labour Code with a view to fighting labour market segmentation and raise the use of open-ended contracts. This proposal will lead to draft legislation to be submitted to Parliament by **Q1-2012**.

- i. Individual dismissals linked to unsuitability of the worker should become possible even without the introduction of new technologies or other changes to the workplace (art. 373-380, 385 Labour Code). Inter alia, a new reason can be added regarding situations where the worker has agreed with the employer

¹⁵ Structural benchmark in the Memorandum of Economic and Financial Policies.

specific delivery objectives and does not fulfil them, for reasons deriving exclusively from the workers' responsibility;

- ii. Individual dismissals linked to the extinction of work positions should not necessarily follow a pre-defined seniority order if more than one worker is assigned to identical functions (art. 368 Labour Code). The predefined seniority order is not necessary provided that the employer establishes a relevant and non-discriminatory alternative criteria (in line with what already happens in the case of collective dismissals);
- iii. Individual dismissals for the above reasons should not be subject to the obligation to attempt a transfer for a possible suitable position (art. 368, 375 Labour Code). As a rule, whenever there are work positions available that match the qualifications of the worker, dismissals should be avoided.

Working time arrangements

4.6. The Government will carry out reforms in working time arrangements with a view to contain employment fluctuations over the cycle, better accommodate differences in work patterns across sectors and firms, and enhance firms' competitiveness.

- i. The Government will prepare an assessment regarding the use made of increased flexibility elements by the social partners associated with the 2009 Labour Code revision and prepare an action plan to promote the use of flexible working time arrangements, including on modalities for permitting the adoption of "bank of hours" working arrangement by mutual agreement of employers and employees negotiated at plant level. **[Q4-2011]**
- ii. Draft legislation will be submitted to Parliament **by Q1-2012** on the following aspects:
 - implementation of the commitments agreed in the March Tripartite Agreement regarding working time arrangements and short-time working schemes in cases of industrial crisis, by easing the requirements employers have to fulfil to introduce and renew these measures;
 - revision of the minimum additional pay for overtime established in the Labour Code: (i) reduction to maximum 50% (from current 50% for the first overtime hour worked, 75% for additional hours, 100% for overtime during holydays); (ii) elimination of the compensatory time off equal to 25% of overtime hours worked. These norms can be revised, upwards or downwards, by collective agreement.

Wage setting and competitiveness

4.7. The Government will promote wage developments consistent with the objectives of fostering job creation and improving firms' competitiveness with a view to correct macroeconomic imbalances. To that purpose, the Government will:

- i. commit that, over the programme period, any increase in the minimum wage will take place only if justified by economic and labour market developments and agreed in the framework of the programme review;
- ii. define clear criteria to be followed for the extension of collective agreements and commit to them. The representativeness of the negotiating organisations and the implications of the extension for the competitive position of non-affiliated firms will have to be among these criteria. The representativeness of negotiating organisations will be assessed on the basis of both quantitative and qualitative indicators. To that purpose, the Government will charge the national statistical authority to do a survey to collect data on the representativeness of social partners on both sides of industry. Draft legislation defining criteria for extension and modalities for their implementation will be prepared by **Q2-2012**;
- iii. prepare an independent review by **Q2-2012** on:
 - how the tripartite concertation on wages can be reinvigorated with the view to define norms for overall wage developments that take into account the evolution of the competitive position of the economy and a system for monitoring compliance with such norms;
 - the desirability of shortening the survival (sobrevigência) of contracts that are expired but not renewed (art 501 of the Labour Code).

4.2. The Government will promote wage adjustments in line with productivity at the firm level. To that purpose, it will:

- i. implement the commitments in the Tripartite Agreement of March 2011 concerning the "organised decentralisation", notably concerning: (i) the possibility for works councils to negotiate functional and geographical mobility conditions and working time arrangements; (ii) the creation of a Labour Relations Centre supporting social dialogue with improved information and providing technical assistance to parties involved in negotiations; (iii) the lowering of the firm size threshold above which works councils can conclude firm-level agreements to 250 employees. Action for the implementation of these measures will have to be taken **by Q4-2011**;
- ii. promote the inclusion in sectoral collective agreements of conditions under which works councils can conclude firm-level agreements without the delegation of unions. An action plan will have to be produced **by Q4-2011**.
- iii. **By Q1-2012**, present a proposal to reduce the firm size threshold for works councils to conclude agreements below 250 employees, with a view to adoption **by Q2-2012**.

Draft legislation will be submitted to Parliament by **Q1-2012**.

Active labour market policies

4.3. The Government will ensure good practices and an efficient amount of resources to activation policies to strengthen job search effort by the unemployed and to other Active Labour Market Policies (ALMPs) to improve the employability of the young and disadvantaged categories and ease labour market mismatches. The Government will present by **Q4-2011**:

- i. a report on the effectiveness of current activation policies and other ALMPs in tackling long-term unemployment, improving the employability of the young and disadvantaged categories, and easing labour market mismatch;
- ii. an action plan for possible improvements and further action on activation policies and other ALMPs, including the role of Public Employment Services.

Education and training

4.4. The Government will continue action to tackle low education attainment and early school leaving and to improve the quality of secondary education and vocational education and training, with a view to increase efficiency in the education sector, raise the quality of human capital and facilitate labour market matching. To this purpose, the Government will:

- i. Set up an analysis, monitoring, assessment and reporting system in order to accurately evaluate the results and impacts of education and training policies, notably plans already implemented (notably concerning cost saving measures, vocational education and training and policies to improve school results and contain early school leaving). **[Q4-2011]**
- ii. Present an action plan to improve the quality of secondary education services including via: (i) the generalization of trust agreements between the Government and public schools, establishing wide autonomy, a simple formula-based funding framework comprising performance evolution criteria, and accountability; (ii) a simple result-oriented financing framework for professional and private schools in association agreements based on fixed per-class funding plus incentives linked to performance criteria; (iv) a reinforced supervisory role of the General Inspectorate. **[Q1-2012]**
- iii. Present an action plan aimed at (i) ensuring the quality, attractiveness and labour market relevance of vocational education and training through partnerships with companies or other stakeholders; (ii) enhancing career guidance mechanisms for prospective students in vocational educational training. **[Q1-2012]**

5. Goods and services markets

Energy markets

Objectives

Complete the liberalisation of the electricity and gas markets; ensure the sustainability of the national electricity system and avoid further unfavourable developments in tariffs deficit; ensure that the reduction of the energy dependence and the promotion of renewable energies is made in a way that limits the additional costs associated with the production of electricity under the ordinary and special (co-generation and renewables) regimes; ensure consistency of the overall energy policy, reviewing existing instruments. Continue promoting competition in energy markets and to further integrate the Iberian market for electricity and gas (MIBEL and MIBGAS).

Liberalisation of electricity and gas markets

5.1. Regulated electricity tariffs will be phased out **by January 1, 2013**. The government and the regulator will launch information campaigns to raise awareness of consumers **[Q3-2011]**. Following the approval in the resolution of Council of Ministers of 27 July 2011 of a roadmap setting the main principles for the liberalisation of electricity markets, the government will implement it through legislation by **[Q4-2011]**. The provisions will:

- i. specify the timeline and criteria to liberalise the remaining regulated segments, such as pre-determined conditions relating to the degree of effective competition in the relevant market; and shorten the maximum length of the transitory period for the segment 10,35 kVA to 41,4 kVA, from 3 years, as set out in the resolution of the Council of Ministers, to 30 months.
- ii. ensure that during the phasing-out period, transitory tariffs will be above market prices – while countering any anti-competitive behavior by market players – and that this difference will be increasing in time, if necessary, in order to create incentives for a gradual switching of consumers to the liberalised market;

5.2. Implement the Third EU Energy Package by **[Q1-2012]**. This will ensure the National Regulator Authority's independence and all powers foreseen in the package.

5.3. In the gas market, the Government will take measures to accelerate the establishment of a functioning Iberian market for natural gas (MIBGAS), in particular through regulatory convergence. Take up political initiatives with Spanish authorities with the aim of eliminating the double tariff. **[Q3-2011]**

5.4. Regulated gas tariffs are to be phased out by **January 1, 2013**. The government will implement, through legislation, the roadmap proposed in the resolution of Council of Ministers of 27 July 2011 by **[Q4-2011]**.

5.5. Review in a report the reasons for lack of entry in the gas market, despite the availability of spare capacity, and the reasons for the lack of diversification of gas sources. The report will also propose possible measures to address the identified problems. **[Q4-2011]**

Additional costs associated with electricity production under the ordinary regime

5.6. Take measures in order to limit the additional cost associated with the production of electricity under the ordinary regime, in particular through renegotiation or downward revision of the guaranteed compensation mechanism (CMEC) paid to producers under the ordinary regime and the remaining long-term power-purchase agreements (PPAs). **[Q4-2011]**

Support schemes for production of energy under the special regime (co-generation and renewables)

5.7. Review the efficiency of support schemes for co-generation and propose possible options for adjusting downward the feed-in tariff used in co-generation (reduce the implicit subsidy).¹ **[Q4-2011]**

5.8. Review in a report the efficiency of support schemes for renewables, covering their rationale, their levels, and other relevant design elements.² **[Q4-2011]**

5.9. For existing contracts in renewables, assess in a report the possibility of agreeing a renegotiation of the contracts in view of a lower feed-in tariff.³ **[Q4-2011]**

5.10. For new contracts in renewables, revise downward the feed-in tariffs and ensure that the tariffs do not over-compensate producers for their costs and they continue to provide an incentive to reduce costs further, through digressive tariffs. For more mature technologies develop alternative mechanisms (such as feed-in premiums). Reports on action taken will be provided annually in **Q3-2011, Q3-2012 and Q3-2013**.

5.11. Decisions on future investments in renewables, in particular in less mature technologies, will be based on a rigorous analysis in terms of its costs and consequences for energy prices. International benchmarks will be used for the analysis and an independent evaluation will be

¹ Structural benchmark in the Memorandum of Economic and Financial Policies.

² Structural benchmark in the Memorandum of Economic and Financial Policies.

³ Structural benchmark in the Memorandum of Economic and Financial Policies.

carried out. Reports on action taken will be provided annually in **Q3-2011, Q3-2012 and Q3-2013**.

5.12. Reduce the delays and uncertainty surrounding planning, authorisation and certification procedures and improve the transparency of administrative requirements and charges for renewable energy producers (in line with Article 13 and 14 of EU Directive 2009/28/EC). Provide evidence of the measures taken to this end. **[Q4-2011]**

Energy policy instruments and taxation

5.13. Review existing energy related instruments, including taxation and energy efficiency incentives. In particular, evaluate the risk of overlapping or inconsistent instruments **[Q3-2011]**.

5.14. Based on the results of the review, modify energy policy instruments to ensure that they provide incentives for rational use, energy savings and emission reductions. **[Q4-2011]**

5.15. Increase VAT tax rate in electricity and gas (presently at 6%) as well as excises for electricity (presently below the minima required by EU legislation). **[Q4-2011]**

Telecommunications and postal services

Objectives

Increase competition in the market by lowering entry barriers; guarantee access to network/infrastructure; strengthen power of the National Regulator Authority.

Telecommunications:

The Government will:

5.16. Ensure more effective competition in the sector by implementing the new Directive on EU electronic communications regulatory framework (“Better Regulation Directive”), which will (among others) enhance independence of the National Regulator Authority. **[Q3-2011]**

5.17. Facilitate market-entry by lowering mobile termination rates **[Q3-2011]** and by launching the auction for the assignment of further radio frequencies (i.e. auction of spectrum) for broadband wireless access **[Q4-2011]**. In designing the spectrum auction rules, it will be ensured that they adhere to the legal principles of the EU framework and that potential new entrants are not placed at a competitive disadvantage. In particular, the auction tender will:

- i. announce the commitment to an ex-post assessment, to be carried out by the regulator, of possible competitive distortions, covering the electronic communications mobile markets for which the spectrum is to be used as well as the commitment to, where justified and proportionate, the implementation of remedies to redress any resulting situation considered anti-competitive.
- ii. include appropriate caps for strategic spectrum bands (under 1 GHz) which, while respecting the technological neutrality principle, facilitates an effective

entry into the market avoiding that potential new entrants will face competitive disadvantages in terms of service quality and network costs.

- iii. as a contribution to the enhancement of market competition, conditions for potential new operators to have access to national roaming will strike an effective balance between safeguarding the interests of current operators and those of potential new entrants. The regulator will adopt the necessary measures in order to enable potential new entrants to benefit from a level playing field as to the provision of high quality mobile broadband services. This will be achieved namely by ensuring operators' obligation to negotiate fair and reasonable national roaming access, unless otherwise justified and proportionate.
- iv. Auction pricing rules such as reserve prices and potential new entrant price discounts will take full account of the objective of facilitating market entry by creating a level playing field.

5.18. The Government will ensure the existence of an adequate monitoring and enforcement mechanism to guarantee the effective implementation of the obligations to negotiate fair and reasonable access to national roaming and mobile virtual network operator (MVNO) agreements, ensuring timely access and reasonable prices. Such mechanism will be announced in the auction tender **[Q4-2011]**.

5.19. The Government will review the current value of the fees on the use of frequencies to ensure that they are objectively justified, transparent, non-discriminatory and proportionate in relation to their intended purpose. Such review will be announced in the auction tender **[Q4-2011]**.

5.20. Ensure that the provision on universal service designation and the incumbent's concession contract are non-discriminatory: re-negotiate the concession contract with the undertaking currently providing the universal service and launch a new tender for designation of universal service providers. **[Q4-2011]**

5.21. Adopt measures to increase competition in the fixed communications market by: i) alleviating restrictions on mobility of consumers by reducing costs faced when deciding on provider along the lines proposed by the Competition Authority (such as standardized contracts, explicit right to free cancellation and facilitating price comparison) **[Q3-2011]**; ii) reviewing barriers on entry and adopting measures to reduce them. **[Q1-2012]**

Postal services

The Government will:

5.22. Further liberalise the postal sector by transposing the Third Postal Directive ensuring that powers and independence of the National Regulator Authority are appropriate in view of its increased role in monitoring prices and costs **[Q3-2011]**.

Transport

Objectives

Adopt a strategic plan to: rationalise networks and improve mobility and logistic conditions in Portugal; improve energy efficiency and reduce environmental impact; reduce transport costs and ensure financial sustainability of the companies; strengthen competition in the railways sector and attract more traffic; integrate ports into the overall logistic and transport system, and make them more competitive.

The Government will take the following measures in the transport sector:

Strategic Plan for Transport:

5.23. Present a Strategic Plan for Transport, which will specifically include **[Q3-2011]**

- i. An in-depth analysis of the transport system including an assessment of existing capacity, forecast demand, and projected traffic flows;
- ii. Measures to integrate rail, port and air transport services into the overall logistic and transport system, notably by improving competition in these transport modes;
- iii. Measures to facilitate entry for low-cost airline companies, making use of the existing infrastructure;
- iv. A set of priorities for investment with an estimate of the financial needs and the foreseen sources of financing as well as of energy savings.

Measures will be concrete, including the exact instruments used to achieve them. Measures will be chosen based on criteria of cost-effectiveness (comparing savings/costs).

Railways sector

5.24. Transpose the EU Railway Packages and in particular: **[Q3-2011]**

- i. Strengthen the rail regulator independence and competences including by strengthening its administrative capacity in terms of decision and execution powers and staffing;
- ii. Ensure full independence of the state-owned railway operator CP from the State;
- iii. Balance the infrastructure manager's revenues and expenditures on the basis of a multi-annual contract with the infrastructure manager of a duration of at least three years and concrete commitments on State finance and performance;
- iv. Carry-out a rationalisation of the network and effective incentives for the infrastructure manager to reduce its costs, whereby the regulatory body will be given a monitoring role;

- v. Revise the existing Public Service Obligations (PSOs) on rail passenger transport, including the legal basis and administrative capacity for stepwise introduction of competitive tendering for PSOs;
- vi. Revise the infrastructure charging scheme to introduce a performance scheme, permitting operators to introduce yield management of tickets, in particular to raise ticket prices;
- vii. Privatised the freight branch of the state-owned rail operator and some suburban lines.

Ports [Q4-2011]

5.25. Define a strategy to integrate ports into the overall logistic and transport system. Specify the objectives, scope and priorities of the strategy, and the link to the overall Strategic Plan for the Transport sector.

5.26. Develop a legal framework to facilitate the implementation of the strategy and to improve the governance model of the ports system. In particular, define the necessary measures to ensure the separation of regulatory activity, port management and commercial activities.

5.27. Specify in a report the objectives, the instruments and the estimated efficiency gains of initiatives such as the interconnection between CP Cargo and Ex-Port, the Port Single Window and Logistic Single Window.

5.28. Revise the legal framework governing port work to make it more flexible, including narrowing the definition of what constitutes port work, bringing the legal framework closer to the provisions of the Labour Code.

Other services sector

Objectives

Eliminate entry barriers in order to increase competition in the services sector; soften existing authorisation requirements that hinder adjustment capacity and labour mobility; reduce administrative burden that imposes unnecessary costs on firms and hamper their ability to react to market conditions.

Sector-specific legislation of Services

5.29. Adopt the remaining necessary amendments to the sector specific legislation to fully implement the Services Directive, easing the requirements related to establishment and reducing the number of requirements to which cross-border providers are subject. Amendments will be presented to the Parliament [Q4-2011] and adopted by [Q1-2012].

5.30. In case unjustified restrictions remain following the notification to the Commission of the recently adopted sector-specific amendments in the areas of construction and real estate,

review and modify them accordingly. This includes making less burdensome the requirements applying to cross-border providers, both for construction and real estate activities, and reviewing obstacles to the establishment of service providers such as restrictions on subcontracting (for construction) and on excessive liquidity obligations and physical establishment (for real estate). [Q4-2011]

Professional qualifications

5.31. Improve the recognition framework on professional qualifications by adopting the remaining legislation complementing the Portuguese Law 9/2009 on the recognition of professional qualifications in compliance with the qualifications directive. Adopt the law concerning professions not regulated by Parliament [Q3-2011] and present to Parliament the law for those regulated by Parliament [Q3-2011] to be approved by [Q1-2012].

Regulated professions

5.32. Eliminate restrictions to the use of commercial communication (advertising) in regulated professions, as required by the Services Directive. Necessary amendments will be presented to the Parliament [Q4-2011] and adopted by [Q1-2012].

5.33. Review and reduce the number of regulated professions and in particular eliminate reserves of activities on regulated professions that are no longer justified. Adopt the law for professions not regulated by Parliament [Q3-2011] and present to Parliament the law for those regulated by Parliament [Q3-2011] to be approved by [Q1-2012].

5.34. Adopt measures to liberalize the access and exercise of regulated professions by professionals qualified and established in the European Union. Adopt the law for professions not regulated by Parliament [Q3-2011] and present to Parliament the law for those regulated by Parliament [Q3-2011] to be approved by [Q1-2012].

5.35. Further improve the functioning of the regulated professions sector (such as accountants, lawyers, notaries) by carrying out a comprehensive review of requirements affecting the exercise of activity and eliminate those not justified or proportional. [Q4-2011]

Administrative burden

5.36. Continue the simplification reform effort by:

- i. presenting a roadmap to monitor progress in building up the Points of Single Contact (PSC) by **Q3-2011**;
- ii. making available the PSC in three languages with general information covering all relevant aspects of the Services Directive and of the Professional Qualifications Directive as well as at least five procedures on-line by **October 2011**;
- iii. making the Points of Single Contact (PSC) more user-friendly and responsive to SMEs needs, extending on-line procedures to all sectors covered by the Services Directive and to Professional Qualifications Directive as well as adapt the content and information available at the PSC to the new legislation to be adopted [Q1-2012];

- iv. making fully operational the “Zero authorisation” project that abolishes authorisations/licensing and substitute them with a declaration to the PSC for the wholesale and retail sector and restaurants and bars [Q2-2012]. The platform will be available to all levels of administration, including all municipalities [Q3-2012];
- v. extending PSC to services not covered by the Services Directive [Q2-2013];
- vi. extending the Zero authorisation project to other sectors of the economy [Q3-2013].

6. Housing market

Objectives

Improve access to housing; foster labour mobility; improve the quality of housing and make better use of the housing stock; reduce the incentives for households to build up debt.

Rental market

6.1. The Government will present measures to amend the New Urban Lease Act Law 6/2006 to ensure balanced rights and obligations of landlords and tenants, considering the socially vulnerable. [Q3-2011] This plan will lead to draft legislation to be submitted to Parliament by [Q4-2011]. In particular, the reform plan will introduce measures to: i) broaden the conditions under which renegotiation of open-ended residential leases can take place, including to limit the possibility of transmitting the contract to first degree relatives; ii) introduce a framework to improve households' access to housing by phasing out rent control mechanisms, considering the socially vulnerable; iii) reduce the prior notice for termination of leases for landlords; iv) provide for an extrajudicial eviction procedure for breach of contract, aiming at shortening the eviction time to three months; and v) strengthen the use of the existing extrajudicial procedures for cases of division of inherited property.

Administrative procedures for renovation

6.2. The Government will prepare draft legislation to simplify administrative procedures for renovation [Q3-2011], and adopt legislation by [Q4-2011]. In particular, the specific measures will: i) simplify administrative procedures for renovation works, safety requirements, authorisation to use and formalities for innovations that benefit and enhance the building's quality and value (such as energy savings measures). The majority of apartment owners will be defined as representing the majority of the total value of the building; ii) simplify rules for the temporary relocation of tenants of building subject to rehabilitation works with due regard of tenants needs and respect of their living conditions; iii) grant landlords the possibility to ask for termination of the lease contract for major renovation works (affecting the structure and stability of the building) with a maximum 6 months of prior notice; iv) standardise the rules determining the level of conservation status of property and the conditions for the demolition of buildings in ruin.

Property taxation

6.3. The Government will review the framework for the valuation of the housing stock and land for tax purposes and present measures to (i) ensure that by end 2012 the taxable value of all property is close to the market value and (ii) property valuation is updated regularly (every year for commercial real estate and once every three years for residential real estate as foreseen in the law). These measures could include enabling municipal officers, in addition to tax officers, to evaluate the taxable value of property and the use of statistical methods to monitor and update valuations. **[Q3-2011]**

6.4. The Government will modify property taxation with a view to level incentives for renting versus acquiring housing. **[Q4-2011]** In particular, the Government will: i) limit income tax deductibility of rents and mortgage interest payments as of 01.01.2012, except for low income households. Principal payments will not be deductible as of 01.01.2012; ii) rebalance gradually property taxation towards the recurrent real estate tax (IMI) and away from the transfer tax (IMT), while considering the socially vulnerable. Temporary exemptions of IMI for owner-occupied dwellings will be considerably reduced and the opportunity cost of vacant or non-rented property will be significantly increased.

6.5. The Government will undertake a comprehensive review of the functioning of the housing market with the support of internationally-reputed experts. **[Q2-2013]**

7. Framework conditions

Judicial system

Objectives

Improve the functioning of the judicial system, which is essential for the proper and fair functioning of the economy, through: (i) ensuring effective and timely enforcement of contracts and competition rules; (ii) increasing efficiency by restructuring the court system, and adopting new court management models; (iii) reducing slowness of the system by eliminating backlog of courts cases and by facilitating out-of-court settlement mechanisms.

The Government will:

Court backlog

Recognising the urgency of the judicial reform to make the judicial system more efficient and more effective:

7.1. Eliminate court backlogs by **Q2-2013**.

7.2. Based on the audit of backlog cases which has been completed in June 2011, develop targeted measures to expedite the resolution of the backlog **[Q3-2011]**

7.3. Given the pivotal role of enforcement agents in the debt enforcement process, strengthen the legal and institutional framework in line with international practice with a

particular focus on the financing structure and authority of the oversight body, including adopting a decree law by end-December 2011 to ensure the oversight body's full access to the enforcement case files.

Management of courts

Advance with reforms aimed at improving management efficiency of the court system:

7.4. Remain committed to the implementation of the Judicial Reform Map and the creation of 39 court units, with added management support for each unit, entirely financed through expenditure savings and gains of efficiency [Q4-2012]. This measure is part of the rationalisation effort, in order to improve efficiency in the management of infrastructures and public services. Finalise a roadmap on this reform identifying key quarterly milestones. [Q3-2011]

7.5. Conduct an assessment of court management with a view to speeding up court proceedings and improving cost efficiency. [Q4-2011]

7.6. Define a new personnel management plan to support judicial specialisation and mobility of court officials. [Q4-2011]

Alternative dispute resolution for out-of-court settlement

Continue strengthening alternative dispute resolution (ADR) to facilitate out-of-court settlement:

7.7. The Government will adopt a Law on Arbitration by **end-September 2011** and measures to give priority to the ADR enforcement cases in the courts by end-2011. The Government is committed to take all necessary legal, administrative, and other steps to make arbitration fully operational by **end-February 2012** to facilitate resolution of backlog cases and out of court settlement.⁴

7.8. Optimize the regime for Justices for the Peace to increase its capacity to handle small claim cases. [Q1-2012]

Civil cases in the courts

Further streamline and speed up civil case processing in the courts:

7.9. Make the new courts on Competition and on Intellectual Property Rights fully operational. [Q1-2012]

7.10. Assess the need for separate Chambers within the Commercial Courts with specialised judges for insolvency cases. [Q4-2011]

⁴ Structural benchmark in the Memorandum of Economic and Financial Policies.

7.11. To review the Code of Civil Procedure and to prepare a proposal in a consultative manner **by end-2011** to analyse the experience with the new experimental regime that has been applied to seven courts, and building on such experience, to address the key areas for refinement, including (i) consolidating legislation for all enforcement cases before the court, (ii) giving judges the power to expedite cases, (iii) reducing administrative burdens on judges, and (iv) enforcing statutory deadlines for court processes and in particular injunction procedures and debt enforcement and insolvency cases.⁵

7.12. Following the steps taken to implement the Tax Arbitration Law (to enable an effective out of court resolution of tax claims), adopt further specific measures for an orderly and efficient resolution of outstanding tax cases (also covered under revenue administration). In particular, assess the scope for measures to expedite the resolution of tax cases such as: i) creating a special procedure for high value cases; ii) establishing criteria for prioritizing; iii) extending statutory interests for the entire the court proceeding; iv) imposing a special statutory interest payment on late compliance with a tax court decision. **[Q4-2011]**

Budget and allocation of resources

Remain committed to putting in place a more sustainable and transparent budget for the judiciary:

7.13. Standardise court fees and introduce special court fees for certain categories of cases and procedures with the aim of boosting revenue and disincentivising spurious civil litigation. **[Q3-2011]**

7.14. Publish an annual workplan for 2012 on the allocation of resources based on court by court performance data, which will be published on the internet by end-January 2012.

7.15. Conduct a workload/staffing assessment for the six pilot courts under the Judicial Reform Map, as well as for the specialist courts. **[Q1-2012]**

7.16. Prepare and publish quarterly reports on recovery rates, duration and costs of corporate insolvency and tax cases, with the report for third quarter of 2011 to be published by end-October 2011.

Competition, public procurement and business environment

Objectives

Ensure a level playing field and minimise rent-seeking behaviour by strengthening competition and sectoral regulators; eliminate special rights of the state in private companies (golden shares); reduce administrative burdens on companies; ensure fair public procurement processes; improve effectiveness of existing instruments dealing with export promotion and access to finance and support the reallocation of resources towards the tradable sector.

⁵ Structural benchmark in the Memorandum of Economic and Financial Policies.

Competition and sectoral regulators

7.17. The Government shall take the necessary measures to ensure that the Portuguese State or any public bodies do not conclude, in a shareholder capacity, shareholder agreements the intention or effect of which hinder the free movement of capital or which influence the management or control of companies. Concerning the existing shareholder agreement of CGD in Galp, the Portuguese State will ensure that CGD alienates its participation in Galp. **[Q4-2011]**

7.18. Going beyond elimination of special rights of the State, the authorities also commit to ensure that obstacles to free movement of capital will not be created by their action. The authorities acknowledge that the discretion granted under the amended article 13(2) of the Framework Law of Privatisations (Law 11/90 amended by Decree 3/XII of the Parliament of 5 August 2011), if used, shall be restricted solely to the concrete privatization operation and thus used in such a proportionate manner that privatization's implementing laws will not set or allow holding or acquisition caps beyond the privatization transaction. **[Q3-2011]**

7.19. Take measures to improve the speed and effectiveness of competition rules' enforcement. In particular:

- i. Following the already adopted legislation establishing specialised court for Competition, Regulation and Supervision, make it operational in the context of the reforms of the judicial system (see measure 7.10) **[Q1-2012]**.
- ii. Propose a revision of the competition law, making it as autonomous as possible from the Administrative Law and the Penal Procedural Law and more harmonized with the European Union competition legal framework, in particular:⁶ **[Q4-2011]**
 - simplify the law, separating clearly the rules on competition enforcement procedures from the rules on penal procedures with a view to ensure effective enforcement of competition law;
 - rationalize the conditions that determine the opening of investigations, allowing the competition authority to make an assessment of the relevance of the claims;
 - establish the necessary procedures for a greater alignment between Portuguese law on merger control and the EU Merger Regulation, namely with regard to the criteria to make compulsory the ex ante notification of a concentration operation.;
 - ensure more clarity and legal certainty in the application of Procedural Administrative law in merger control.
 - evaluate the appeal process and adjust it where necessary to increase fairness and efficiency in terms of due process and timeliness of proceedings.

⁶ Structural benchmark in the Memorandum of Economic and Financial Policies.

- iii. Ensure that the Portuguese Competition Authority has sufficient and stable financial means to guarantee its effective and sustained operation. **[Q4-2011]**

7.20. Ensure that the national regulator authorities (NRA) have the necessary independence and resources to exercise their responsibilities. **[by Q3-2012 for the main NRAs and by Q4-2012 for the others]** In order to achieve this:

- i. provide an independent report (by internationally recognised specialists) on the responsibilities, resources and characteristics determining the level of independence of the main NRAs. The report will benchmark nomination practices, responsibilities, independence and resources of each NRA with respect to best international practice. It will also cover scope of operation of sectoral regulators, their powers of intervention, as well as the mechanisms of coordination with the Competition Authority. **[Q1-2012]** The call for tender for the report will be launched by **end-October 2011** and the report will be completed by **March 2012**;
- ii. based on the report, present a proposal to implement the best international practices identified to reinforce the independence of regulators where necessary, and in full compliance with EU law by **Q2-2012**.

Public procurement

The Government will modify the national public procurement legal framework and improve award practices to ensure a more transparent and competitive business environment and improve efficiency of public spending. In particular, it will:

7.21. Eliminate, with regard to public foundations as set out in Law n.º 62/2007, all exemptions permitting the direct award of public contracts above the Public Procurement Directives thresholds to ensure full compliance with the Directives **[Q4-2011]**.

7.22. Eliminate all special, permanent or temporary exemptions, permitting the direct award of public contracts below the Public Procurement Directives thresholds to ensure full compliance with the principles of the TFEU by the end of **Q3-2011** wherever this does not entail amending the Public Procurement Code, and by the end of **Q4-2011** otherwise.

7.23. Amend the Portuguese Public Procurement Code provisions on errors and omissions and additional works/services in accordance with the Public Procurement Directives. **[Q4-2011]**

7.24. Implement appropriate measures to address the currently existing problems with regard to direct awards for additional works/services and to ensure that such awards occur exclusively under strict conditions foreseen by the Directives. **[Q4-2011]**

7.25. Take measures to render contracting authorities' administrators financially responsible for lack of compliance with public procurement rules as recommended by the Portuguese Court of Auditors. **[Q4-2011]**

7.26. Ensure ex-ante auditing/checks on public procurement by the appropriate national bodies (most notably the Portuguese Court of Auditors) as a tool to prevent and counteract

the practice of illegal award of additional works/services and increase transparency. Amendments to the Court of Auditors' bylaws to be adopted by Parliament by **[Q4-2011]**.

7.27. Upgrade the national Public Procurement Portal (Base) based on Resolution n° 17/2010 of the National Parliament in order to improve transparency of award procedures **[Q4-2011]**.

7.28. Repeal Art. 42 (7) (8) (9) of the Public Procurement Code which sets out a requirement for investment in R&D projects on all public contracts worth more than EUR 25 million **[Q4-2011]**.

Business environment

7.29. Adopt the “Simplex Exports” programme, including measures to accelerate the procedures for requesting VAT exemption for exporting firms and simplify procedures associated with indirect exports. **[Q4-2011]**

7.30. Reinforce measures to facilitate access to finance and export markets for companies, in particular for SMEs. This will include a review of the overall consistency and effectiveness of existing measures. **[Q4-2011]**

7.31. Promote liquidity conditions for business by timely implementing the New Late Payments Directive. **[Q1-2013]**

7.32. Reduce administrative burdens by including municipalities and all levels of public administration within the scope of the Simplex Programme. **[Q1-2013]**

Annex 1. Provision of data

During the programme, the following indicators and reports shall be shared with the European Commission, the ECB and the IMF by the authorities on the agreed periodic basis. Data for past periods should also be included in subsequent transmissions in case of revision. Other indicators may also be requested to and reported by the Portuguese Authorities.

To be provided by the Ministry of Finance (or INE)

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| 1. | Data on cash balances of the State Budget. Data will include detailed information on revenue and expenditure items, in line with monthly reports that are published by the Ministry of Finance (MoF). Data on tax revenue should be decomposed in gross tax revenue received and tax reimbursements paid by the State (detailed per main individual taxes) | Monthly, 3 weeks after the end of the month |
| 2. | Data on the cash balances of the other parts of General Government (Autonomous Funds and Services, Social Security and Other entities, including Incorporated State-owned enterprises (ISOEs) or extra-budgetary funds (EBF) not part of the State Budget, but which are, under the European System of Accounts (ESA95) and ESA95 Manual on Government Deficit and Debt rules, classified by the National Statistical Institute (INE) as part of the Central Government; Regional and Local Governments (<i>Administrações Regionais and Locais</i>); Regional and local government-owned enterprises or companies, foundations, cooperatives, and other agencies and institutions, which are, under the ESA95 and ESA95 Manual on Government Deficit and Debt rules, classified by the INE as Local Government, as defined in paragraph 4 of the TMoU) | Monthly, as soon as the data are available and no later than 7 weeks after the end of the month |
| 3. | Accrual data on budget execution of the National Health System (NHS) | Monthly, 3 weeks after the end of each month |
| 4. | Consolidated cash data on the General Government budget execution initially comprising the Central Government and Social Security and enlarging progressively the scope as in indicated in the TMoU, MoU and MEFP | Monthly, 7 weeks after the end of each month |
| 5. | Number of General Government staff; Stock and flows (i.e. new hiring, retirement flows, and exit to other public entity, private sector or unemployment) over the relevant period per employment entity, such as Ministry, Regional Government, Local Government or SOE | Quarterly, no later than 30 days after the end of the quarter (as of March 2012) |
| 6. | Consolidated account on an accrual basis of the non-financial SOEs that are classified within the Central Government | Quarterly, 90 days after the end of the quarter |
| 7. | Data on the past and projected financing needs of SOEs, including for the major SOEs details on the financing needs for the operational balance, capital expenditure, interest payments and debt principal repayments | Monthly, 4 weeks after the end of the month |
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8.	Data on arrears of: <ul style="list-style-type: none"> • the General Government, detailed by subsector • the incorporated (SOEs) government-owned hospitals that are not part of the General Government • other non-financial SOEs that are not part of the General Government 	Monthly, 7 weeks after the end of each month (as of September 2011)
9.	Information on Public-Private Partnerships (PPP) related revenue and expenditure, for those PPP reclassified within the General Government (in line with paragraph 5.2 of the TMoU)	Monthly, 30 days after the end of the each month
10.	New guarantees granted by the State to SOEs, PPPs, banks and the non-financial private sector	Monthly, 30 days after the end of each month
11.	Detailed information on called guarantees of the State	Monthly, 30 days after the end of each month
12.	Data on proceeds from asset sales by the Central, Regional and Local Government	Monthly for Central Government Quarterly for Regional and Local Government 30 days after the end of reference period
13.	Quarterly data on General Government accounts as per the relevant EU regulations on statistics, showing also the main items of the transition from cash balances to the General Government balances in national accounts	Quarterly, 90 days after the end of each quarter

To be provided by ESAME

14.	Report on progress with fulfilment of economic policy conditionality on a quarterly basis. In addition, a short summary report should be sent on a monthly basis	Quarterly (report), two weeks after the end of each quarter. Monthly (short summary report) two weeks after the end of each month for which a report is not due.
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To be provided by the Debt Management Office

15.	Accrual data on interest spending of the State	Quarterly, 7 weeks after the end of the quarter
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To be provided by the Ministry of Labour

16.	Data on labour market as follows: <ul style="list-style-type: none"> a. layoffs by type b. collective agreements by type and number of collective agreements that are extended by the Ministry of Labour to non-signatory firms c. number of collective agreements that regulate the use of the Bank of Hours working time arrangement d. proportion of unemployed receiving unemployment benefits 	Every six months, 6 weeks after the end of each semester
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- e. distribution of the unemployed in terms of amount of benefits received (mean of benefits received, median, number of unemployed receiving an unemployment benefit amount equal to the IAS and number of unemployed receiving the maximum amount of unemployment benefits allowed)
 - f. unemployment duration

To be provided by the Ministry of Health

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| 17. Data on health expenditure as follows: | Quarterly, 30 days after the end of each quarter. |
| a. hospital expenditure for the different hospitals and by sub-category of hospital expenditure (e.g., pharmaceuticals, medical supplies, other supplies, services contracted to private providers such as diagnostic tests and treatments, staff) | |
| b. outpatient pharmaceutical expenditure | |
| c. remuneration costs for staff, by type of staff and specifying remuneration costs related with overtime work | |

To be provided by the Banco de Portugal

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| 18. Detailed monthly data on the financing of the General Government | Monthly, 7 weeks after the end of each month |
| 19. Data on General Government debt as per the relevant EU regulations on statistics national accounts, showing also the main factors other than the Government deficit that contributed to the variation of the General Government debt level (Stock-flow adjustment) | Quarterly, 90 days after the end of the quarter
Monthly estimates for the stock of General Government debt, 7 weeks after the end of the month |
| 20. Government debt (Portuguese and foreign) held by banks | Monthly, 40 days after the end of each month |
| 21. Data on domestic and external debt redemptions (securities), new domestic and external debt issuance (securities), change in the domestic and foreign currency assets and liabilities of the Central Government at the BdP and other financial institutions. | Monthly, 40 days after the end of the month |
| 22. Assets and liabilities of Banco de Portugal | Monthly, 10 days after the end of each month |
| 23. Assets and liabilities of the Portuguese banking system – aggregate monetary balance sheet of credit institutions | Monthly, 40 days after the end of each month |
| 24. Report on banking sector liquidity situation, including collateral | Weekly on Friday, reporting on the previous Friday |
| 25. Report on financial stability indicators for the banking sector as whole and for individual systemic important banks | Quarterly, 60 days after the end of each quarter |
| 26. Report on results from the regular quarterly solvency and deleveraging | Quarterly, 60 days after the end of each quarter depending on data |
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assessment	availability.
27. Detailed report on the dedicated account, on which the funding for Bank Support Facility is held with indication of changes in the amounts	Weekly on Monday, reporting on the previous Friday
28. Detailed breakdown of lending to the economy by category of borrower: government, SOEs inside and outside the government, large enterprises, SMEs, households	Monthly, 40 days after the end of each month



Press Release No. 11/330
FOR IMMEDIATE RELEASE
September 12, 2011

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes First Review Under an EFF with Portugal and Approves €3.98 Billion Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the first review of Portugal's performance under an economic program supported by a 3-year, SDR 23.742 billion (about €27.27 billion) Extended Fund Facility (EFF). The completion of the review enables the immediate disbursement of an amount equivalent to SDR 3.467 billion (about €3.98 billion), bringing total disbursements under the EFF to SDR 9.078 billion (about €10.43 billion).

The EFF, which was approved on May 20, 2011 (see [Press Release No. 11/190](#)) is part of a cooperative package of financing with the European Union amounting to €78 billion over three years. It entails exceptional access to IMF resources, amounting to 2,306 percent of Portugal's IMF quota, and was approved under the IMF's fast-track Emergency Financing Mechanism procedures.

Following the Executive Board's discussion, Ms. Nemat Shafik, Deputy Managing Director and Acting Chair, said:

“The new government has signaled its strong commitment to the program, and good progress has been achieved on policy implementation. While the external environment—with market pressures affecting several euro area countries and demand in export markets showing signs of slowing—has remained very difficult, the recent policy action by the European Council to strengthen the euro area crisis management framework has increased the chances of success.

“The authorities are addressing recent fiscal slippages to ensure the 2011 program targets are met. They are committed to refocusing the 2012 budget on permanent expenditure measures. Advancing structural fiscal reforms, including through strengthened commitment controls, a streamlined function of the public sector, and a reduction in fiscal risks—particularly those stemming from state-owned enterprises and private-public partnership operations—will significantly strengthen medium-term fiscal sustainability.

“Banks' progress toward improving capital positions through market-based solutions and the recent augmentation in the amount available for capital and liquidity support are key to

achieving an orderly deleveraging and restoring confidence. Continued close monitoring of deleveraging will help ensure that the adjustment safeguards adequate credit. The economy's growth potential and competitiveness will be enhanced over time by the ongoing structural reforms in the labor and product markets (supported by a fiscal devaluation) as well as in the judicial system."

**Statement by Arrigo Sadun, Executive Director for Portugal and
José Cardoso, Advisor to Executive Director
September 12, 2011**

We thank staff for the comprehensive report on the first review under the Extended Arrangement for Portugal.

1. Overview

All the quantitative performance criteria for the first review were met. We welcome staff's appraisal that "the ambitious program is broadly on track, and the new government's strong commitment is encouraging".

Portugal will comply with the fiscal target of a general government deficit of 5.9 percent of GDP in 2011. The Portuguese authorities are strongly committed to the program leading to a general government deficit of 3 percent of GDP in 2013, in line with the EDP requirements, and leading to the reduction in the public debt ratio.

The Portuguese government assumed office less than three months ago and, as agreed, adopted the economic adjustment program that had been signed in May 2011 with the IMF, the European Commission, and the ECB. The program has three main features: fiscal consolidation, gradual deleveraging of the financial system, and a comprehensive program of reforms to enhance competitiveness and growth. These are instrumental in ensuring that the public debt ratio and the net international investment position of the Portuguese economy start to decline after 2013. According to the Fiscal Strategy Document presented on August 31st, the public debt will increase to a peak in 2013 and is expected to decline thereafter. The general government and the current account are expected to be broadly in balance in 2015. In this context, and assuming that the adjustment evolves in line with expectations, by that time Portugal will have eliminated the macroeconomic imbalances that have been present in the economy for more than a decade.

Fiscal consolidation and financial deleveraging are necessary but not sufficient conditions for employment and growth. They must be complemented by a far-reaching structural reform agenda. This is crucial for restoring competitiveness and growth to a sustainable basis. The privatization program and the opening up of the non-tradable sector to competition are critical elements of the structural reforms program. The enforcement of competition rules will be strengthened and measures to increase the efficiency of the justice system will be put in place. In addition, reforms allowing for a more integrated provision of services and regulated professions are envisaged, and important labor market reforms to boost flexibility will be adopted.

2. Fiscal Policy

Portugal's fiscal performance has been in line with the program, but pressures have emerged: the Portuguese authorities identified expenditure slippages early, particularly those regarding the central government's wage bill, intermediate consumption, and

support to SOEs. This shortfall was proactively offset by measures on the revenue side: a one-time surcharge in the context of personal income tax, the frontloading of the increase in VAT rates on natural gas and electricity, additional sales of concessions, and the transfer of banks' pension funds to the state social security system (that will be exceptionally used to meet the fiscal target this year, but not in 2012 and beyond). The authorities agreed that one-off measures are unsatisfactory, but emphasized that some of the slippages also had a one-off nature.

Fiscal devaluation is a key element of the strategy to boost competitiveness. At the end of July, the authorities presented a report on fiscal devaluation that reviews and analyzes several possible solutions regarding its precise calibration. The government is considering all the pros and cons of each option put forward. In close consultation with the IMF, the European Commission, and the ECB, a final decision will take place ahead of the finalization of the 2012 budget. The government will also consult the social partners, in a spirit of constructive dialogue, before the final decision on this matter is taken.

3. Financial Sector Policies

The banking system's resilience and ability to adapt during the current challenging times is noteworthy. Recent developments have evolved in line with the requirements and expectations underlying the program.

The banking sector has proceeded with its deleveraging process, aimed at eliminating the current funding imbalances on a structural basis. Recent evidence points to a slight decline in the credit to the private sector, both for households and non-financial corporations. This is in line with the funding and capital plans submitted in end-June by the eight largest banking groups. Those plans envisage a deleveraging toward an indicative loan-to-deposit ratio of 120 percent by 2014. It remains of the essence that this path is consistent with the continuing financing support of those firms with stronger growth prospects and higher productivity. In this context, it is also decisive to ensure a balanced deleveraging of the banks' exposure to the public sector, consistent inter alia with the medium-term restructuring plans envisaged for SOEs.

The liquidity situation of the banking sector remains a challenge. During the last few quarters, the Portuguese banking sector has faced extreme constraints in accessing international wholesale debt markets. The recourse to Eurosystem financing has thus remained high over this period. However, some progress in this domain is worth underlining. First, there has been a significant increase in customers' deposits, due inter alia to increasing deposit rates and to portfolio shifts of savings under the banking groups' management in the form of mutual funds and unit-linked and life insurance policies. Second, there has also been an increase in the proportion of deposits with longer maturities, contributing favorably to decrease the maturity mismatch between banks' assets and liabilities. Finally, banks have been reinforcing their collateral buffers, and the authorities have raised the maximum amount of government guaranteed uncovered bank bonds to €35 billion.

4. Structural Reforms

Business Environment

A comprehensive audit on insolvency, enforcement, and labor backlog cases to accelerate the resolution of pending cases was undertaken and published. The tax arbitration law has been fully implemented. The “golden shares” and all other special rights held in EDP, Galp, and Portugal Telecom were abolished.

State-Owned Enterprises (SOEs)

As a first step toward promoting the public transport sector sustainability, tariffs have been increased on average by 15 percent as of August 1st. The plan to reduce the operating costs of SOEs by 15 percent is now being implemented, and tighter debt ceilings for SOEs have been imposed. The 2010 annual report on SOEs, published in July 2011, includes a chapter with the requested information regarding all central government SOEs.

Public-Private Partnerships (PPPs)

An initial assessment of PPP contracts has been undertaken. A top tier international accounting firm will now be recruited to undertake a more detailed study of PPPs.

Labor Market

With a view to reducing the costs of dismissal, a law proposal was submitted to parliament which will reduce severance payments substantially for new contracts.

Goods and Services Markets

The government approved a roadmap for the phasing out of regulated tariffs for all clients by January 1, 2013, starting July 1, 2012. The Third Energy Package was transposed. The government advanced substantially in the transposition of the new Directive on EU electronic communications regulatory framework.

5. Critical Factors for the Program’s Success

The first review of the economic adjustment program covered a period that included general elections and a change in the ruling government. The government and the main opposition party are fully committed to the program.

The staff’s appraisal for the first review is a promising start. It adds to the authorities’ strong motivation to pursue an agenda of structural transformation for the Portuguese economy. Structural changes will, eventually, lead to job creation, economic growth, and prosperity.