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Portugal: Fifth Review Under the Extended Arrangement and Request for Waivers of Applicability and Nonobservance of End-September Performance Criteria—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Portugal.

In the context of the Fifth Review Under the Extended Arrangement and Request for Waivers of Applicability and Nonobservance of End-September Performance Criteria, the following documents have been released and are included in this package:

- The staff report for the Fifth Review Under the Extended Arrangement and Request for Waivers of Applicability and Nonobservance of End-September Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on September 11, 2012, with the officials of Portugal on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on October 15, 2012. 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.

- A Press Release summarizing the views of the Executive Board as expressed during its October 24, 2012 discussion of the staff report.

- A statement by the Executive Director for Portugal.

The documents listed below have been or will be separately released.

Letter of Intent*
Memorandum of Economic and Financial Policies*
Technical Memorandum of Understanding*
Letter of Intent to the European Commission and the European Central Bank*
Memorandum of Understanding on Specific Economic Policy Conditionality*

*Also included in Staff Report

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

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PORTUGAL

Fifth Review Under the Extended Arrangement and Request for Waivers of Applicability and Nonobservance of End-September Performance Criteria

Prepared by the European Department
(In consultation with other departments)

Approved by Poul M. Thomsen and Martin Mühleisen

October 15, 2012

Executive Summary

Developments. The authorities have made good progress in reducing macroeconomic imbalances under the program. But after a strong start, the program has entered a more challenging phase. On the economic front, a large and durable fiscal gap has emerged due to a shift in the composition of output from domestic demand to less-taxed net-exports. And, politically, the broad-based consensus that has buttressed the program to date is being tested.

Program performance. All end-June PCs and structural benchmarks for the review were met. However, the end-September PC on the government deficit was missed.

Focus. Discussions centered on how best to address the revenue shortfall in the context of the 2013 Budget. The authorities and staff agreed that there was scope to recalibrate the fiscal path while maintaining a sufficient degree of frontloading to stabilize debt in the very near-term and ensure the required fiscal adjustment can be completed within the program period. Even in the wake of these developments, yields have remained in the lower end of the trading range since the program was approved.

Outlook. The recession is set to extend into next year—reflecting the slowdown in economic activity in the euro area as well as fiscal drag from additional adjustment that is now needed. Output is likely to contract by around 1 percent next year. External adjustment continues apace, with the current account deficit projected to fall below 2 percent of GDP next year. Under the new baseline public debt will peak at a higher level—at some 124 percent of GDP in 2014

Risks. The risks to the macroeconomic outlook and fiscal targets are significant and tilted to the downside. To mitigate these risks, staff is relying on more conservative macroeconomic assumptions and tax elasticities. An improvement in the broader euro area economic environment will be critical to the program's success.

Staff supports the authorities' request for completion of the fifth review, including waivers of applicability and nonobservance of end-September performance criteria. The purchase subject to completion of this review would be in an amount equivalent to SDR 1.259 billion.

Mission. Discussions took place during August 28–September 11 in Lisbon. The staff team comprised A. Selassie (head), D. Gershenson, M. Goretti, H. Lin, S. Roudet, and I. Vladkova-Hollar (all EUR); A. Piris (SPR); A. Lemgruber and M. Soto (FAD); M. Anthony and D. Parker (MCM); W. Bergthaler (LEG); and A. Jaeger and M. Souto (Res. Reps). Mr. Cardoso (OED) also participated in meetings.

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I. BACKGROUND

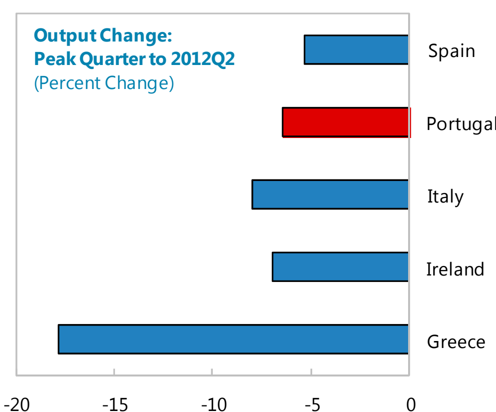
1. **After a good start, the program has entered a more challenging phase:**

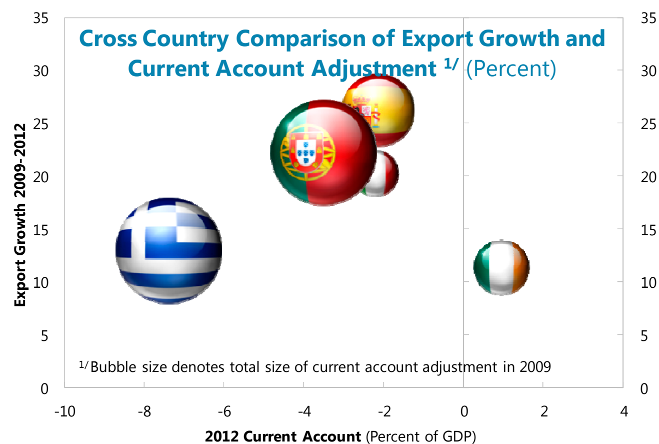
- ***Fiscal adjustment is facing strong headwinds.*** Despite spending discipline and output evolving broadly as envisaged in 2012, the fiscal deficit targets for this year and next are beyond reach due to a large (and persistent) shortfall in tax revenue collections.

- ***The recession is set to extend into next year.*** Reflecting the slowdown in activity in the euro area as well as fiscal drag from additional adjustment now needed, output is set to contract by around 1 percent next year.

- ***Social and political resistance to adjustment has heightened.*** With unemployment high and real disposable incomes falling for several quarters in a row already, the announcement of further austerity measures to underpin the 2013 Budget is testing the broad-based political and social consensus that has buttressed the program to date.

2. **However, these developments, problematic as they are, do not negate the important strides that have been made under the program.** Macroeconomic imbalances have been reduced sharply since the start of the program. By end-2012, some two-thirds of the 10 percentage points of GDP of underlying structural primary adjustment required to stabilize public debt will have been completed. Playing of this, the external current account deficit has also narrowed sharply from 10 percent of GDP in 2010 to 3 percent this year—a largely export-driven improvement. The financial sector has been kept stable. And perhaps more important from a medium- to long-term perspective, a range of essential labor and product market reforms that should enhance competitiveness and productivity have been put in place. Partly reflecting this progress but also recent ECB policy initiatives and a successful bond exchange, yields on Portuguese government bonds have fallen to the lowest level since the start of the program, even in the wake of news of fiscal underperformance.





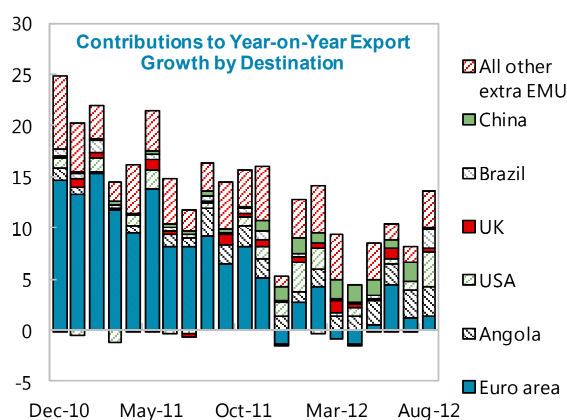
3. **Against this backdrop, the review sought to strike the right balance between advancing the required fiscal adjustment and minimizing strains on employment and output.** The authorities and staff agreed that there was scope to recalibrate the fiscal path while maintaining a sufficient degree of frontloading to stabilize debt in the very near-term. In particular, the remaining 3½ percentage points of structural primary adjustment is to be completed over two years—2013 and 2014. After taking into account the related downward revisions to the growth path and additional financing that this creates, public debt will now peak at close to 124 percent of GDP in 2014. Thereafter, it is expected to decline steadily.

4. **Nonetheless, risks to the attainment of the program's objectives have increased markedly.** While the program's core objectives remain within reach, the buffers in the program to cope with further adverse shocks have narrowed. The program also remains short of policies that offer any upsides to near-term employment and competitiveness prospects. To address the heightened risks facing the program, more conservative macroeconomic assumptions are being used in the baseline. Implementation risks are also being addressed through upfront submission to Parliament of the necessary permanent fiscal measures. Still, the program's success will also critically depend on improvements in the euro area economic environment and, more specifically, implementation of the steps being considered to strengthen the incomplete economic architecture of the currency union.

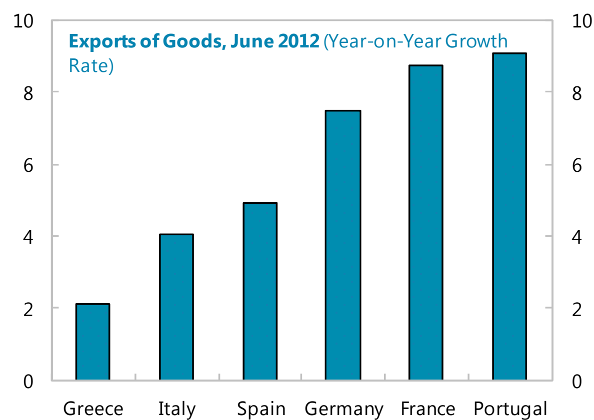
II. RECENT DEVELOPMENTS

5. **The slump in domestic demand continues, partly offset by stronger net exports:**

- Output contracted by 1¼ percent in the second quarter, broadly in line with staff expectations. The contribution from net exports was, however, stronger than expected, with import compression complementing strong export growth (see below). High frequency indicators have also been broadly consistent with staff's projected quarterly path for output in 2012—implying a contraction of some 3 percent this year (Figure 1).

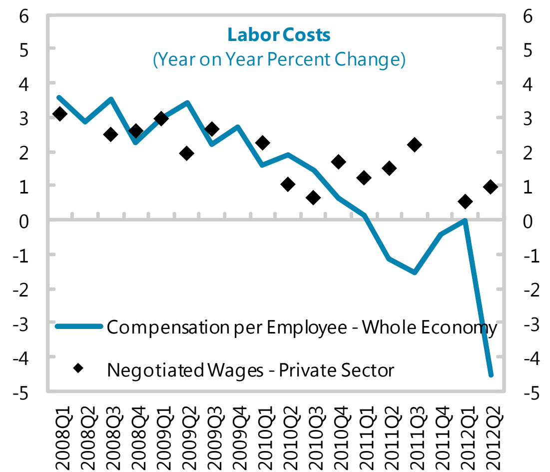


Source: INE



Sources: National Authorties

- Export growth has remained robust, even as it has decelerated throughout the year. Demand for exports continues to be broad-based across product categories, with a notable contribution from refined fuels, and has been driven by extra-EMU destinations. In the first seven months, nominal exports of goods and services grew by 10½ percent year-over-year. The growth of exports to the euro area, particularly Spain, has been volatile and declining. More recently, import compression (-2½ percent in nominal terms through July) has started to contribute more to the external adjustment—partly driven by a larger-than-expected decline in investment.



Source: Statistical Office of the European Communities; Bank of Portugal; and IMF staff calculations

- Labor market adjustment has continued, with employment declining by 4¼ percent in the second quarter over the preceding year, accompanied by a decline in the number of hours worked (Figure 2). Job losses continue to be more pronounced in the labor-intensive non-tradable sectors, suggesting that an increasing share of unemployment—at 15 percent in Q2—could be of structural nature.

- Average nominal compensation declined by 4½ percent in the year to end-June, reflecting mainly cuts in public sector wages and, to a lesser extent, lower pay increases in the private sector. As a result of this as well as job-loss related productivity increases, unit labor costs declined by 5½ percent in the year to end-June 2012 (Figures 2 and 3).

- Broader measures of inflation highlight the significant slack in demand. Headline consumer price inflation remains elevated at 3¼ percent, but it mainly reflects the effects of tax increases and administered price changes in the context of the fiscal consolidation effort. Inflation at constant tax rates has been declining since February, averaging 1 percent for the first seven months of the year—about 1¼ percentage points lower than the euro area average. Core HICP inflation has also been on the downward trajectory and lower than the euro area average.

6. **Significant fiscal pressures and challenges have emerged:**

- Although spending has been kept under tight control, revenue shortfalls, mainly driven by economic developments, have opened a large fiscal gap. Despite higher unemployment benefit payments, spending has been kept well below budgetary appropriation. This is particularly true for the wage bill, reflecting a faster-than-expected reduction in the number of employees and favorable wage composition effects.

- However, the risks to the revenue outlook highlighted at the time of the Fourth Review have fully materialized. The rebalancing of growth away from highly-taxed domestic demand and the downward shift in incomes toward lower tax brackets have greatly affected tax and social security contribution bases (MEFP ¶3). The expected annual revenue deviation compared to the supplementary budget (some 2 percent of GDP) essentially reflects change in the macroeconomic environment (1½ percent of GDP), including changes to the composition of the revenue bases.

- Overall, a fiscal gap of about 1½ percent of GDP with respect to the 2012 fiscal deficit target has now emerged, most of which will carry-over into 2013. The end-June performance criteria (PC) on the general government cash deficit and debt were met, but preliminary estimates indicate that the end-September PC on the general government deficit has been missed.[1]

- And in July, the Constitutional Court called for a rebalancing of the adjustment effort across a broader range of economic agents and incomes. The Court ruled that the cuts to the 13th and 14th month salaries of government employees as well as beneficiaries of the public pension system disproportionally affected the incomes of public sector workers and were inconsistent with the equality of treatment provision under the Constitution. The decision does not affect budget execution in 2012 but it needs to be adhered to starting in 2013. The cuts had represented an important measure under the program—contributing over 1 percent of GDP to the fiscal consolidation in 2012—and had been designed partly to mitigate the imbalance between public and private sector wages.

7. **Fiscal structural reforms are broadly on track, with control over domestic arrears still a key challenge.**

- *Public financial management.* Following the publication of a decree in June to clarify operational aspects of the law on expenditure commitment controls, commitment systems have been updated in the majority of spending units. The main delay has been among the smaller municipalities. The government also completed its partial program of settlement of domestic arrears in the health sector (€1½ billion).[2] But underlying domestic arrears have continued to be volatile, notably in hospitals and the region of Madeira, leading to new breaches of the indicative target under the program in recent months. The mid-September structural benchmark on the elaboration of a PFM Strategy Document was met.

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[1] The end-September PC on the general government debt appears to be reachable, but data to assess performance will only become available in late November.

[2] Domestic arrears amounted to about 3 percent of GDP at end-July. But with the bulk of the payments under the program of settlement of arrears in the health sector having taken place in August, this amount is expected to have decreased substantially since then.

- *Tax administration.* Program commitments—including meeting the end-December structural benchmark on the Large Taxpayer Office—are on track, although the ongoing property evaluation program is experiencing delays, which the authorities hope to overcome rapidly. The council of ministers recently approved the transposition of the EU VAT invoice directive into Portuguese legislation, a measure intended to encourage proper issuance of electronic invoices, to strengthen tax control (MEFP ¶16).

- *Public-private partnerships.* A detailed study of the 36 largest PPP contracts was completed in June, and puts PPP payment estimates higher than the authorities' projections. This is mainly due to the use of more conservative traffic assumptions for road concessions. The study also points to a large stock of contractual claims by road concessionaires—about €0.8 billion have already been recognized by the State and another €1.1 billion are under evaluation—suggesting that fiscal risks related to these contracts are higher than previously assumed.[3] On the positive side, the authorities have concluded the renegotiation of road sub-concessions (still in construction phase). By reducing the scope of these contracts and future maintenance costs, NPV savings of about €1.3 billion have been made.

8. **Bank liquidity remains adequate, buttressed by continued Eurosystem support, stable deposits, and the ongoing deleveraging process.**

- The ongoing deleveraging process and the recent capital increases have allowed banks to reduce their reliance on Eurosystem liquidity to about €56 billion as of end-August (from nearly €63 billion at end-June), with most outstanding credit from the three-year LTRO. Deposits have remained relatively stable across the banking system,[4] notwithstanding the heightened uncertainty in the region and the sizable decline in deposit rates in the wake of the prudential measures introduced by Banco de Portugal (BdP).[5]

- Credit to the private sector continues to contract (by some 5 percent year-on-year through end-July), and more so for the more leveraged firms and those operating in less profitable segments of the economy (Figure 5). Lending rates remain elevated, despite a recent decline triggered by the reduction in deposit rates. Access to credit by exporting and larger firms shows some signs of improvement and, more recently,

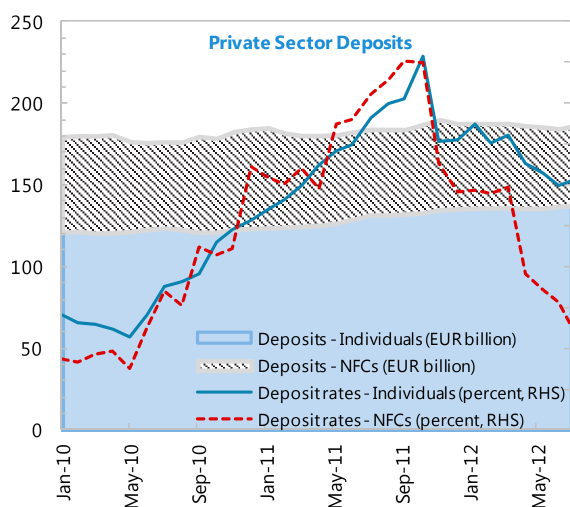
[3] Potential fiscal consequences of risks stemming from PPPs as well as SOEs are analyzed through a contingent liability shock in the debt sustainability analysis (see Appendix I).

[4] The slight reduction in customer deposits recorded in more recent months has been largely associated with the successful placement by some of the largest Portuguese firms of corporate bonds in the retail market.

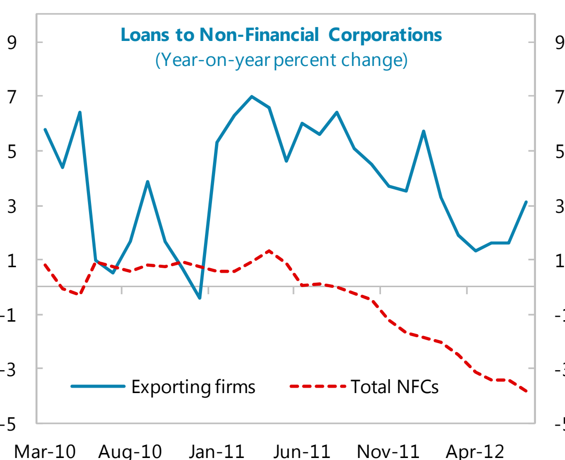
[5] To mitigate a scramble for deposits, since November 2011, BdP has imposed a deduction from Core Tier 1 own funds based on the amount of deposits contracted at interest rates above the relevant Euribor rate, depending on the term of the deposits.

some of the largest firms have been able to successfully tap the corporate bond market, diversifying their funding options.

- At end-June, all the systemic banks were able to comply with the capital needs arising from the EBA 2011 Capital Exercise, the Special On-Site Inspection Program (SIP), and the pension fund transfer. The capital support provided by the state to two large private banks, from the resources in the Bank Solvency Support Facility (BSSF), amounted to €4.3 billion in contingent instruments.[6] The state-owned Caixa Geral de Depositos (CGD) also received capital support for €1.65 billion from non-BSSF resources.

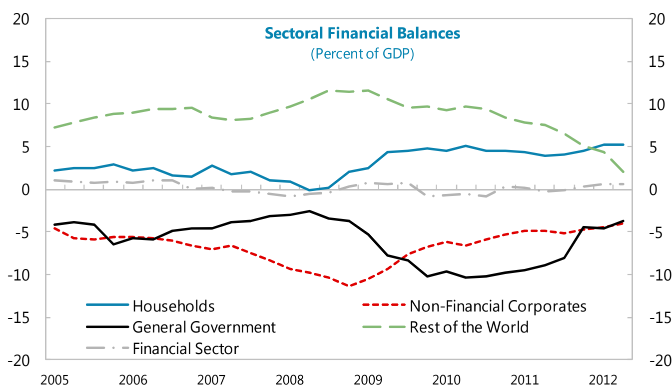


Source: Banco de Portugal



Source: Banco de Portugal

- Private sector deleveraging is advancing, with steady improvements in private sector savings. Nevertheless, the adjustment of the large corporate debt overhang is proceeding only gradually, despite already significant cuts in operational costs and notably investment. Against a weak external and domestic environment, depressed sales and high cost of credit have led to a deterioration in firms'

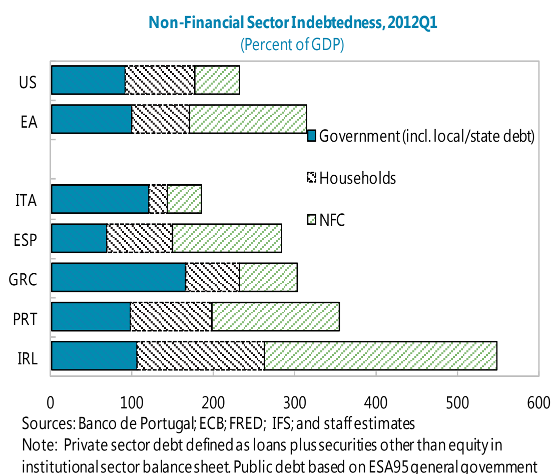


Source: Portuguese National Institute of Statistics; and IMF staff calculations.

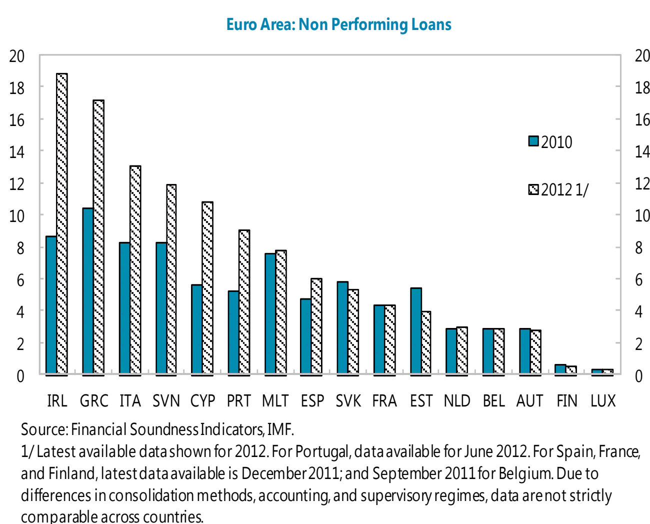
[6] Contingent instruments for €200 million were bought back by one of the private banks in August following a successful private issuance for the same amount. Another private bank completed a €500 million private equity issuance, underwritten by the state, in September.

capacity to repay and a rising number of bankruptcies, especially among SMEs (Box 1).

- Bank profitability continues to weaken. Reflecting the output contraction and the ongoing balance-sheet adjustment of the corporate sector, NPLs have increased—to about 9 percent as of end-June 2012 (Table 7). Declining mortgage rates (typically linked to the Euribor plus a fixed spread) have allowed NPLs on housing credit to remain relatively stable and low at around 5.5 percent at end-June 2012, but have proved an additional drag on banks' profitability. As a result of these developments some banks recorded losses in their mid-2012 results.

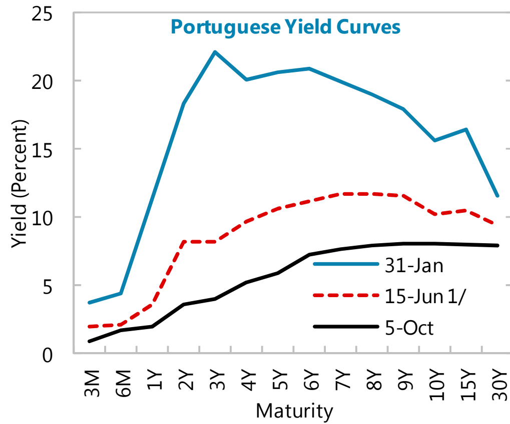


Sources: Banco de Portugal; ECB; FRED; IFS; and staff estimates
Note: Private sector debt defined as loans plus securities other than equity in institutional sector balance sheet. Public debt based on ESA95 general government

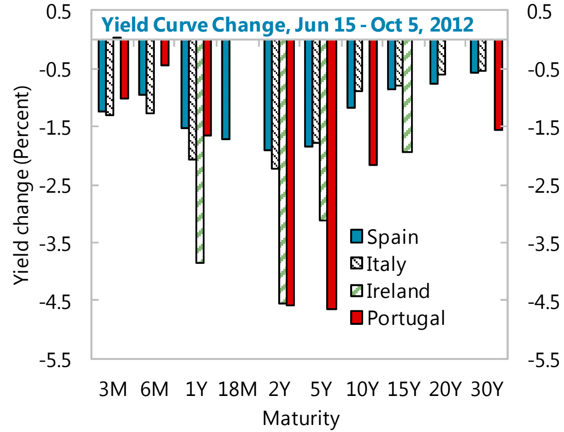


Source: Financial Soundness Indicators, IMF.
1/ Latest available data shown for 2012. For Portugal, data available for June 2012. For Spain, France, and Finland, latest data available is December 2011; and September 2011 for Belgium. Due to differences in consolidation methods, accounting, and supervisory regimes, data are not strictly comparable across countries.

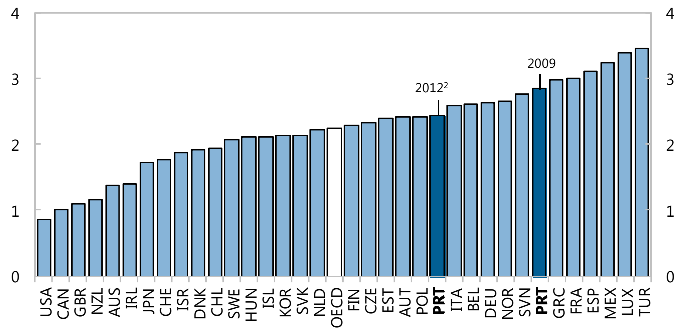
9. **Short- and long-term yields on government paper have declined significantly over the past few months.** T-bill issuance has continued to improve, with yields declining further (to between 1¾ and 3 percent at the short end) and indications of stronger interest from foreign investors. The 2-year yield has recently fallen to close to 4¼ percent (or by more than 350 basis points since mid-June), reflecting expectations of ECB intervention at the short end of the yield curve in countries with EFSF/IMF-supported programs. Perhaps most significantly, the government took an important first step towards the gradual resumption of market access by implementing a successful liability management operation—consisting in exchanging some €3¾ billion (out of €9¾ billion) of a bond due in September 2013 for one due in 2015. The yield on the 10-year bond has also been at the lower-end of its trading range over the past year in spite of the announcement that the initial fiscal deficit target for this year and next will not be met (Figure 6). All the same, the yield remains about 150 basis points above staff's assumed rate in the Debt Sustainability Analysis (DSA) analysis for market re-access in 2013.



1/ Date preceding the day when the Spanish 10-yr yield reached the 7% mark



10. **Additional steps of a comprehensive institutional reform of the labor market are being completed.** With the two latest measures under the program fulfilled—the changes to the extension mechanism for collective agreements (end-September structural benchmark met with delay) and a further reduction of severance pay (to be completed by mid-November)—the government will have legislated substantive changes to labor market institutions (Box 2). These changes will help address some of the key remaining concerns highlighted in the OECD's 2012 Economic Survey of Portugal.



1. Weighted average of three sub-indices: protection of permanent workers against (individual) dismissal, regulation on temporary forms of employment and specific requirements for collective dismissal.
2. Based on changes to the Labour Code due to come into force in August 2012.
Source: OECD (2012), "Employment Protection Legislation", OECD Employment and Labour Market Statistics (database), July.

11. **Product market reforms have further advanced.** Reforms focus on measures designed to increase competition and reduce profit margins in regulated industries:

- *Competition and regulatory frameworks.* The new Competition Law as well as the new Public Procurement Code entered into force in the beginning of July. The authorities have been monitoring the flow of cases through the Competition Court, and although there are no signs of an emerging backlog, they have assigned additional staff to the Court. A comprehensive external expert study on the resources, responsibilities and characteristics determining independence of the main sectoral regulators was completed in August. The authorities are preparing a framework law for regulation that responds to the findings and recommendations of the report (end-September structural benchmark). The objective is to guarantee the independence as

well as the financial, administrative and management autonomy of those regulatory bodies (see MEFP ¶33).

- *Services and regulated professions.* A framework law that establishes clearer and more transparent rules on the exercise of professions regulated by professional public associations, and thus reduces obstacles to entry including for professionals from other EU countries, is under consideration by the Parliament. Revisions to the draft legislation governing real estate activities regime have established less burdensome requirements for cross-border service providers.

- *Network industries.* Efforts to contain price pressure in the electricity sector are ongoing. Executive orders governing incentives for investment and the provision of guarantees of energy availability by conventional power generators were published, further rationalizing and reducing associated subsidies and increasing monitoring of recipients. A more efficient time-bound support scheme for cogeneration activity has been set, reducing associated compensation and increasing the monitoring of recipients of such subsidies. The authorities now expect to exceed the broad target set for incentive reduction in the areas of power guarantee and co-generation by a small margin (about €100 million).

III. POLICY DISCUSSIONS

Discussions focused on recalibrating the fiscal targets, the authorities' financing strategy, policies to preserve the resilience of the banking sector, and the next steps in the reform agenda to spur job creation and investment and boost competitiveness and growth.

A. Outlook and Risks: A More Protracted Recession

12. **The macroeconomic projections underpinning the program have been revised, particularly for 2013.** As expected, output is set to contract by around 3 percent in 2012, but with a shift in composition towards net exports that has continuously exceeded expectations. Against this backdrop, in revisiting the projections for 2013, the authorities and staff considered two central questions.

- ***Will external adjustment continue to exceed expectations?*** The authorities argued that the higher-than-anticipated improvement in the current account showed the economy to be adjusting swiftly, particularly as the improvement has been export-led. They saw scope for a further large improvement in 2013. But staff was more hesitant for two reasons. First, external demand, particularly from neighboring Spain, may weaken further. Second, gains in competitiveness have been limited so far—with the real effective exchange rate adjustment of only between 3 and 6 percent—raising questions about the potential for further large improvements in the current account. After extensive discussions, it was agreed to rely on more conservative numbers, and

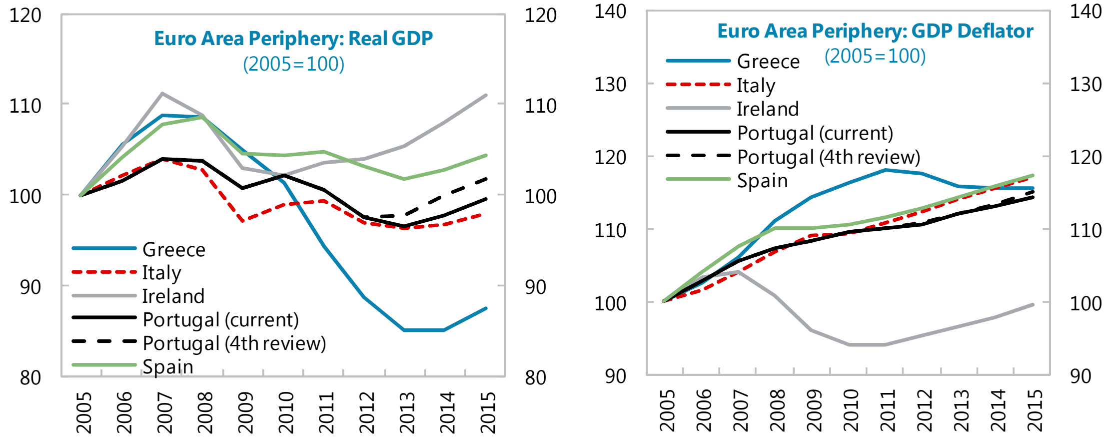
the current account is now only expected to improve modestly (by some 1 to just under 2 percent of GDP in 2013).

- ***How strong will the drag from fiscal adjustment be on growth?*** Previously, staff used a fiscal multiplier of 0.5, drawn from previous Portugal-specific empirical studies. But recent experience, both within Portugal and elsewhere, suggests the need for caution in this regard—indeed Portugal's output has been broadly in line with projections but the degree of fiscal adjustment has been lower, suggesting the possibility of a higher multiplier. Staff and the authorities therefore agreed to use a higher multiplier for the incremental fiscal adjustment being undertaken in 2013, raising the average multiplier to 0.8.[7]

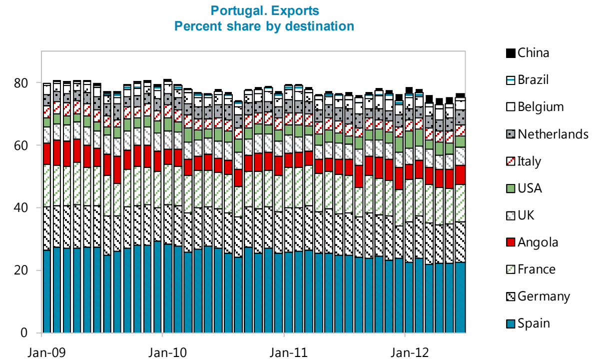
13. **Consequently, the recession is now expected to extend into 2013.** Output growth has been revised down to -1 percent in 2013 (from 0.2 percent). The within-year profile is the one where output bottoms out in the first quarter and starts to expand very gradually from there on. Consistent with these, the unemployment rate is now projected to peak at around the 16½ percent mark next year. Staff has also revised down the output growth for 2014 from 2 to some 1¼ percent, reflecting the decision to push fiscal adjustment further into 2014 as well as the carry-over from the revision to 2013 growth. The recovery in 2014 is expected to be underpinned by a gradual increase in investment outlays by more export-oriented firms as capacity constraints become more binding. The easier access to credit that such firms have and healthier balance sheet positions should put firms in a better position to expand investment once confidence starts to turn around.

14. **Under the new baseline public debt will peak at a higher level—at some 124 percent of GDP and one year later in 2014.** The main reasons for the 5 percentage points increase in the peak debt-to-GDP ratio since the last review are the slower pace of fiscal adjustment, the protracted recession that now extends into 2013, and more conservative projections for privatization receipts. Overall, as before, the debt path remains extremely sensitive to the economic growth and interest rate assumptions. And the possible migration of contingent liabilities from either state-owned enterprises or the highly indebted nonfinancial corporate sector to the sovereign balance sheet, via the banking system, remains a high risk factor for the debt trajectory. With debt set to peak in 2014 and start declining steadily thereafter, the debt outlook remains sustainable, although the room for maneuver has narrowed somewhat. A more positive development in recent weeks has been the sharp drop in secondary market yields on government bonds. The current ten-year yield of 8½ percent, while still high, is now closer to the market reentry rate of 7 percent assumed in the Debt Sustainability Analysis than at any time since the program started (DSA, see appendix I).

[7] Recent IMF staff research also suggested that fiscal cutbacks over 2010–11 in advanced economies had larger-than-expected negative short-term multiplier effects on output (Fall 20112 WEO).



15. **Downside risks to the economic outlook are significant.** First, the risk of still-weaker demand for Portuguese exports from the euro area countries remains elevated. Relatedly, the intensification of euro area stress due to, for example, heightened economic and political difficulties in Greece and/or heightened economic difficulties in Spain would have significant adverse implications for Portugal. Second, domestically, fiscal adjustment could bear down on growth even more than the revised and more conservative assumptions allow for. Third, corporate deleveraging has yet to start in earnest; once it is underway, its impact on aggregate spending and employment could exceed expectations. Lastly, mounting political and social resistance to further adjustment could also have an adverse bearing on economic outcomes—by heightening uncertainty and undermining the confidence that is necessary to revive private investment.



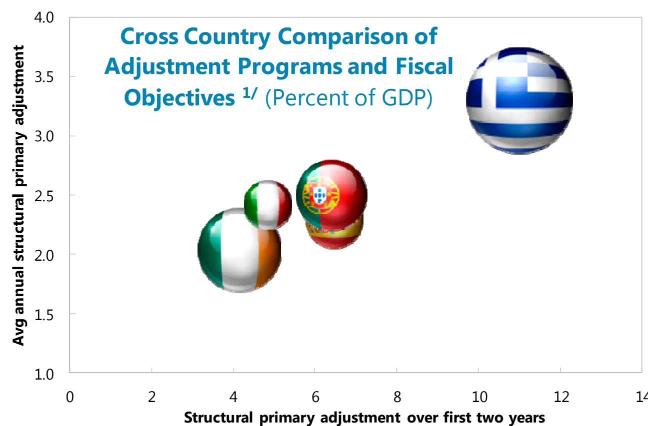
16. **A number of steps have been taken to mitigate these risks.** As noted above, the fiscal adjustment effort going forward is being underpinned by permanent structural measures to ensure that the adjustment will be durable. More conservative macroeconomic and fiscal assumptions are also being used to reduce the risk of the fiscal targets being missed going forward. And implementation risk is being addressed by making the submission of the 2013 Budget, with the agreed permanent measures, a prior action for the completion of this review. Efforts are also ongoing to secure prompt and effective restructuring of corporate debt, monitoring and updating the impact on banks' balance sheets, while steps are being taken to minimize the risk of a credit crunch in the productive segments of the economy without posing additional fiscal risks.

B. Fiscal Policy: Balancing Growth and Debt Sustainability Considerations

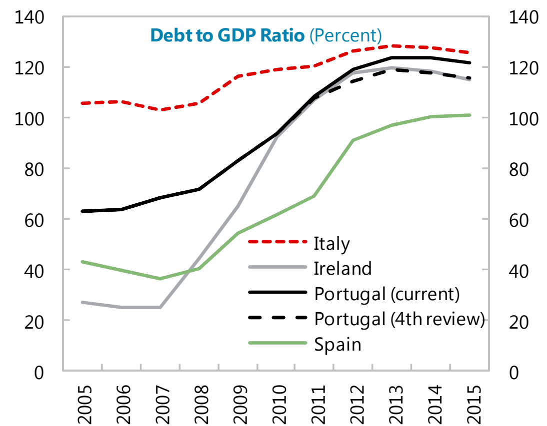
Adjustment Path

17. **A review of recent fiscal developments points to significant adjustment since 2010 but also constraints on what can be achieved in the near-term.** There was broad agreement between staff and the authorities on many key issues:

- Significant progress in advancing fiscal adjustment—of the 10 percentage points structural primary adjustment considered necessary at the start of the program to stabilize public debt, around 6½ percentage points will have been effected by the end of this year.
- Fiscal adjustment this year, however, has been less than programmed—a structural primary improvement of 3 rather than 4 percentage points of GDP envisaged.
- Moreover, the fiscal gap that has emerged this year is to a large extent of a permanent nature, as the revenue shortfall reflects a structural shift in the composition of output towards net exports. And, cyclical factors (such as the sharp drop in consumption of durable goods) are unlikely to unwind in the near future. This leaves around 3½ percentage points of GDP in structural primary adjustment to be effected over the remainder of the program period.
- This adjustment should take into account the objectives of (i) stabilizing public debt quickly and (ii) avoiding undue strains on employment and output.



Source: IMF WEO
1/ Bubbles denote total size of adjustment

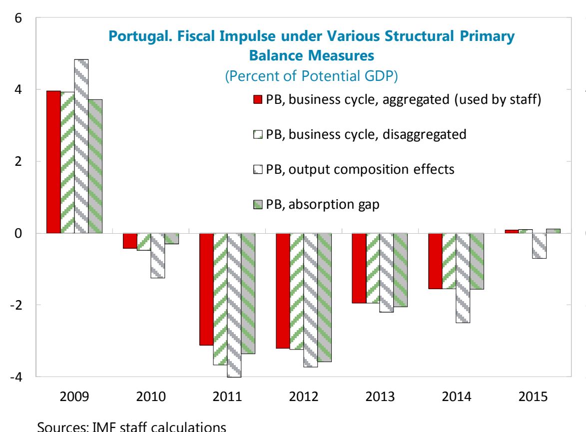


Source: WEO; and IMF staff calculations

18. **Against this backdrop, the authorities made a compelling case for allowing more time to complete the required fiscal adjustment.** They stressed their commitment to completing the adjustment within the program period, but noted that there was scope to smooth the required adjustment over 2013–14, with manageable financing implications. The consolidation challenge was compounded by the need to find offsetting measures to finance

the partial unwinding of the 13th and 14th pension and wage cuts mandated by the Constitutional Court ruling. Staff agreed to the proposed rephasing, including in light of evidence of higher fiscal multipliers at work in Portugal and in other similar cases. But the mission also stressed that this would reduce the room for maneuver under the program going forward, particularly in the face of adverse shocks.

19. **The revised fiscal path strikes a reasonable balance**—one that allows for the partial accommodation of automatic stabilizers, while ensuring that the terminal structural primary balance being implicitly targeted under the program (3¾ percent of GDP) can be reached in 2014.[8] In particular:



- The 2012 headline general government deficit target is being revised upward to 5 percent of GDP (from 4½);
- For 2013, the target is being adjusted from 3 percent to 4½ percent of GDP (corresponding to a small primary surplus).[9]
- The Stability and Growth Path (SGP) deficit threshold of 3 percent would be comfortably met in 2014, with the deficit targeted at some 2½ percent of GDP.
- The new deficit adjustment path is as front-loaded as in other countries in the periphery. The SGP target, previously expected to be met in 2013, will now be met later, as in Ireland and Spain.

20. **The additional financing implication of the revised deficit path is manageable.** The €3½ billion incremental financing need generated over 2012–13 will be financed through increased issuance of T-Bills (see below). Relatedly, the authorities have committed to widening the scope of the privatization program to partially offset the loss of some of the ANA (airport company) privatization proceeds, some of which is now to be recorded as concession revenue. So far the privatization program has proceeded well, with close to two-thirds of the €5 billion odd in privatization proceeds assumed under the program realized.

[8] The authorities medium-term fiscal strategy (SGP) is more ambitious still, envisaging further adjustment beyond this period—consistent with the European fiscal compact, the objective is to reach a structural deficit of 0.5 percent of GDP by 2015 (or a primary structural surplus of about 4½ percent of GDP).

[9] Performance criteria and indicative targets were reset according to the new fiscal path.

Staff stressed that ensuring that the remainder of the program is completed soon would be critical.[10]

Portugal. General Government Balances

	2010	2011	2012	2013	2014
Fourth review fiscal path					
Overall balance (percent of GDP)	-9.8	-4.2	-4.5	-3.0	-2.3
Excluding one-offs	*-9.1*	*-7.5*	*-4.9*	*-3.0*	*-2.3*
Primary balance (percent of GDP)	-7.0	-0.4	0.2	1.7	2.6
Excluding one-offs	*-6.3*	*-3.7*	*-0.2*	*1.7*	*2.6*
Fiscal impulse (change in structural primary balance; percent of potential GDP)	-0.5	-3.2	-4.2	-1.6	-0.1
Fifth review fiscal path					
Overall balance (percent of GDP)	-9.8	-4.4	-5.0	-4.5	-2.5
Excluding one-offs	*-9.1*	*-7.4*	*-6.0*	*-4.5*	*-2.5*
Primary balance (percent of GDP)	-7.0	-0.4	-0.5	0.2	2.4
Excluding one-offs	*-6.3*	*-3.4*	*-1.5*	*0.2*	*2.4*
Fiscal impulse (change in structural primary balance; percent of potential GDP)	-0.1	-3.6	-2.9	-1.9	-1.6

Measures to Reach the Deficit Targets

21. **Reaching the 5-percent of GDP deficit target in 2012 requires additional measures.** The authorities have committed to taking additional measures of about ¼ percent of GDP this year. These include freezing some of the remaining budget appropriations and frontloading a number of the 2013 measures (MEFP ¶6). Meeting the new fiscal target is also contingent on the appropriate classification of the expected revenue from the one-off sale of an airport concession (0.7 percent of GDP) to the soon-to-be-privatized airport concessionaire ANA. In the event the operation has to be reclassified below the line, the deficit would be closer to 5.7 percent of GDP in 2012.[11]

22. **The 2013 Budget is expected to be underpinned by permanent adjustment measures of the order of 3 percent of GDP (MEFP ¶8).**

- In response to the Constitutional Court's ruling that the burden of adjustment needs to be more broadly shared, the government is reinstating one of the two monthly wage

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[10] The government wants to separate the concession to run the airport from the current airport company (ANA) so that when the concession period expires other companies can also bid to run the airport.

[11] The authorities are of the view that this operation should be recorded above the line, and are awaiting confirmation from Eurostat. The appropriate recording of this transaction has no bearing on the assessment of the fiscal consolidation effort discussed in this section nor the 2013 deficit target, which is calibrated excluding one-off measures or transactions such as this.

cuts to public sector employees and slightly more than one-month's public pension payment.[12] The gap that this creates will be more than covered by:

- A personal income tax (PIT) surcharge equivalent to about one-half of an average monthly salary will be adopted (yielding some 0.4 percent of GDP). The surcharge will be levied on monthly incomes above the minimum wage and remain in effect at least for the duration of the program or until replaced by permanent spending cuts.

- A change in the PIT structure (yielding slightly over 1 percent of GDP). In this context, the number of the brackets will be reduced from eight to five, and the average effective rate will be increased by 2.9 percentage points to around 12½ percent. This would still keep Portugal's average effective PIT rate lower than in most other euro area countries.[13]

- Other revenue measures (0.4 percent of GDP) consist mainly in (i) an increase in property tax proceeds stemming from property values revaluations and a new stamp duty on high-value properties; (ii) limits to interest deductibility with a view to reducing the debt bias in the corporate income tax (CIT) system; and (iv) updates to a number of excise tax rates.

- Expenditure measures (1.6 percent of GDP) include (i) a further reduction in the number of public employees; (ii) further streamlining and better targeting of social transfers; and (iii) continued progress on health sector and SOE reforms.

- The measures are tilted more to the revenue side than staff would have preferred. When taking into account the reinstatement of the public sector wage, expenditure measures only account for about one-fourth of the total. Staff stressed that additional permanent cuts to the large social transfers bill would facilitate faster progress toward medium-term fiscal objectives (in view of the already relatively high tax burden and unsustainable government expenditure level). However, the authorities found it challenging to indentify more expenditure cuts at this stage. They saw the need for a comprehensive expenditure review to do so, and committed to conducting such a review to underpin adjustment over 2014–15 (MEFP ¶9).

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[12] Initially, to address the unfair burden sharing point raised by the Court, the government had planned to increase the social security contribution rate for all employees from 11 to 18 percent. This had the logic of being the equivalent of one month's cut to private sector employee's pay. But because this generated additional revenues and in order to avoid too large an increase in the tax wedge on labor and costs, the authorities announced that they would partially reduce employers' social security contributions. However, this decision to shift some of the tax burden from employers to employees unleashed strong social and political protests, causing the government to abandon the plan.

[13] The effective rate in the euro area ranges from 7 percent in Slovakia to about 28 percent in Belgium.

Fiscal Structural Reforms

23. **Vigorous pursuit of the ongoing fiscal structural reforms is necessary to underpin durable fiscal consolidation.** Policy discussions focused on arrears control, tax compliance, and PPP renegotiation.

- *Arrears.* While the authorities were committed to curb arrears accumulation, they also acknowledged complications due to the autonomy of some of the spending units, leaving the bulk of arrears outside direct central government control. Staff recognized that the recent upward trend in arrears of hospitals may have reflected strategic behavior ahead of the settlement process (to negotiate discounts and extension of payment on a larger stock of claims), but stressed that to the extent it represents a structural mismatch between the level of services and available financing, this would need to be properly addressed through additional financing and adjustment measures. Stricter controls should be exercised over local governments and regions (particularly Madeira), and non-reporting needs to be quickly addressed.

- *Tax compliance.* Even though the authorities did not see clear signs of compliance deterioration, in view of the already significant drop in revenues, staff urged them to start analyzing compliance patterns in a deeper way, and FAD provided assistance in this area during a recent mission. A greater degree of information exchange and cooperation between the tax and the social security administrations is urgently needed. Enlarging the tax administration's access to third-party information—including bank and real estate information—would also be welcome.

- *PPP operations.* The authorities showed commitment in pressing ahead on PPP reforms. Following the renegotiation of the sub-concessions, the next step is the challenging renegotiation of the ex-SCUTS (road concessions that underwent contract changes granting the State the right to charge toll fees), which are facing severe financial imbalances. The authorities agreed to look at various options and will finalize a clear renegotiation strategy by the time of the sixth review.

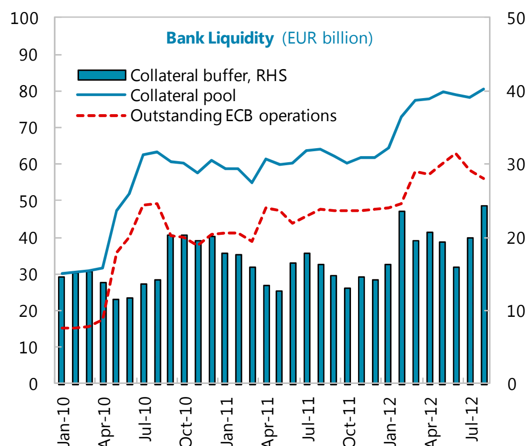
24. **The reform of the SOE sector is advancing well.** The sector as a whole will achieve operational balance ahead of the authorities' end-year 2012 objective, and, with further scope for cost reduction, some will be in a position to begin reducing their debt burdens. A new legal framework for SOEs has been submitted to Parliament, and will grant the Ministry of Finance much greater financial control over the companies it owns, and greater monitoring capacity over local government owned SOEs. Interest in the privatization program has remained strong, with sales of the airline TAP and the airport concessionaire ANA scheduled to be completed by the end of the year, and plans to sell the postal company CTT and the waste management subsidiary of the water company Águas de Portugal scheduled for early in 2013. The authorities are identifying further firms that could be restructured and privatized.

25. **Addressing the debt overhang of some SOEs remains an important challenge.** Some SOEs outside the general government perimeter have heavy debt burdens to meet going forward (see Box 4 in IMF Country Report 12/77), even after their operations have become more profitable. Discussions focused on ways of dealing permanently and transparently with the problem, including ensuring that tight budget constraints remain in place, pre-empting pressure points in amortization schedules and maintaining contacts with creditors, identifying potentially problematic loan features such as call options or ratings triggers, and selling assets and other mechanisms for reducing debt burdens through time. Significant progress has been made to date in monitoring these companies' situation; and financing pressures have so far been manageable.

C. Safeguarding Financial Stability

Liquidity and Private Sector Deleveraging

26. **Eurosystem support remains an essential source of liquidity for banks.** In the wake of the ECB's recent decision to further restrict the use of government-guaranteed bank bonds (GGBBs) for own use as collateral for Eurosystem operation, banks have been forced to look for ways to mobilize alternative collateral.[14] Banco de Portugal (BdP) was confident that other measures taken by the Eurosystem—in particular, broadening collateral eligibility, notably for additional credit claims—would allow banks to maintain a comfortable buffer of over €20 billion (equivalent to more than six months of refinancing needs). Staff acknowledged this but also stressed that continued pragmatism by the ECB would be important to avoid unduly rapid private sector deleveraging. The mission also welcomed BdP's recent initiative to launch a new platform for interbank unsecured lending, to be extended to secured transactions by the beginning of next year. This move is expected to revive the domestic interbank market and facilitate effective reallocation of liquidity.



27. **But credit conditions, particularly for small and medium-sized enterprises, remain very tight.** The authorities continue to explore ways to facilitate credit to productive firms while ensuring that these steps do not pose risks to public finances. Specifically, discussions focused on the proposal, prepared by the Ministry of Finance, jointly with the BdP and other stakeholders (as a structural benchmark under the program), to encourage the

[14] The decision allows for use of additional GGBBs under exceptional circumstances, subject to derogation of the rule by the Governing Council. The stock of GGBBs approved by Parliament, but so far unutilized, is of the order of €17 billion.

diversification of funding sources for the corporate sector. The options, which are still at a very preliminary stage, place a special emphasis on SMEs, given their large role in the Portuguese economy and limited access to non-bank credit, and fall under three main categories:

- *Improving firms' capital market access*: Leveraging on recent successful issuances by large Portuguese firms, the authorities are exploring ways to support the retail market for corporate bonds. Options under consideration to promote the equity and bond market for SMEs include the possible aggregation of SMEs loans into larger portfolios and the development of SME equity funds.

- *Exploring alternative sources of finance*: The options here include establishing a privately-run working capital platform for SMEs, strengthening the effectiveness of existing public financing entities (e.g. IAPMEI), and developing funding solutions in cooperation with the EIB.

- *Enhancing the regulatory environment*: Recognizing the important link between availability of information and access to finance the authorities are evaluating the possibility of setting up an SME credit bureau.

28. **In parallel, the authorities continue to promote initiatives to facilitate the balance sheet adjustment of the corporate sector.** After the entry into force of amendments to the insolvency law supporting early rescue of viable firms, a new conciliation framework, supported by a public entity for the promotion of SMEs (IAPMEI), has become effective to facilitate extrajudicial corporate debt restructurings for viable SMEs (SIREVE). Under this new framework, IAPMEI will act as a mediator between debtors and creditors, so as to find a financial solution for viable firms that are facing liquidity constraints, before they become insolvent (MEFP ¶26). A wide campaign has been launched to increase firms' awareness about these procedures and a large number of firms are expected to go through SIREVE. As part of its recent initiatives to avoid evergreening and promote prompt restructuring of problem loans, the BdP has issued new instructions for banks to earmark and report any changes in the terms of a loan triggered by financial difficulties of the borrower,[15] with a first report expected by end-November.

29. **Initiatives are also being implemented to tackle household indebtedness.** A new framework giving guidance to financial institutions to facilitate out-of-court debt restructuring for household debts and mortgages has been adopted (MEFP ¶27). As part of this initiative, banks will develop systems to detect households prone to financial distress,

[15] According to the BdP instructions, banks are required to identify and earmark as "restructured loans due to financial difficulties of the client" operations resulting in changes of the contract that rules a credit operation, in the form of an extension of the repayment term, the introduction of grace periods or capitalization of interest, or new operations to ensure the payment of principal or income of current operations.

and propose them affordable debt restructuring options. In addition, an existing network of consumer protection counselors will be trained by Banco de Portugal to advise households under financial distress on how to avoid getting over indebted again. Finally, Parliament adopted a temporary and targeted regime enabling a limited number of household mortgage debtors in serious financial difficulties due to temporary unemployment or reduction in salary to restructure and possibly discharge mortgages.

Bank Capital, Supervision, and Resolution

30. **The BdP is closely monitoring compliance with the capital requirements, with a view to promptly taking appropriate action if needed.** The capital injections by the government together with private rights issuances (of which three already completed) are expected to ensure that all banks can meet the program target of 10 percent Core Tier 1 by end-year. These projections already reflect the various factors expected to affect banks' prudential capital throughout the rest of 2012. These include, to a varying degree, the expected losses for the year and the capital implications of the ongoing deleveraging process, the increase in the risk parameters associated with the macroeconomic situation, and the sale of parts of their investment portfolios.

31. **Supervisory activities are currently focused on asset classes that are more sensitive to market conditions.** To this end, the BdP launched in May a new onsite inspections program. In parallel, the supervisors continue to update the stress test exercise on a quarterly basis, ensuring banks quickly address any identified deficiencies on asset quality and stress testing methodologies. While the authorities will continue to encourage banks to seek private solutions, in case of further capital needs, additional resources from the Bank Solvency Support Facility (BSSF) remain available to support the banking sector, if needed.

32. **The authorities are engaged in disposing of the distressed assets that were transferred to the state as part of the Banco Português de Negócios (BPN) resolution.** Management of the loan portfolio currently held by Parvalorem (one of the three state-owned SPVs created as part of the BPN resolution) will be contracted to a professional third party to expedite the asset recovery process. The asset management contract's terms of reference should be finalized soon; the tender will begin by end-October at the latest, aiming to conclude the selection of the asset manager by end-March 2013 (MEFP ¶24). The timely disposition of the subsidiaries and the real assets in the other two state-owned SPVs is being actively managed. All asset management strategies are geared toward maximizing recoveries to the state.

33. **The measures necessary for the completion of the new early intervention and resolution framework are being finalized.** The regulation governing the organization and operation of the resolution fund has been established, with a decree law on the banks' contributions to the resolution fund to be approved by end-November (MEFP ¶25). By then,

the BdP is also expected to finalize two supervisory notices on recovery plans and bridge banks, together with the supervisory notice on resolution plans by end-November.

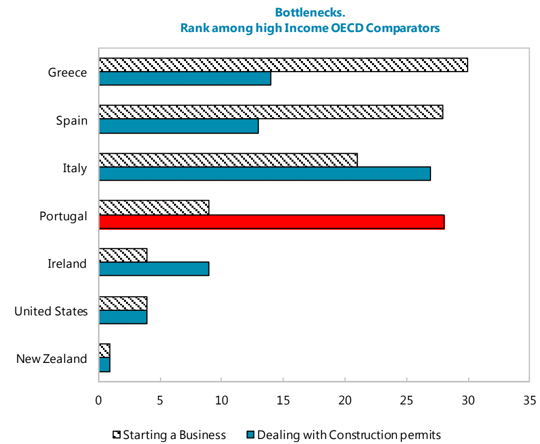
D. Boosting Competitiveness and Growth

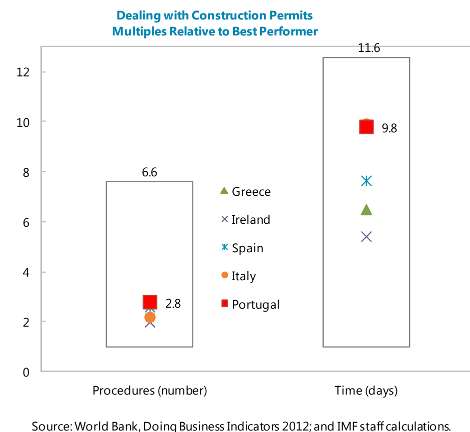
34. **The status of the structural reform agenda was also a focus of discussions.** Staff noted that the reforms to date were significant—including, the removal of significant policy-induced distortions in the housing, product, and labor markets. All the same, the payoff to these reforms would only be evident over the medium-term. In the interim, staff expressed concern that the required improvement in competitiveness is excessively reliant on demand compression generating competitiveness gains. And here the signs are mixed: economy-wide unit labor costs are declining but mainly at the expense of labor-shedding induced productivity gains and public sector wage cuts, some of which are soon to be reversed. The authorities countered by highlighting the strong export-driven improvement in the current account deficit as a sign that the competitiveness gap may not be as large as is commonly believed. Staff acknowledged this but also stressed that particularly in light of signs that export growth may be beginning to decelerate, work needed to be done by both staff and the authorities to identify reforms that could help boost competitiveness in the near-term.

35. **Previously identified structural reforms are progressing in many areas.** The privatization of the national air carrier and the airport concession are under preparation, and ports are becoming more competitive. Active labor market policies are addressing the immediate challenges of high unemployment, with the revised Labor Code entering into force in August. Critical legislation, already approved, should revive the housing market. The judiciary reforms in the areas of civil procedure and court organization, which will speed up civil and commercial litigation and unclog the court system, are also progressing well. However, it remains unclear whether these reforms will prove adequate to engender the relative price adjustment required to raise competitiveness, employment, and potential growth rapidly enough to avoid adjustment through a drawn-out economic depression. The mission urged the authorities to continue exploring options to reduce production costs and compress mark-ups in the non-tradable sector and boost productivity.

36. **Steps are being taken to boost price-competitiveness in ports.** A landmark draft law amending the traditionally highly protected port work regime has been sent to Parliament. It aims at lowering wage costs substantially and facilitating a more flexible use of labor. To ensure the proper transmission of the lower wage costs to prices for port users, the government is revising incentives for port operators by adopting a new performance-based model for concession contracts as they expire, looking to encourage entry of new operators, and reducing fees on port use (MEFP ¶31). The authorities' ultimate objective is to gradually reduce port costs by 25–30 percent.

37. **The authorities are turning their focus towards the cumbersome business licensing process as a new reform priority.** These explicit and implicit barriers to the establishment, operation, and expansion of firms create substantial uncertainty, discourage investment and limit job growth. The authorities consider the uncertainty particularly damaging for foreign firms. The costs imposed by the licensing process in Portugal are indeed high in cross-country comparison—the licensing process in Portugal takes almost 10 times longer (255 days) than the process in the best performer among 188 countries surveyed (text figure). Staff supports the authorities' newly proposed strategy to substantially streamline licensing requirements, the first step of which consists in preparing an inventory of regulations at all levels of government, with a view to eliminating overlapping and redundant regulations (MEFP ¶30). Priority is also being given to advancing the availability of zero-licensing procedures for industrial and commercial activities via an online portal, alongside actions to strengthen competition in the services sector (MEFP ¶32).





Source: World Bank, Doing Business Indicators 2012; and IMF staff calculations.

38. **Reforms to improve the efficiency of the judicial system are on track.** The authorities continue pushing ahead with targeted measures to reduce the backlogged enforcement cases and advancing reforms to streamline the court structure and procedures, taking into account cross-country experience and IMF/EU technical assistance (MEFP ¶33 and ¶34). They are on track to meet the two end-November 2012 structural benchmarks, namely the new Code of Civil Procedure to speed up the court procedures and the implementation of the judicial roadmap to streamline the court structure.

IV. FINANCING

39. **Despite the slower pace of fiscal adjustment, near-term financing conditions have improved.** The authorities have successfully expanded their Treasury bill program, lengthening maturities as yields decline significantly across the maturity spectrum. This suggests that the strategy of a gradual return to markets is still viable, and the authorities are confident that a good cash management strategy will be sufficient to cover needs while access is gradually restored. Specific plans comprise exploiting scope for further Treasury bill issuance, stopping the continuous outflow of retail savings instruments issued by the state

through offering higher rates of return, and seeking to ensure the roll-over of medium-term instruments where possible. As market conditions allow, the possibility of debt exchanges or issuance of debt at two or three year tenors will be pursued, and the authorities are actively engaging with potential investors.

40. **Staff is therefore of the view that exceptional access remains appropriate.** Balance of payments needs continue to be pressing, with very large outflows for both public and private sectors, and the current account still in deficit (Criterion 1). Notwithstanding the rise in the projected peak debt ratio, staff considers debt to be sustainable over the medium term (Criterion 2). While this cannot be asserted with high probability, risks of spillovers to other vulnerable Euro Area countries should Portugal fail to fully service its debts remain a fundamental concern justifying exceptional access. Staff considers that market access can be regained within the period that Fund resources are outstanding, although there remain risks of delay in market access and euro area lenders may be called upon their commitment to provide adequate support to Portugal so long as performance under the program is on track (Criterion 3).[16] Prospects of success for the program remain reasonably strong: the measures announced in the context of this review once again reaffirm the authorities' commitment and capacity to meet adjustment and reform objectives (Criterion 4).

41. **Capacity to repay the Fund remains adequate.** The Fund's exposure to Portugal rises to substantial levels, reaching 17 percent of GDP in 2014, with debt service expected to peak in 2018, at 5.8 percent of exports of goods and services, or 2.8 percent of GDP. Export strength has partially compensated the increased burden on the economy of Euro weakness, and downward revisions to nominal GDP. Despite fiscal and political setbacks, program implementation capacity remains strong, and the rapid closure of the external imbalances also provides assurance that adequate resources will be available to repay the Fund.

V. Staff Appraisal

42. **The program remains broadly on track, but it faces increasingly difficult policy choices.** The Portuguese authorities have continued with their impressive policy effort to gradually reverse the large economic imbalances accumulated over the last two decades. And there are visible economic pay-offs from the effort. Sovereign yield spreads have come down from the heights reached earlier this year, albeit with the help of ECB policy actions. Exports are performing well, and the external position has improved much faster than expected. But a sharp rise in unemployment and a marked shift in tax bases away from more highly-taxed activities are weighing strongly on revenue collections, while also signaling rising social hardship. With the program approaching its mid-point, few easy adjustment options remain. Policy choices therefore have to strike a balance between going ahead with the additional

[16] The first repurchase under the Extended Arrangement is in 2015.

adjustment measures needed to lower debt and bring the public finances to a sustainable path, and avoiding undue strains on the economy and employment.

43. **Nonetheless, risks surrounding the program's baseline have increased significantly.** First, there are signs aplenty of adjustment fatigue. With unemployment already very high and the economy in recession, the difficult policy choices that have to be made are testing the broad-based political consensus in support of the program that has been in place to date. Second, the feedback loops between internal devaluation, deleveraging, and the weakening external outlook have made fiscal adjustment more difficult. Overcoming these challenges will be important for the success of the program.

44. **The weakening short-term outlook should not distract from efforts to strengthen long-term growth potential within the constraints of a monetary union.** With euro area trading partner growth slowing, the economy is likely to remain in recession for the first part of 2013, while unemployment will continue to increase from the already high levels. While the turnaround is envisaged to begin relatively early next year, further adjustment needs and the weakening external environment represent significant risks to the growth outlook. Beyond the short term, ensuring that fiscal discipline will endure, while enabling a gradual deleveraging of private-sector balance sheets remain policy imperatives. Since the remedies of the pre-monetary union era—high inflation and exchange rate devaluations—are no longer available to reconcile incompatible policy choices, fostering a more competitive economy by consistently implementing difficult structural reforms is the only way forward.

45. **The short-term fiscal deficit targets have been relaxed.** While spending in 2012 has continued to perform better than budgeted, revenues are lagging behind. To allow some operation of automatic fiscal stabilizers, the deficit targets were revised upward to 5 percent of GDP in 2012 and from 3 percent to 4.5 percent in 2013. This revised path partially accommodates the shortfall, recognizing its economic rather than policy-driven nature, and will allow the government to focus on structurally sound fiscal measures while smoothing the economic and social costs of fiscal adjustment. Debt will now peak at a higher level, and—should outturns again prove worse than expected—the room for further accommodation of shortfalls would be limited.

46. **Achieving the revised targets will still require strong additional consolidation efforts.** Agreement was reached on a range of permanent spending and revenue measures to underpin the deficit target in 2013 which also make up for the one-off measures in 2012. The reliance so far on raising new revenues and their disappointing performance so far, point to a source of risk to achieving the targets and put a premium on completing the planned expenditure review and rebalancing the adjustment effort. Continued efforts in consistently implementing the law on expenditure commitment controls, further strengthening revenue administration, reducing the cost of public-private partnerships, and streamlining public administration will contribute to the needed fiscal adjustment.

47. **Risks to financial stability need to be monitored vigilantly.** The recapitalization of the banking sector and the strengthening of banking supervision and resolution frameworks are well advanced. Liquidity in the banking system, underpinned by stable deposits, continues to benefit from exceptional support from the Eurosystem, and the recent ECB decisions aimed at safeguarding the monetary policy transmission mechanisms in all countries of the euro area should also prove helpful. Deleveraging in the banking system has proceeded on pace, although access to credit at reasonable conditions remains difficult for parts of the economy. The authorities are preparing a number of policy measures to ensure that viable companies, particularly in the tradable sectors, can adequately fund their activities.

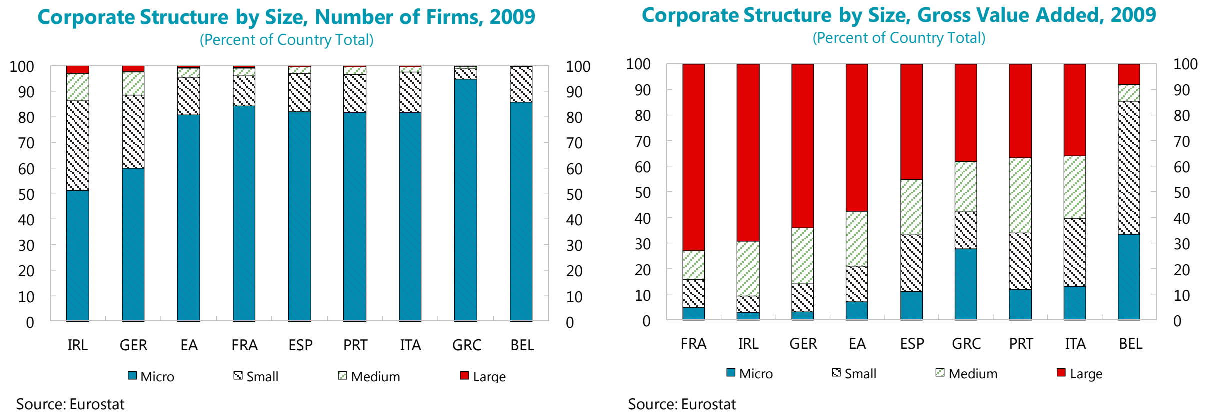
48. **Without more decisive actions to raise competitiveness, employment, and potential growth, adjustment risks being effected through a drawn-out recession.** Progress on labor and product market reforms as well as in the judiciary area should go a long way in making the economy more efficient. But staff remains concerned whether these measures will add up to what is needed to raise external competitiveness and potential growth at the pace needed to avoid adjustment through a protracted demand-driven slump. A reduction in labor costs, briefly considered during this review, could have been the fillip needed to forestall this specter. Staff urges the authorities to continue exploring alternative policy options to catalyze significant reductions in production costs and compress excessive non-tradable sector profit margins. This entails rigorous enforcement of competition laws and regulations as well as identifying and tackling more decisively any explicit and implicit policies that limit market entry and hinder competition.

49. **The success of the program will also depend critically on continued external support and resolving euro-area fissures.** The commitment by European leaders to support Portugal until market access is restored, as long as the program is on track, continues to provide a valuable financing assurance. At the same time, considerable uncertainties persist and Portugal remains vulnerable to shocks stemming from other euro area countries or policy failures at the regional level. While implementation of the authorities' adjustment program is the key for mending Portugal's deep-seated economic problems, these domestic efforts need to be complemented by institutional reforms at euro-area level to clear a path toward a durable return to market financing.

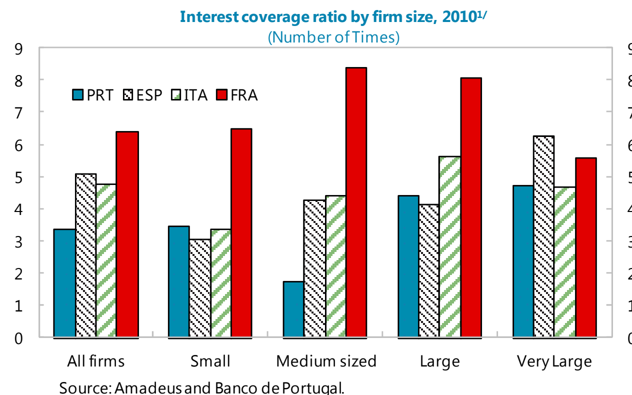
50. **Staff recommends completion of the fifth review and the granting of waivers of nonobservance and applicability.**

Box 1. The SME Sector in Portugal

The structure of the Portuguese sector is dominated by a large number of micro, small, and medium enterprises—a characteristic attributed by Braguinsky et al. (2011) to Portugal's rigid labor market institutions. Overall, micro firms and SMEs account for about 99 percent of the total number of firms and 63 percent of corporate value added. While these figures are not out of line with other Euro area countries, like Spain and Italy, they bear important implications.



Bank loans are one of the most important source of financing for Portuguese micro firms and SMEs, representing roughly 40 percent of their total financing needs, followed by trade credits and other accounts payable, while access to financing through equity and bond issuances in capital markets remains mostly restricted to a few larger companies. Due to their overleveraged positions and short-term exposures, Portuguese companies are highly vulnerable to credit and rollover risk.



The high debt burden and the concentration of a large number of firms in the non-tradable sector has resulted in declining profits, low capacity to service the debt, and an increase in debt at risk and overdue loans. While the interest coverage ratio (ICR) for small Portuguese firms covered in the Amadeus database is comparable to some of its peers (Spain and Italy), it is much smaller for medium sized firms. When comparing the ICR for different sectors in Portugal where SMEs operate, real estate and construction companies are among those with the lowest ratio, followed by firms in the food and accommodation sector.

Box 2. Comprehensive Labor Market Reform

Measures under the program have tackled all obvious policy-induced distortions: (i) an extreme level of employment protection; (ii) a wage setting system governed by strong multi-year increases in the minimum wage and sectoral collective wage agreements traditionally extended without regard to the competitive position of nonaffiliated firms; and (iii) the most generous unemployment benefit system in Europe, in terms of replacement rates but particularly with respect to duration.

1. **Employment Protection**

- **Severance pay has been reduced significantly. *Starting from 30 days per year of service, uncapped*,** a reduction in severance pay for all new contracts to 20 days pay per year of service, with a cap of 12 months, and an elimination of the 3 month minimum entered into effect on November, 2011. The new Labor Code, effective as of August 1, 2012, aligned the accumulation rate of severance payments for existing contracts with those of new hires. Finally, the authorities have committed to further reduce severance payments to 8-12 days, broadly in line with the European average. This cummulative decline to 1/3 of the original severage pay level represents an important reduction in non-wage labor costs, although the effect is difficult to calibrate and quantify.

- **The conditions under which employers can dismiss workers have been broadened to alleviate the most relevant constraints to efficient labor allocation. *Individual dismissals based on extinction of position*** would no longer require the employer to follow a seniority rule, as long as a relevant justification for the selection of workers is presented. The obligation on the employer to attempt a transfer for a possible suitable position inside the firm is abolished. ***Dismissals based on worker's unsuitability*** are now possible also without the introduction of new technologies or other changes to the work place.

2. **Wage Bargaining**

- The upward pressures on wages from strong **minimum wage increases were halted,** starting in May 2011.

- **Wage bargaining has been reformed to allow wages to reflect better heterogeneous firm-level conditions, notably for smaller firms.** The departure point was a virtually automatic extension of collective agreements negotiated between trade unions (generally the sole parties able to negotiate on the workers' side) and employers' associations (generally representing large firms), many of which represent only a small share of employment in the sector over which they were extended. Clear criteria for extension have been defined and legislated to ensure better representation before collective agreement extension..

3. **Unemployment Benefits**

- **The duration of unemployment benefits—the feature that lends the Portuguese system its notable generosity—has been reduced, but this is an area where more can be done.** The minimum duration of unemployment benefits was reduced from 270 days to 120 days. The maximum duration was also reduced, but the system remains complicated, with a large number of age-linked brackets, leaving certain workers with the right to collect unemployment benefits for up to 26 months. Beyond duration reform, the maximum monthly benefits amount was reduced from 3 to 2.5 times the social support index (IAS), or almost twice the minimum wage. In addition, a declining profile of the daily amount of unemployment insurance was introduced, with payments falling by 10% after 6 months of unemployment (previously held constant).

Table 1. Portugal: Selected Economic Indicators - Program Baseline

(Year-on-year percent change, unless otherwise indicated)

				Projections					
	2009	2010	2011	2012	2013	2014	2015	2016	2017
Real GDP	-2.9	1.4	-1.7	-3.0	-1.0	1.2	1.8	1.8	1.8
Total domestic demand	-3.3	0.8	-5.7	-6.8	-2.8	0.3	1.2	1.3	1.1
Private consumption	-2.3	2.1	-4.0	-5.9	-2.2	0.2	0.7	0.8	0.8
Public consumption	4.7	0.9	-3.8	-3.5	-3.5	-1.5	0.5	0.4	0.5
Gross fixed investment	-8.6	-4.1	-11.3	-14.1	-4.2	2.7	4.0	4.0	3.0
Private	-10.2	-8.2	-7.0	-12.5	-2.7	4.9	4.9	4.1	3.1
Government	2.0	19.5	-30.3	-24.0	-15.0	-14.4	-4.5	2.9	2.1
Exports	-10.9	8.8	7.5	4.3	3.6	5.5	5.3	4.9	5.2
Imports	-10.0	5.4	-5.3	-6.6	-1.4	3.3	4.1	3.9	3.9
Contribution to Growth									
Total domestic demand	-3.6	0.9	-6.2	-7.0	-2.8	0.3	1.2	1.2	1.1
Private consumption	-1.5	1.4	-2.7	-3.9	-1.4	0.1	0.5	0.5	0.5
Public consumption	1.0	0.2	-0.8	-0.8	-0.7	-0.3	0.1	0.1	0.1
Gross fixed investment	-1.9	-0.9	-2.2	-2.5	-0.7	0.4	0.6	0.6	0.5
Foreign balance	0.6	0.5	4.5	4.1	1.9	0.9	0.6	0.6	0.7
Savings-investment balance (percent of GDP)									
Gross national savings	9.4	9.9	10.9	13.1	13.5	14.4	15.2	16.1	16.8
Private	16.4	16.8	15.8	16.0	16.2	15.4	15.7	16.6	17.2
Public	-6.9	-6.9	-4.9	-3.0	-2.7	-1.1	-0.5	-0.5	-0.4
Gross domestic investment	20.2	19.6	17.5	15.9	15.2	15.6	15.9	16.1	16.2
Private	17.2	16.0	15.0	14.0	13.5	14.2	14.5	14.7	14.9
Public	3.0	3.6	2.5	2.0	1.7	1.4	1.3	1.3	1.3
Resource utilization									
Potential GDP	0.0	0.0	-0.3	-0.6	-0.4	-0.2	0.0	1.2	0.8
Output Gap (% of potential)	-1.7	-0.3	-1.6	-4.0	-4.6	-3.3	-1.6	-1.0	0.0
Employment	-2.6	-1.5	-1.5	-4.0	-1.7	0.3	0.6	0.4	0.4
Unemployment rate (%) 1/	9.5	10.8	12.7	15.5	16.4	15.9	15.3	14.8	14.3
Prices									
GDP deflator	0.9	1.1	0.7	0.3	1.3	1.0	1.2	1.2	1.3
Consumer prices (harmonized index)	-0.9	1.4	3.6	2.8	0.9	1.1	1.4	1.5	1.5
Compensation per worker (whole economy)	2.8	1.4	-0.8	-3.0	2.0	0.5	0.9	1.0	1.0
Labor productivity	-0.3	3.0	-0.1	1.0	0.7	0.9	1.2	1.4	1.4
Unit labor costs (whole economy)	3.2	-1.5	-0.7	-4.0	1.3	-0.4	-0.3	-0.4	-0.4
Money and credit (end of period, percent change)									
Private sector credit	3.4	-0.3	-1.5	-4.6	-3.2	-1.3	1.1	1.6	2.0
Broad money	-3.3	-1.3	-1.3	-1.2	0.3	2.2	3.0	3.0	3.1
Interest rates (percent)									
6-month interbank rate	1.7	0.8	1.4	0.6	0.2	0.5	0.9	1.4	1.9
Government bond rate, 10-year	4.2	5.4	10.2	11.5	7.9	4.7	4.4	4.6	4.7
Fiscal indicators (percent of GDP)									
General government balance (percent of GDP) 2/	-10.2	-9.8	-4.4	-5.0	-4.5	-2.5	-1.9	-1.9	-1.8
Primary government balance (percent of GDP)	-7.3	-7.0	-0.4	-0.5	0.2	2.4	3.1	3.2	3.3
Structural balance	-9.1	-9.0	-6.5	-4.1	-2.3	-1.0	-1.2	-1.4	-1.8
Structural primary balance (percent of potential GDP)	-6.3	-6.1	-2.6	0.3	2.2	3.8	3.7	3.6	3.3
General government debt	83.1	93.3	108.1	119.1	123.7	123.6	121.2	118.4	116.0
External sector (percent of GDP)									
Trade balance (goods)	-10.6	-10.5	-7.7	-4.6	-3.1	-2.5	-2.1	-1.9	-1.5
Trade balance (G&S)	-7.0	-6.7	-3.2	0.7	2.6	3.5	4.0	4.5	5.1
Current account balance	-10.9	-10.0	-6.5	-2.9	-1.7	-1.2	-0.7	0.0	0.6
Net international investment position	-110.6	-107.2	-103.8	-107.8	-107.8	-105.4	-101.7	-97.4	-92.6
REER based on ULC (2000=100)	108.6	107.4	107.7	101.7	102.6	101.9	101.1	100.1	99.2
(rate of growth)	1.3	-1.1	0.3	-5.6	0.8	-0.6	-0.8	-0.9	-0.9
REER based on CPI (2000=100)	113.6	111.1	112.0	111.8	110.4	110.0	109.9	109.6	109.5
(rate of growth)	-0.7	-2.2	0.8	-0.2	-1.2	-0.4	-0.1	-0.2	-0.2
Nominal GDP (billions of euro)	168.5	172.7	170.9	166.3	166.8	170.4	175.5	180.8	186.5

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.

2/ EDP notification concept.

Table 2a. General Government Accounts 1/

(Billions of euros)

	2009	2010	2011	Projections					
				2012 Fourth Review	2012	2013	2014	2015	2016
Revenue	66.7	71.5	76.9	71.6	69.4	71.7	72.7	74.7	76.7
Taxes	36.6	38.4	40.4	40.8	38.6	41.4	41.8	43.2	44.5
Taxes on production and imports	21.5	23.2	23.4	24.3	22.8	23.1	23.4	24.2	24.9
Current taxes on income, wealth, etc. and capital taxes	15.1	15.3	17.0	16.4	15.8	18.3	18.5	19.0	19.5
Current taxes on income, wealth, etc.	15.1	15.2	17.0	16.4	15.8	18.3	18.5	19.0	19.5
Capital taxes	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	21.0	21.1	20.9	20.0	19.5	19.3	19.7	20.0	20.4
Grants and other revenue	9.0	11.9	15.6	10.9	11.2	11.0	11.2	11.5	11.9
Property income	1.3	1.2	1.1	1.2	1.2	1.2	1.2	1.3	1.3
Sales of goods and services	4.1	4.1	4.4	4.9	4.9	4.9	5.0	5.2	5.4
Other current revenue	2.4	2.1	2.5	2.6	2.7	2.7	2.8	2.8	2.9
Capital transfers and investment grants	1.2	4.6	7.6	2.3	2.5	2.2	2.2	2.2	2.3
of which: Pension funds transfer	0.0	2.8	6.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure 2/	83.8	88.5	84.4	79.1	77.7	79.1	77.1	78.1	80.1
Expense	82.2	85.8	83.8	79.7	78.3	80.4	78.8	80.1	82.2
Compensation of employees	21.4	21.1	19.4	16.6	16.3	16.6	16.1	16.4	16.6
Use of goods and services	8.4	8.7	8.0	7.5	7.4	7.4	6.9	7.0	7.1
Consumption of fixed capital	3.6	3.8	3.9	4.0	4.0	4.2	4.3	4.5	4.6
Interest (ESA95)	4.8	5.0	6.9	7.8	7.5	7.8	8.5	8.8	9.1
Subsidies	1.3	1.2	1.2	1.7	1.7	1.6	1.3	1.3	1.4
Social benefits	37.0	37.8	37.6	36.7	36.8	37.4	37.1	37.9	38.9
Grants and other expense	5.7	8.2	6.8	5.5	4.6	5.5	4.6	4.2	4.5
Other current expense	4.3	4.9	4.4	3.8	4.0	3.9	3.1	2.9	3.2
Capital transfers	1.4	3.3	2.4	1.7	0.6	1.7	1.5	1.3	1.2
Net acquisition of nonfinancial assets	1.7	2.7	0.5	-0.6	-0.6	-1.2	-1.8	-2.0	-2.1
Gross fixed capital formation	5.2	6.5	4.4	3.5	3.4	2.9	2.5	2.4	2.5
(-) Consumption of fixed capital	-3.6	-3.8	-3.9	-4.0	-4.0	-4.2	-4.3	-4.5	-4.6
Acquisitions less disposals of other nonfinancial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-11.9	-10.5	-3.1	-4.0	-4.9	-4.6	-1.8	-1.0	-0.9
Net lending (+)/borrowing (–) (ESA95)	-17.1	-17.0	-7.5	-7.5	-8.3	-7.5	-4.3	-3.4	-3.4
Net lending (+)/borrowing (–) (EDP notification)	-17.1	-17.0	-7.5	-7.5	-8.3	-7.5	-4.3	-3.4	-3.4
Net acquisition of financial assets	1.1	4.9	14.8	…	…	…	…	…	…
Monetary gold and SDRs	0.0	0.0	0.0	…	…	…	…	…	…
Currency and deposits	-0.5	0.7	10.2	…	…	…	…	…	…
Debt securities	0.4	-0.1	0.4	…	…	…	…	…	…
Loans	-0.2	1.3	0.9	…	…	…	…	…	…
Equity and investment fund shares	1.0	1.6	-0.3	…	…	…	…	…	…
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	…	…	…	…	…	…
Financial derivatives and employee stock options	-0.1	-0.4	-0.2	…	…	…	…	…	…
Other accounts receivable	0.4	1.8	3.9	…	…	…	…	…	…
Net incurrence of liabilities	18.2	21.9	22.4	…	…	…	…	…	…
SDRs	0.0	0.0	0.0	…	…	…	…	…	…
Currency and deposits	-0.5	-0.8	-3.1	…	…	…	…	…	…
Debt securities	16.2	17.8	-11.2	…	…	…	…	…	…
Loans	1.6	3.6	35.8	…	…	…	…	…	…
Equity and investment fund shares	0.0	0.0	0.0	…	…	…	…	…	…
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	…	…	…	…	…	…
Financial derivatives and employee stock options	0.0	0.0	0.3	…	…	…	…	…	…
Other accounts payable	0.9	1.3	0.6	…	…	…	…	…	…
Memorandum items:									
Primary balance	-12.3	-12.0	-0.6	0.3	-0.8	0.3	4.2	5.5	5.7
Interest (EDP notification)	4.8	4.9	6.9	7.8	7.5	7.8	8.5	8.8	9.1
Debt at face value (EDP notification)	139.9	161.1	184.7	190.9	198.1	206.4	210.6	212.7	214.2
Nominal GDP	168.5	172.7	170.9	166.9	166.3	166.8	170.4	175.5	180.8

Sources: Portuguese statistical authorities; and IMF staff projections.

1/ GFSM 2001 presentation.

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

Table 2b. General Government Accounts 1/

(Percent of GDP)

				Projections					
	2009	2010	2011	2012 Fourth Review	2012	2013	2014	2015	2016
Revenue	39.6	41.4	45.0	42.9	41.7	43.0	42.7	42.6	42.4
Taxes	21.7	22.3	23.6	24.4	23.2	24.8	24.6	24.6	24.6
Taxes on production and imports	12.8	13.4	13.7	14.6	13.7	13.8	13.7	13.8	13.8
Current taxes on income, wealth, etc. and capital taxes	9.0	8.8	9.9	9.8	9.5	11.0	10.8	10.8	10.8
Current taxes on income, wealth, etc.	9.0	8.8	9.9	9.8	9.5	11.0	10.8	10.8	10.8
Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	12.5	12.2	12.2	12.0	11.7	11.6	11.6	11.4	11.3
Grants and other revenue	5.4	6.9	9.1	6.5	6.8	6.6	6.6	6.5	6.6
Property income	0.8	0.7	0.6	0.7	0.7	0.7	0.7	0.7	0.7
Sales of goods and services	2.4	2.4	2.6	2.9	2.9	2.9	2.9	2.9	3.0
Other current revenue	1.4	1.2	1.5	1.5	1.6	1.6	1.6	1.6	1.6
Capital transfers and investment grants	0.7	2.6	4.4	1.4	1.5	1.3	1.3	1.3	1.3
of which: Pension funds transfer	0.0	1.6	3.5	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure 2/	49.8	51.3	49.4	47.4	46.7	47.5	45.2	44.5	44.3
Expense	48.8	49.7	49.1	47.8	47.1	48.2	46.3	45.7	45.5
Compensation of employees	12.7	12.2	11.4	9.9	9.8	10.0	9.5	9.3	9.2
Use of goods and services	5.0	5.1	4.7	4.5	4.5	4.4	4.1	4.0	3.9
Consumption of fixed capital	2.1	2.2	2.3	2.4	2.4	2.5	2.5	2.5	2.5
Interest (ESA95)	2.9	2.9	4.0	4.7	4.5	4.7	5.0	5.0	5.0
Subsidies	0.8	0.7	0.7	1.0	1.0	1.0	0.8	0.7	0.8
Social benefits	22.0	21.9	22.0	22.0	22.1	22.4	21.8	21.6	21.5
Grants and other expense	3.4	4.7	4.0	3.3	2.8	3.3	2.7	2.4	2.5
Other current expense	2.5	2.8	2.6	2.3	2.4	2.3	1.8	1.6	1.8
Capital transfers	0.9	1.9	1.4	1.0	0.4	1.0	0.9	0.8	0.7
Net acquisition of nonfinancial assets	1.0	1.6	0.3	-0.4	-0.4	-0.7	-1.0	-1.2	-1.2
Gross fixed capital formation	3.1	3.7	2.6	2.1	2.0	1.7	1.5	1.4	1.4
(-) Consumption of fixed capital	-2.1	-2.2	-2.3	-2.4	-2.4	-2.5	-2.5	-2.5	-2.5
Acquisitions less disposals of other nonfinancial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-7.1	-6.1	-1.8	-2.4	-3.0	-2.7	-1.1	-0.5	-0.5
Net lending (+)/borrowing (–) (ESA95)	-10.2	-9.8	-4.4	-4.5	-5.0	-4.5	-2.5	-1.9	-1.9
Net lending (+)/borrowing (–) (EDP notification)	-10.2	-9.8	-4.4	-4.5	-5.0	-4.5	-2.5	-1.9	-1.9
Net acquisition of financial assets	0.6	2.8	8.7	…	…	…	…	…	…
Monetary gold and SDRs	0.0	0.0	0.0	…	…	…	…	…	…
Currency and deposits	-0.3	0.4	6.0	…	…	…	…	…	…
Debt securities	0.2	0.0	0.2	…	…	…	…	…	…
Loans	-0.1	0.7	0.5	…	…	…	…	…	…
Equity and investment fund shares	0.6	0.9	-0.2	…	…	…	…	…	…
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	…	…	…	…	…	…
Financial derivatives and employee stock options	-0.1	-0.2	-0.1	…	…	…	…	…	…
Other accounts receivable	0.3	1.0	2.3	…	…	…	…	…	…
Net incurrence of liabilities	10.8	12.7	13.1	…	…	…	…	…	…
SDRs	0.0	0.0	0.0	…	…	…	…	…	…
Currency and deposits	-0.3	-0.5	-1.8	…	…	…	…	…	…
Debt securities	9.6	10.3	-6.5	…	…	…	…	…	…
Loans	1.0	2.1	20.9	…	…	…	…	…	…
Equity and investment fund shares	0.0	0.0	0.0	…	…	…	…	…	…
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	…	…	…	…	…	…
Financial derivatives and employee stock options	0.0	0.0	0.2	…	…	…	…	…	…
Other accounts payable	0.5	0.8	0.4	…	…	…	…	…	…
Memorandum items:									
Primary balance	-7.3	-7.0	-0.4	0.2	-0.5	0.2	2.4	3.1	3.2
Structural balance (Percent of potential GDP)	-9.1	-9.0	-6.5	-2.5	-4.1	-2.3	-1.0	-1.2	-1.4
Structural primary balance (Percent of potential GDP)	-6.3	-6.1	-2.6	1.9	0.3	2.2	3.8	3.7	3.6
Interest (EDP notification)	2.8	2.9	4.0	4.7	4.5	4.7	5.0	5.0	5.0
Debt at face value (EDP notification)	83.1	93.3	108.1	114.4	119.1	123.7	123.6	121.2	118.4

Sources: Portuguese statistical authorities; and IMF staff projections.

1/ GFSM 2001 presentation.

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

Table 3. General Government Stock Positions

(Billions of Euros)

	2008	2009	2010	2011
Net financial worth	-93.1	-108.7	-110.0	-92.6
Financial assets	45.7	48.6	58.4	74.1
Monetary gold and SDRs	0.0	0.0	0.0	0.0
Currency and deposits	7.3	6.8	7.7	18.0
Debt securities	1.5	1.9	1.8	2.2
Loans	3.0	2.8	4.1	5.0
Equity and investment fund shares	25.8	28.7	34.3	34.2
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0
Financial derivatives and employee stock options	-0.1	0.0	0.1	0.4
Other accounts receivable	8.1	8.5	10.3	14.2
Liabilities	138.8	157.2	168.3	166.7
Special Drawing Rights (SDRs)	0.0	0.0	0.0	0.0
Currency and deposits	19.5	18.9	18.1	15.0
Debt securities	98.1	114.3	120.4	85.1
Loans	15.7	17.4	21.2	58.0
Equity and investment fund shares	0.0	0.0	0.0	0.0
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0
Financial derivatives and employee stock options	0.0	0.0	0.0	0.9
Other accounts payable	5.6	6.5	8.5	7.8
Memorandum items:				
Gross debt (at market value)	138.8	157.2	168.3	165.8
Gross debt at face value	128.7	146.5	169.7	192.5
Gross debt at face value (EDP notification)	123.1	139.9	161.1	184.7
Other economic flows - financial assets	…	1.8	4.9	0.9
Other economic flows - liabilities	…	0.3	-10.8	-24.0

Sources: Portuguese statistical authorities; and IMF staff calculations.

Table 4. Portugal: General Government Financing Requirements and Sources 1/
(In billion of euros)

	2009	2010	2011	2012	2013	2014	2015	2016	2017
Gross borrowing need	**45.3**	**58.4**	**59.3**	**59.1**	**33.6**	**35.5**	**37.3**	**40.3**	**31.2**
Overall balance	17.1	17.0	7.5	8.3	7.5	4.3	3.4	3.4	3.3
Amortization	26.1	31.0	40.7	35.2	23.7	31.3	35.2	38.8	28.9
M<	6.5	7.7	12.8	15.5	7.8	15.2	16.9	12.6	9.0
Residents	0.9	0.7	3.9	8.9	3.0	6.8	9.7	6.3	4.7
Of which within general government	0.1	0.0	0.4	2.2	0.9	1.5	0.8	0.7	0.6
Non-residents	5.6	7.1	8.9	6.5	4.8	8.4	7.2	6.3	4.3
ST	19.6	23.3	27.9	18.8	15.9	16.1	16.1	16.1	16.1
Residents	5.6	6.4	16.9	17.0	14.7	12.7	10.6	8.6	8.6
Of which within general government	0.9	1.1	3.3	4.7	1.0	…	…	…	…
Non-residents	14.0	16.9	11.0	1.8	1.2	3.4	5.4	7.5	7.5
EU and IMF	0.0	0.0	0.0	1.0	0.0	0.0	2.3	10.1	3.9
Other (net) 2/	2.1	10.4	11.0	15.6	2.4	-0.1	-1.3	-1.9	-1.0
Of which within general government 3/	2.1	4.6	3.9	3.5	…	…	…	…	…
Gross financing sources	**45.3**	**58.4**	**23.9**	**29.7**	**23.3**	**28.5**	**37.3**	**40.3**	**31.2**
Privatization receipts	0.0	0.7	0.6	2.1	2.0	0.0	0.0	0.0	0.0
Market access	44.0	59.0	36.8	21.0	22.7	28.5	37.3	40.3	31.2
M<	20.8	31.0	18.0	5.1	6.6	12.4	21.2	24.2	15.1
Residents	7.3	15.9	13.7	4.7	3.6	5.8	7.9	9.0	6.4
Of which from general government	1.2	3.0	6.1	1.8	…	…	…	…	…
Non-residents	13.5	15.1	4.3	0.3	3.0	6.6	13.3	15.1	8.7
ST	23.3	27.9	18.8	15.9	16.1	16.1	16.1	16.1	16.1
Residents	6.4	16.9	17.0	14.7	12.7	10.6	8.6	8.6	8.6
Of which from general government	1.1	3.3	4.7	…	…	…	…	…	…
Non-residents	16.9	11.0	1.8	1.2	3.4	5.4	7.5	7.5	7.5
Use of deposits 4/	1.3	-1.3	-13.5	6.7	-1.3	0.0	0.0	0.0	0.0
Of which intra-government 3/	0.8	-0.6	-3.2	2.4	…	…	…	…	…
Financing under the program	**0.0**	**0.0**	**35.3**	**29.4**	**10.2**	**7.1**	**0.0**	**0.0**	**0.0**
European Union	…	…	22.2	20.3	6.5	5.2	…	…	…
IMF	…	…	13.1	9.1	3.7	1.9	…	…	…
Net placement (market access-amortization)	17.9	28.0	-3.9	-14.3	-1.0	-2.9	2.1	1.5	2.3
Residents	7.1	25.8	9.9	-6.2	-1.4	-3.1	-3.8	2.7	1.8
M<	6.3	15.3	9.8	-4.2	0.6	-1.0	-1.7	2.7	1.8
ST (net increase)	0.8	10.5	0.1	-2.1	-2.1	-2.1	-2.1	0.0	0.0
Non-residents	10.9	2.2	-13.8	-4.0	0.4	0.2	8.2	8.8	4.4
M<	7.9	8.0	-4.6	-6.2	-1.8	-1.8	6.1	8.8	4.4
ST (net increase)	2.9	-5.9	-9.2	2.2	2.2	2.1	2.1	0.0	0.0

Source: Portuguese authorities and Fund staff estimates.

1/ The coverage of this table has been expanded to fully reflect all general government (including local and regional governments and SOES) financing operations. However, data are on a non-consolidated basis (with intra-government flows presented where available). On a consolidated basis, they are smaller, by the amount of intra-government transactions.

2/ Includes use of Bank Solvency Support Facility and other net financial transactions, net financing from retail government securities programs, as well as adjustments for cash-accrual differences and consistency between annual projections and preliminary quarterly accounts.

3/ Values for 2012 are H1 estimates.

4/ Changes in government deposits (including deposits in BSSF).

Table 5. Portugal: Balance of Payments, 2009–17

	2009	2010	2011	2012	2013	2014	2015	2016	2017
				Projections					
	(Billions of euro)								
Current account	**-18.4**	**-17.2**	**-11.0**	**-4.8**	**-2.9**	**-2.1**	**-1.2**	**0.0**	**1.0**
Balance of goods and services	-11.8	-11.5	-5.4	1.1	4.3	5.9	7.0	8.1	9.5
Trade balance	-17.8	-18.2	-13.2	-7.6	-5.2	-4.2	-3.7	-3.3	-2.7
Exports fob	32.0	36.9	42.6	45.5	47.5	50.8	54.0	57.3	61.2
Imports fob	49.8	55.1	55.8	53.1	52.7	55.0	57.8	60.7	64.0
Services, net	6.0	6.7	7.7	8.7	9.5	10.1	10.7	11.4	12.2
Exports	16.3	17.6	19.2	19.5	20.2	21.3	22.5	23.7	25.2
Imports	10.3	10.9	11.4	10.8	10.7	11.2	11.7	12.3	13.0
Of which:									
Tourism	4.2	4.6	5.2	5.5	5.9	6.3	6.6	7.0	7.5
Exports	6.9	7.6	8.1	8.3	8.6	9.2	9.7	10.2	10.9
Imports	2.7	3.0	3.0	2.8	2.8	2.9	3.1	3.2	3.4
Income, net	-8.7	-7.9	-8.6	-8.9	-10.2	-11.0	-11.3	-11.1	-11.5
Current transfers, net	2.1	2.2	3.0	3.1	3.1	3.0	3.0	3.1	3.0
Private remittances, net	2.1	2.2	2.4	2.5	2.4	2.4	2.3	2.3	2.4
Official transfers, net	0.1	0.0	0.6	0.5	0.6	0.7	0.7	0.7	0.7
Capital account	**1.4**	**1.9**	**2.1**	**2.7**	**2.4**	**2.2**	**2.4**	**2.4**	**2.4**
Financial account	**17.5**	**15.6**	**-24.4**	**-26.6**	**-9.8**	**-7.2**	**-1.1**	**-2.4**	**-3.5**
Direct investment	1.4	7.7	-1.7	3.9	-2.2	-1.3	-1.4	-1.5	-1.7
Portuguese investment abroad	-0.6	5.7	-9.1	-6.5	-4.0	-4.2	-4.3	-4.5	-4.7
Foreign investment in Portugal	1.9	2.0	7.4	10.4	1.9	2.9	2.9	3.0	3.0
Portfolio investment, net	15.0	-9.7	-4.8	-10.3	-6.4	-6.4	3.8	0.4	-7.4
Financial derivatives	0.2	0.4	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Other investment, net	0.8	18.2	-19.7	-20.1	-1.3	0.4	-3.5	-1.2	5.6
Reserve assets	0.1	-1.0	1.2	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	-0.5	-0.3	-0.6	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	…	…	33.9	28.6	10.2	7.1	…	…	…
European Union	…	…	20.9	19.4	6.5	5.2	…	…	…
IMF	…	…	13.1	9.2	3.7	1.9	…	…	…
Memorandum items:									
Net international investment position 1/	-186.3	-185.1	-177.3	-179.4	-179.8	-179.6	-178.5	-176.1	-172.7
Direct investment, net	-32.1	-33.6	-31.7	-35.5	-33.4	-32.1	-30.7	-29.1	-27.5
Portfolio investment, net	-70.0	-51.3	-29.6	-47.9	-51.7	-52.4	-56.2	-56.6	-49.1
Financial derivatives	-0.4	-1.1	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8
Other investment, net	-94.8	-114.8	-130.7	-110.6	-109.3	-109.8	-106.3	-105.1	-110.7
Reserve assets	11.1	15.7	16.5	16.5	16.5	16.5	16.5	16.5	16.5
Nominal GDP	168.5	172.7	170.9	166.3	166.8	170.4	175.5	180.8	186.5
	(Percent of GDP)								
Current account	**-10.9**	**-10.0**	**-6.5**	**-2.9**	**-1.7**	**-1.2**	**-0.7**	**0.0**	**0.6**
Current account (including capital transfers)	-10.1	-8.9	-5.2	-1.2	-0.3	0.1	0.6	1.3	1.9
Of which: Balance of goods and services	-7.0	-6.7	-3.2	0.7	2.6	3.5	4.0	4.5	5.1
Net international investment position 1/	-110.6	-107.2	-103.8	-107.8	-107.8	-105.4	-101.7	-97.4	-92.6
Direct investment, net	-19.0	-19.5	-18.5	-21.4	-20.0	-18.8	-17.5	-16.1	-14.7
Portfolio investment, net	-41.6	-29.7	-17.3	-28.8	-31.0	-30.8	-32.0	-31.3	-26.3
Financial derivatives	-0.3	-0.7	-1.1	-1.1	-1.1	-1.1	-1.0	-1.0	-1.0
Other investment, net	-56.3	-66.5	-76.5	-66.5	-65.6	-64.4	-60.6	-58.1	-59.4
Reserve assets	6.6	9.1	9.6	9.9	9.9	9.7	9.4	9.1	8.8

Sources: Bank of Portugal; and IMF staff calculations.

1/ End-of-period data.

Table 6. Portugal: External Financing Requirements and Sources, 2009-17

(in billion of Euros)

	2009	2010	2011	2012	2013	2014	2015	2016	2017
GROSS FINANCING REQUIREMENTS	**170.3**	**187.0**	**210.8**	**181.5**	**174.6**	**180.5**	**182.0**	**159.5**	**150.8**
Current account deficit	18.4	17.2	11.0	4.8	2.9	2.1	1.2	0.0	-1.0
Medium- and long-term debt amortization	23.0	30.9	30.8	29.5	28.3	34.4	33.7	14.7	18.5
Public sector	5.6	7.1	8.9	6.5	4.8	8.4	7.2	6.3	4.3
Banks	14.4	20.6	17.9	19.1	15.9	18.7	18.4	4.3	11.3
Other private	3.0	3.3	4.1	3.9	7.6	7.3	8.1	4.0	2.9
Short-term debt amortization	129.0	138.9	168.9	147.2	143.5	144.0	144.8	134.8	129.2
Public sector	32.7	40.3	71.0	63.6	73.8	74.7	74.7	59.9	46.1
Central Bank	19.0	23.4	59.9	61.0	72.7	71.3	69.2	52.4	38.6
General government and SOEs	13.7	16.9	11.1	2.7	1.2	3.4	5.4	7.5	7.5
Banks	79.0	79.5	76.6	57.4	51.3	52.8	54.4	56.0	57.7
Other private	17.3	19.1	21.3	26.3	18.4	16.5	15.7	18.9	25.5
EU and IMF 1/	0.0	0.0	0.0	0.0	0.0	0.0	2.3	10.1	4.1
SOURCES OF FINANCING	**170.3**	**187.0**	**176.8**	**152.9**	**164.4**	**173.4**	**182.0**	**159.5**	**150.8**
Capital account (net)	1.4	1.9	2.1	2.7	2.4	2.2	2.4	2.4	2.4
Foreign direct investment (net)	1.4	7.7	-1.7	3.9	-2.2	-1.3	-1.4	-1.5	-1.7
Inward	1.9	2.0	7.4	10.4	1.9	2.9	2.9	3.0	3.0
New borrowing and debt rollover	183.7	196.1	161.2	150.8	164.5	173.5	179.0	158.4	149.6
Medium and long-term borrowing	44.8	27.3	14.9	7.4	20.5	28.8	44.3	29.2	25.6
General Government	13.5	15.1	4.3	0.3	3.0	6.6	13.3	15.1	8.7
Banks	26.0	5.8	2.8	4.0	11.4	15.6	21.3	8.6	13.4
Other private	5.3	6.4	7.7	3.1	6.1	6.6	9.7	5.4	3.5
Short-term borrowing	138.9	168.8	146.4	143.5	144.0	144.8	134.8	129.2	124.1
Public sector	40.3	71.0	62.8	73.8	74.7	74.7	59.9	46.1	39.2
Central Bank	23.4	59.9	61.0	72.7	71.3	69.2	52.4	38.6	31.7
General government	16.9	11.0	1.8	1.2	3.4	5.4	7.5	7.5	7.5
Banks	79.5	76.6	57.4	51.3	52.8	54.4	56.0	57.7	59.4
Other private	19.1	21.3	26.3	18.4	16.5	15.7	18.9	25.5	25.5
Other (includes asset operations)	-16.1	-18.7	15.1	-4.5	-0.4	-1.1	2.0	0.3	0.5
Of which: Net errors and omissions	-0.5	-0.3	-0.6	0.0	0.0	0.0	0.0	0.0	0.0
FINANCING GAP	**0.0**	**0.0**	**33.9**	**28.6**	**10.2**	**7.1**	**0.0**	**0.0**	**0.0**
European Union (2/3 of total) 1/	…	…	20.9	19.4	6.5	5.2	…	…	…
IMF (1/3 of total)	…	…	13.1	9.2	3.7	1.9	…	…	…
ROLLOVER RATES									
General government	157.7	109.2	30.5	16.0	106.8	101.8	164.6	164.0	137.3
Private	114.2	89.9	78.6	71.9	93.2	96.8	109.6	116.7	104.5
Banks	113.0	82.3	63.7	72.2	95.6	98.0	106.2	109.8	105.4
Other private	119.7	124.0	134.0	71.3	87.1	93.5	120.0	135.0	102.1

Source: Bank of Portugal and staff estimates.

1/ Net of intra-year EFSF treasury bill issuance and amortization and EFSF pre-paid margin.

Table 7. Portugal: Selected Financial Indicators of the Banking System, 2007-2012Q1

(In Percent)

	2007	2008	2009	2010	2011Q1	2011Q2	2011Q3	2011Q4	2012Q1
Capital Adequacy									
Regulatory capital to risk-weighted assets	10.4	9.4	10.5	10.3	10.5	10.1	9.3	9.8	9.9
Regulatory Tier 1 capital to risk-weighted assets	7.0	6.6	7.9	8.3	8.6	8.5	8.2	8.6	8.7
Capital to assets[1/]	6.5	5.8	6.5	6.7	6.8	6.4	6.1	5.3	5.6
Asset composition and quality									
Nonperforming loans to total gross loans[2/]	2.8	3.6	4.8	5.2	5.5	6.2	6.9	7.3	8.1
Nonperforming loans to total gross loans[3/]	2.8	3.5	4.8	5.1	5.5	6.1	6.8	…	…
Sectoral distribution of loans									
Residents	80.7	83.7	83.6	83.3	83.9	84.3	84.8	84.0	83.2
Deposit-takers	5.6	6.2	5.8	5.3	5.1	5.3	5.3	6.5	6.8
Central bank	1.7	1.3	1.2	0.5	0.8	0.5	0.6	0.9	0.4
Other financial corporations	3.8	3.6	3.7	3.9	3.8	3.1	3.1	2.9	2.7
General government	1.4	1.6	1.7	2.9	3.3	4.1	4.2	2.6	3.2
Nonfinancial corporations	28.8	31.6	31.5	30.7	30.8	31.3	31.4	31.0	30.6
Other domestic sectors	39.3	39.5	39.6	39.9	40.2	40.1	40.2	40.1	39.6
Nonresidents	19.3	16.3	16.4	16.7	16.1	15.7	15.2	16.0	16.8
Earnings and profitability									
Return on assets	1.2	0.3	0.4	0.5	0.5	0.3	0.1	-0.4	0.2
Return on equity	18.7	5.6	7.3	7.5	7.3	3.8	2.3	-6.1	4.4
Interest margin to gross income	54.0	59.5	53.8	52.3	58.3	55.8	57.2	58.5	51.6
Noninterest expenses to gross income	55.4	58.0	58.3	58.9	61.0	60.2	61.6	64.8	57.9
Liquidity									
Liquid assets to total assets[4/]	11.2	12.8	13.2	19.0	17.4	16.5	15.6	13.5	11.2
Liquid assets to short-term liabilities[4/]	85.6	67.7	84.5	86.2	80.6	85.9	82.0	87.6	90.0
Loans to deposits[5/]	…	…	161.5	157.8	156.7	149.2	145.9	140.6	138.1
Foreign-currency-denominated liabilities to total liabilities[6/]	8.2	5.8	5.1	5.1	4.9	4.4	4.4	…	…

Sources: Bank of Portugal; and IMF staff estimates.

1/ On accounting basis; consolidated.

2/ New NPL ratio in line with international practices. On a consolidated basis.

3/ New NPL ratio in line with international practices. On a consolidated basis, excluding institutions under intervention.

4/ Three-month residual maturity.

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

6/ 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 8. Portugal Monetary Survey, 2010–2017

(In millions of euros, unless otherwise indicated; end of period)

	Dec-10	Dec-11	Projections Dec-12	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17
Aggregated Balance Sheet of Monetary Financial Institutions (MFIs) 1/								
Assets	490,568	472,496	457,590	452,690	453,295	455,214	462,733	470,997
Cash	1,690	1,606	1,349	1,350	1,348	1,347	1,346	1,346
Claims on Bank of Portugal	4,921	5,692	1,981	1,887	4,991	2,017	816	330
Claims on other FIs	50,095	53,526	46,738	46,299	45,903	45,604	45,903	45,604
Claims on non MFIs	313,188	307,347	300,259	290,061	285,236	287,511	292,943	298,916
General government	33,834	32,309	37,968	36,197	34,711	34,345	35,713	36,541
Central government (excluding SOEs)	18,788	19,544	25,910	23,954	21,909	21,067	22,368	23,242
loans	877	467	903	902	852	803	754	705
securities	17,911	19,078	25,006	23,052	21,057	20,264	21,615	22,537
Bonds	10,949	10,307	13,695	12,970	12,212	12,449	13,799	14,722
Tbills	6,962	8,770	11,312	10,081	8,845	7,815	7,815	7,815
Regional and local government (excl SOEs)	6,217	6,408	6,439	6,627	6,627	6,627	6,627	6,627
SOEs	8,830	6,365	5,619	5,616	6,175	6,651	6,718	6,671
Private sector	279,363	275,038	262,291	253,864	250,524	253,166	257,230	262,375
Claims on non-residents	114,117	96,585	99,729	105,539	108,101	110,786	113,537	116,356
Other assets	6,557	7,740	7,533	7,553	7,717	7,948	8,189	8,446
Liabilities	490,568	472,496	457,590	452,690	453,295	455,214	462,733	470,997
Liabilities to Bank of Portugal	41,936	46,928	58,628	57,253	55,185	38,350	24,554	17,640
Liabilities to other FIs	59,422	60,888	54,432	54,327	54,086	54,809	57,375	59,282
Deposits of non MFIs	162,770	176,290	174,726	177,795	184,815	191,662	198,767	206,138
General government	7,281	12,279	7,925	2,225	2,225	2,225	2,225	2,225
Private sector	155,489	164,011	166,801	175,570	182,590	189,437	196,542	203,913
Securities other than capital	62,592	53,345	35,619	25,188	17,328	20,158	25,398	26,519
Liabilities to non-residents	129,404	105,130	93,044	95,836	98,711	101,672	104,722	107,864
Other	-8,229	-10,690	-13,436	-11,507	-11,524	-10,854	-11,183	-11,535
Capital and reserves	42,674	40,606	54,577	53,797	54,694	59,417	63,101	65,090
Money and Credit								
Broad Money (M3)	174,748	172,547	170,393	170,844	174,544	179,778	185,226	191,044
Intermediate money (M2)	169,560	169,872	165,334	165,772	169,363	174,441	179,727	185,373
Narrow money (M1)	69,930	67,504	68,187	68,368	69,849	71,943	74,123	76,451
Private sector credit	279,363	275,038	262,291	253,864	250,524	253,166	257,230	262,375
Public sector credit	33,834	32,309	37,968	36,197	34,711	34,345	35,713	36,541
				(percent of GDP)				
Broad Money	101.2	101.0	102.4	102.4	102.4	102.4	102.4	102.4
Private sector credit	161.8	160.9	157.7	152.2	147.0	144.3	142.3	140.7
Public sector credit	19.6	18.9	22.8	21.7	20.4	19.6	19.8	19.6
				(percentage change)				
Broad Money	-1.3	-1.3	-1.2	0.3	2.2	3.0	3.0	3.1
Private sector credit	-0.3	-1.5	-4.6	-3.2	-1.3	1.1	1.6	2.0
Public sector credit	102.6	-4.5	17.5	-4.7	-4.1	-1.1	4.0	2.3
Memo items:								
ECB access (% assets)	8.5	9.9	12.8	12.6	12.2	8.4	5.3	3.7
Loan to deposits (%) 2/	155.4	140.9	140.2	135.8	131.1	128.7	126.1	124.2
Wholesale market funding (% change) 3/	-8.2	-16.4	-20.7	-7.4	-5.4	5.4	7.5	3.3
Wholesale market funding (% assets) 3/	34.0	29.5	24.2	22.6	21.4	22.4	23.7	24.1

Sources: Bank of Portugal and staff estimates.

1/ Excludes Bank of Portugal.

2/ Loan to deposit ratio for banking system as a whole based on monetary statistics.

3/ Includes foreign interbank borrowing and securities issued.

Table 9. Portugal: External Debt Sustainability Framework, 2007-2017

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	195.5	200.8	223.8	231.2	230.7	**238.6**	**239.8**	**236.0**	**228.2**	**220.8**	**212.9**	**0.1**
Change in external debt	9.0	5.3	23.0	7.4	-0.5	7.9	1.2	-3.8	-7.8	-7.3	-7.9	
Identified external debt-creating flows (4+8+9)	2.6	5.1	13.3	0.0	12.6	8.3	5.5	-1.4	-3.2	-3.7	-4.1	
Current account deficit, excluding interest payments	3.2	4.7	4.8	4.7	-0.1	-4.2	-5.3	-5.1	-5.2	-6.2	-7.1	
Deficit in balance of goods and services	7.5	9.5	7.0	6.7	3.2	-0.7	-2.6	-3.5	-4.0	-4.5	-5.1	
Exports	32.8	33.2	28.7	31.5	36.1	39.1	40.6	42.3	43.6	44.8	46.3	
Imports	40.3	42.7	35.7	38.2	39.3	38.4	38.0	38.8	39.6	40.4	41.3	
Net non-debt creating capital inflows (negative)	1.8	-4.5	-1.8	-4.6	3.8	-1.7	1.3	0.2	0.2	0.3	0.3	
Automatic debt dynamics 1/	-2.4	4.9	10.3	-0.1	8.9	14.2	9.4	3.5	1.8	2.2	2.6	
Contribution from nominal interest rate	6.9	7.9	6.1	5.3	6.5	7.1	7.0	6.3	5.9	6.2	6.5	
Contribution from real GDP growth	-4.2	0.0	6.0	-3.1	3.9	7.1	2.4	-2.8	-4.1	-4.0	-3.9	
Contribution from price and exchange rate changes 2/	-5.1	-3.0	-1.8	-2.3	-1.5	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	6.4	0.2	9.7	7.4	-13.2	-0.3	-4.3	-2.4	-4.6	-3.6	-3.8	
External debt-to-exports ratio (in percent)	596.5	605.2	780.1	733.1	638.7	610.9	590.8	558.1	523.6	492.8	459.4	
Gross external financing need (in billions of Euros) 4/				187.0	210.8	181.5	174.6	180.5	182.0	159.5	150.8	
in percent of GDP				108.3	123.3	109.1	104.7	105.9	103.7	88.2	80.9	
Scenario with key variables at their historical averages 5/						**238.6**	**239.7**	**241.8**	**242.2**	**243.6**	**244.9**	**-1.7**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	2.4	0.0	-2.9	1.4	-1.7	-3.0	-1.0	1.2	1.8	1.8	1.8	
GDP deflator in Euros (change in percent)	2.8	1.6	0.9	1.1	0.7	0.3	1.3	1.0	1.2	1.2	1.3	
Nominal external interest rate (in percent)	3.9	4.1	3.0	2.4	2.8	3.0	2.9	2.7	2.6	2.8	3.0	
Growth of exports (Euros, in percent)	9.9	2.8	-15.3	12.7	13.3	5.3	4.2	6.4	6.1	6.0	6.7	
Growth of imports (Euros, in percent)	6.7	7.8	-18.1	9.6	1.9	-4.9	-0.7	4.3	5.0	5.0	5.5	
Current account balance, excluding interest payments	-3.2	-4.7	-4.8	-4.7	0.1	4.2	5.3	5.1	5.2	6.2	7.1	
Net non-debt creating capital inflows	-1.8	4.5	1.8	4.6	-3.8	1.7	-1.3	-0.2	-0.2	-0.3	-0.3	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency--not used here), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ 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; deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 10. Portugal: Government Debt Sustainability Framework, 2008-2030

(Percent of GDP, unless otherwise indicated)

	Actual				Projections								
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2020	2025	2030	**Debt-stabilizing primary balance 9/**
Baseline: General Government debt 1/	71.6	83.1	93.3	108.1	**119.1**	**123.7**	**123.6**	**121.2**	**118.4**	**109.2**	**96.6**	**84.8**	**1.5**
Of which: foreign-currency denominated	1.2	1.2	1.5	9.6	15.7	17.9	18.6	17.8	15.7	5.0	1.1	0.9	
Change in public sector debt	3.3	11.5	10.3	14.8	11.0	4.7	-0.1	-2.4	-2.7	-2.6	-2.5	-2.3	
Identified debt-creating flows (4+7+12)	2.5	11.7	8.7	5.5	12.7	3.0	-0.1	-1.7	-1.7	-2.7	-2.5	-2.4	
Primary deficit	0.6	7.3	7.0	0.4	0.5	-0.2	-2.4	-3.1	-3.2	-3.2	-3.2	-3.2	
Revenue and grants	41.1	39.6	41.4	45.0	41.7	43.0	42.7	42.6	42.4	42.2	42.2	42.2	
Primary (noninterest) expenditure	41.7	46.9	48.4	45.4	42.2	42.8	40.2	39.5	39.3	39.0	39.0	39.0	
Automatic debt dynamics 2/	2.0	4.4	0.9	5.0	7.5	4.3	2.4	1.4	1.5	0.5	0.7	0.8	
Contribution from interest rate/growth differential 3/	2.0	4.3	0.9	5.0	7.5	4.3	2.4	1.4	1.5	0.5	0.7	0.8	
Of which contribution from real interest rate	2.0	2.2	2.0	3.4	4.2	3.1	3.8	3.6	3.6	2.7	2.6	2.5	
Of which contribution from real GDP growth	0.0	2.1	-1.1	1.6	3.3	1.2	-1.5	-2.2	-2.1	-2.1	-1.9	-1.7	
Contribution from exchange rate depreciation 4/	0.0	0.1	0.1	0.0	...	...	...	...	...	...	...	...	
Other identified debt-creating flows	-0.1	0.0	0.8	0.1	4.7	-1.2	0.0	-0.1	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	-0.1	0.0	-0.4	-0.4	-1.3	-1.2	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities and reclassifications of entities or operations	0.0	0.0	0.0	0.5	1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Support to financial sector (including use of BSSF)	0.0	0.0	1.2	0.0	4.8	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	
Residual, including net acquisition of financial assets and changes in deposits (2-3) 5/	0.8	-0.2	1.6	9.3	-1.7	1.7	-0.1	-0.7	-1.1	0.1	0.0	0.0	
Public sector debt-to-revenue ratio 1/	174.1	209.8	225.3	240.3	285.5	287.9	289.6	284.6	279.1	258.8	229.0	201.1	
Gross financing need 6/	17.3	36.3	44.0	25.9	17.6	18.1	19.2	23.2	24.1	0.0	0.0	0.0	
Billions of U.S. dollars	40.5	89.3	100.4	58.4	37.0	38.0	41.2	50.9	54.3	0.0	0.0	0.0	
Scenario with key variables at their historical averages 7/				**108.1**	**115.0**	**119.5**	**123.5**	**126.9**	**130.0**	**146.6**	**169.0**	**192.5**	**1.4**
Scenario with no policy change (constant primary balance at 2011 level excluding one-offs)				**108.1**	**122.0**	**130.3**	**136.1**	**140.4**	**144.4**	**162.8**	**185.3**	**211.0**	**1.9**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline													
Real GDP growth (percent)	0.0	-2.9	1.4	-1.7	-3.0	-1.0	1.2	1.8	1.8	2.0	2.0	2.0	
Average nominal interest rate on public debt (percent) 8/	4.6	3.9	3.6	4.3	4.1	3.9	4.1	4.2	4.3	4.5	4.8	5.0	
Average real interest rate (using in GDP deflator, percent)	3.0	3.0	2.5	3.6	3.7	2.6	3.2	3.0	3.1	2.5	2.8	3.0	
Inflation rate (GDP deflator, percent)	1.6	0.9	1.1	0.7	0.3	1.3	1.0	1.2	1.2	2.0	2.0	2.0	
Growth of real primary spending (deflated by GDP deflator, percent)	0.9	9.2	4.6	-7.8	-9.8	0.4	-4.8	-0.2	1.3	1.9	2.0	2.0	
Primary deficit	0.6	7.3	7.0	0.4	0.5	-0.2	-2.4	-3.1	-3.2	-3.2	-3.2	-3.2	

Sources:

1/ General government gross debt (ESA 95 definition).

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = 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 denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ Includes change in deposits, unidentified financial transactions, and cash-accrual adjustments. 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 11. Portugal: Access and Phasing Under the Extended Arrangement, 2011-14

Review	Review date	Action	Purchase	
			In millions of SDRs	in percent of quota
	May 20, 2011	Board approval of Extended Arrangement	5,611	544.9
First review	September 12, 2011	Observation of end-June 2011 performance criteria; completion of first review	3,467	336.7
Second review	December 19, 2011	Observation of end-September 2011 performance criteria; completion of second review	2,425	235.5
Third review	April 4, 2012	Observation of end-December 2011 performance criteria; completion of third review	4,443	431.5
Fourth review	July 16, 2012	Observation of end-March 2012 performance criteria; completion of fourth review	1,197	116.2
Fifth review	October 24, 2012	Observation of end-June 2012 performance criteria; completion of fifth review	1,259	122.3
Sixth review	December 15, 2012	Observation of end-September 2012 performance criteria; completion of sixth review	724	70.3
Seventh review	March 15, 2013	Observation of end-December 2012 performance criteria; completion of seventh review	574	55.7
Eighth review	June 15, 2013	Observation of end-March 2013 performance criteria; completion of eighth review	806	78.3
Ninth review	September 15, 2013	Observation of end-June 2013 performance criteria; completion of ninth review	873	84.8
Tenth review	December 15, 2013	Observation of end-September 2013 performance criteria; completion of tenth review	803	78.0
Eleventh review	March 15, 2014	Observation of end-December 2013 performance criteria; completion of eleventh review	760	73.8
Twelfth review	May 15, 2014	Observation of end-March 2014 performance criteria; completion of twelfth review	800	77.7
Total			23,742	2,305.7

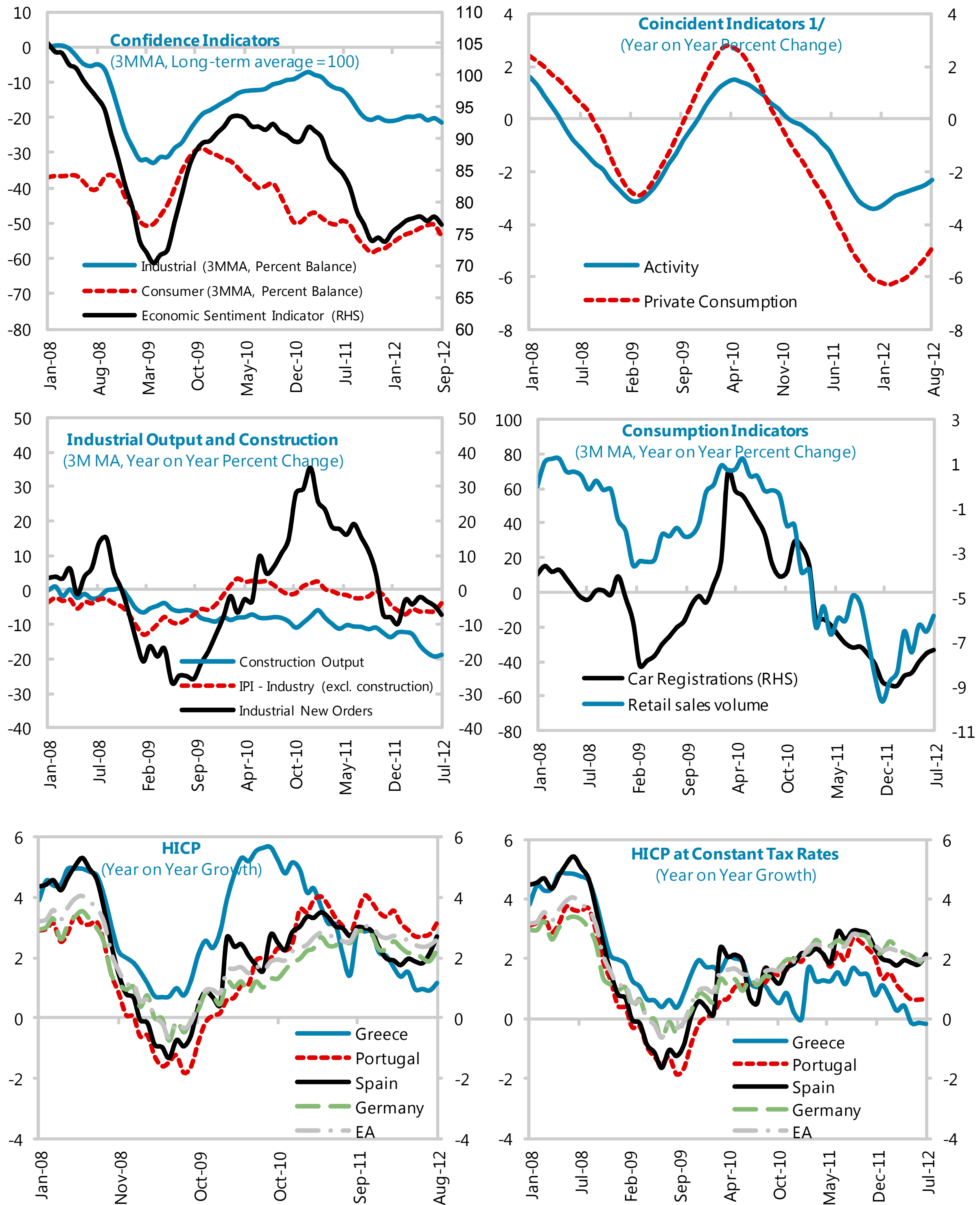
Source: Fund staff projections.

Table 12. Portugal: Indicators of Fund Credit
(In millions of euros, unless otherwise specified)

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Disbursements	13,052	9,071	3,729	1,908	…	…	…	…	…
(in percent of quota)	1,117	740	297	152	…	…	…	…	…
(Projected debt service to the Fund, based on existing and prospective drawings)									
Total	14	153	688	910	1,650	3,849	4,982	5,457	5,422
Interest and charges	14	153	688	910	1,075	1,032	900	728	531
Repayments	0	0	0	0	574	2,818	4,082	4,729	4,890
Total debt service, in percent of									
Exports of goods and services	0.0	0.2	1.0	1.3	2.2	4.8	5.8	5.9	5.6
GDP	0.0	0.1	0.4	0.5	0.9	2.1	2.7	2.8	2.7
(Projected level of credit outstanding based on existing and prospective drawings)									
Outstanding stock	13,052	23,007	27,068	29,041	28,574	25,855	21,855	17,125	12,235
in percent of quota	1,117.1	1,857.4	2,154.2	2,305.7	2,260.3	2,038.2	1,717.4	1,345.8	961.5
in percent of GDP	7.6	13.8	16.2	17.0	16.3	14.3	11.7	8.9	6.2
Memorandum Items (in billions of euros)									
Exports of goods and services	62	65	68	72	76	81	86	92	97
GDP	171	166	167	170	176	181	187	192	198

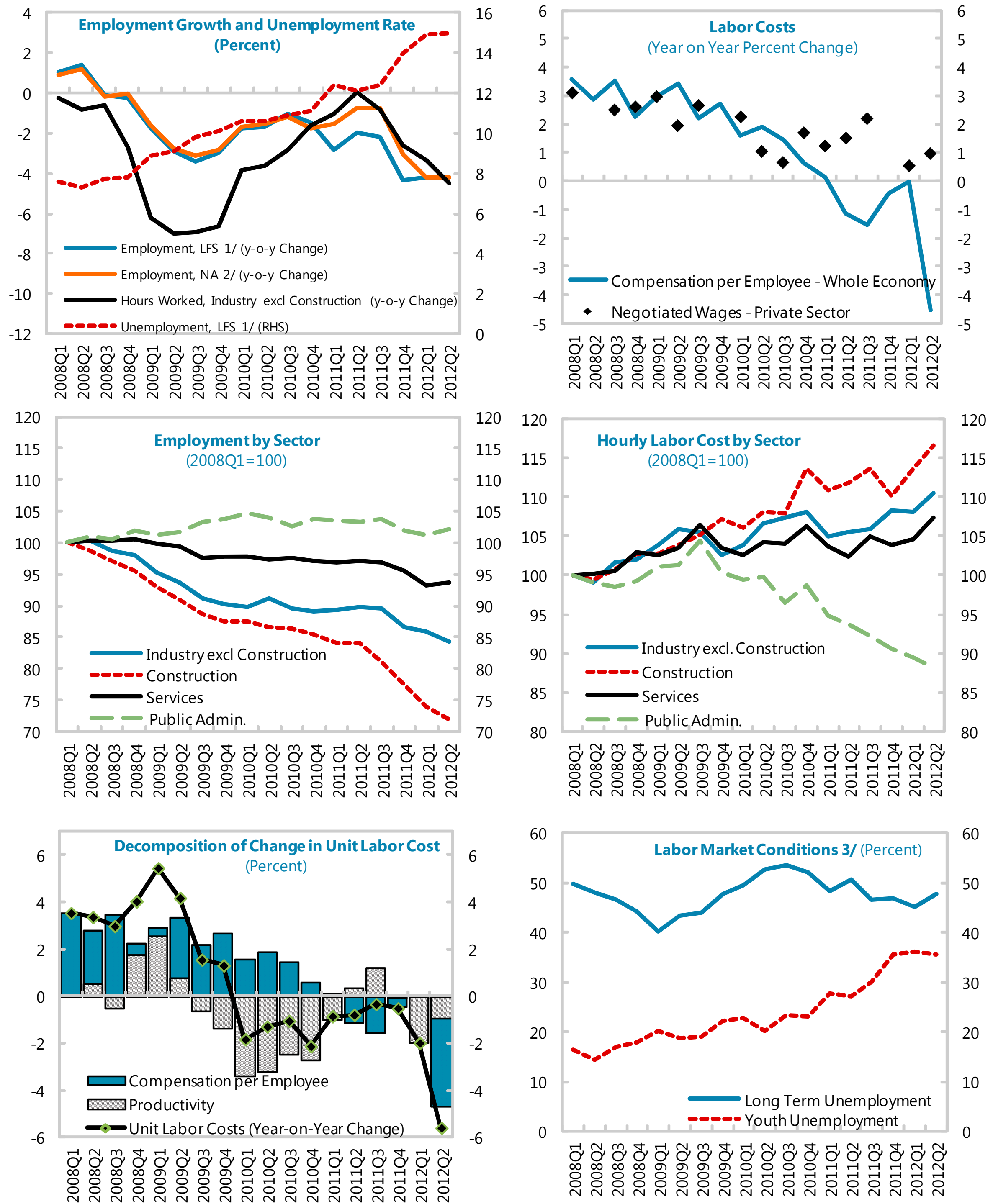
Source: Fund staff projections.

Figure 1: Portugal: High Frequency Indicators



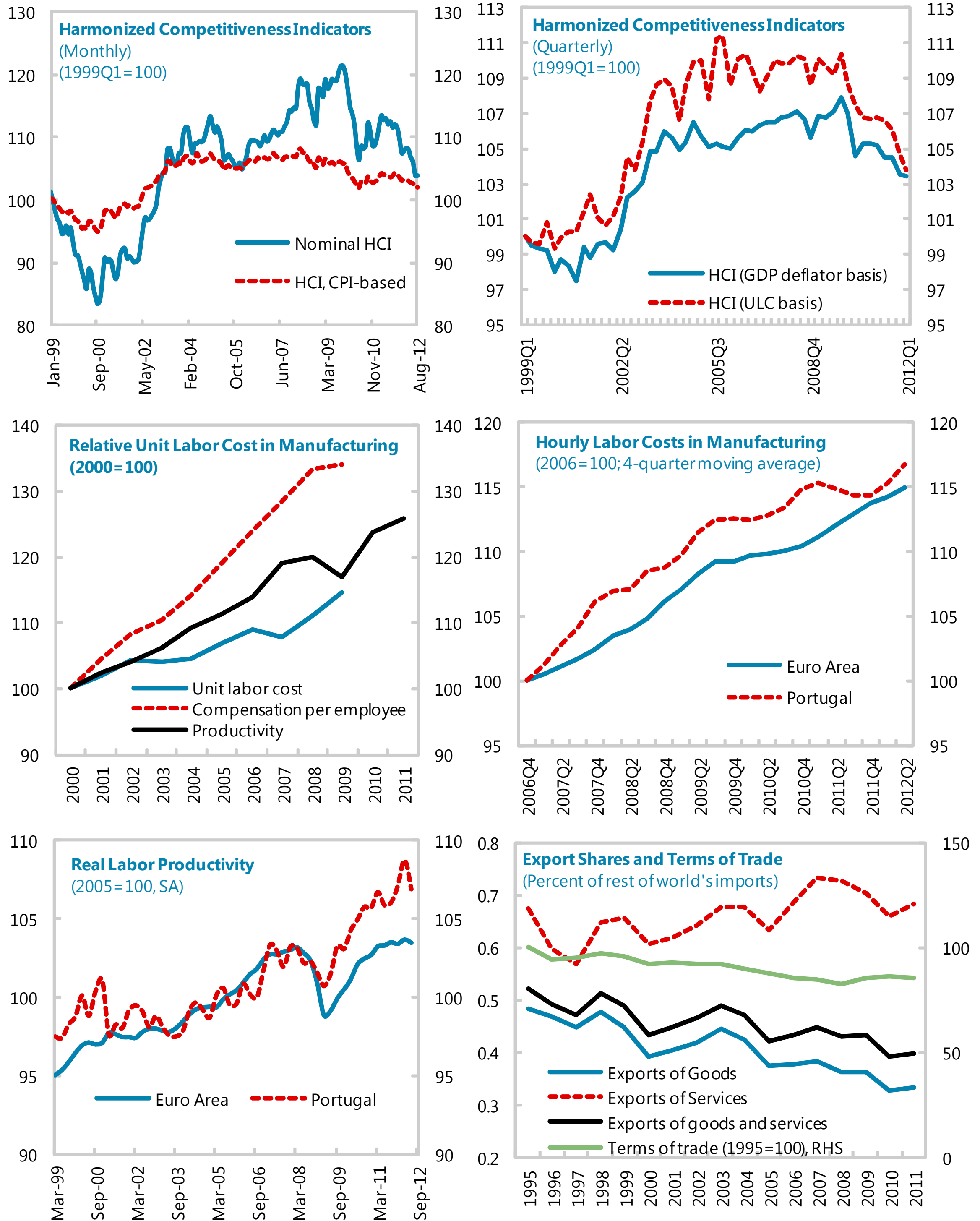
Source: Statistical Office of the European Communities; European Commission; Bank of Portugal; and Fund staff calculations.
1/ Calculated by the Bank of Portugal.

Figure 2. Portugal: Labor Market Indicators



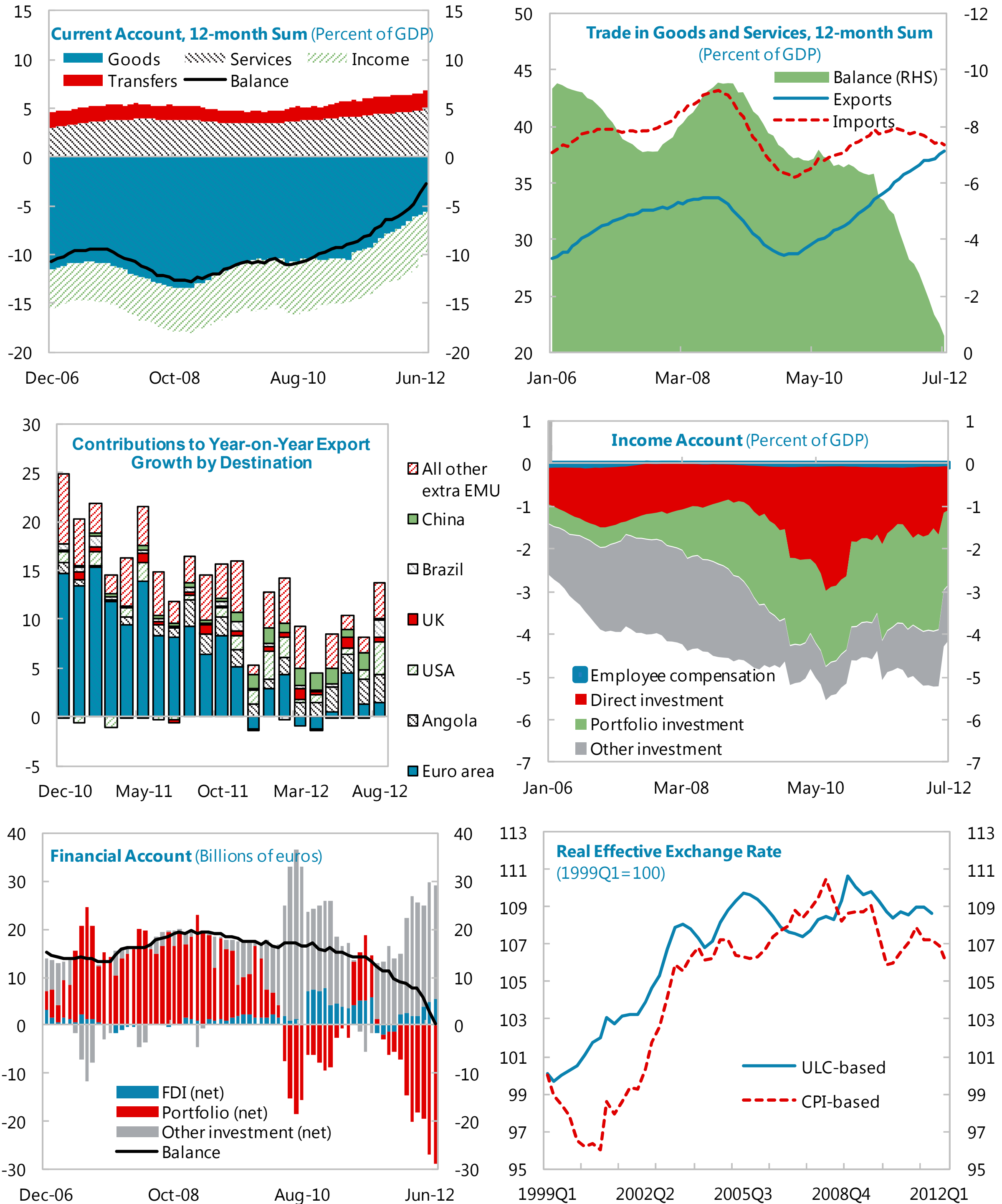
Source: Statistical Office of the European Communities; European Commission; Bank of Portugal; and Fund staff calculations.
1/ Labor Force Survey
2/ National Accounts
3/ Long term unemployment rate as percent of total unemployed; youth unemployment rate as percent of youth labor force.

Figure 3. Portugal: Competitiveness Indicators



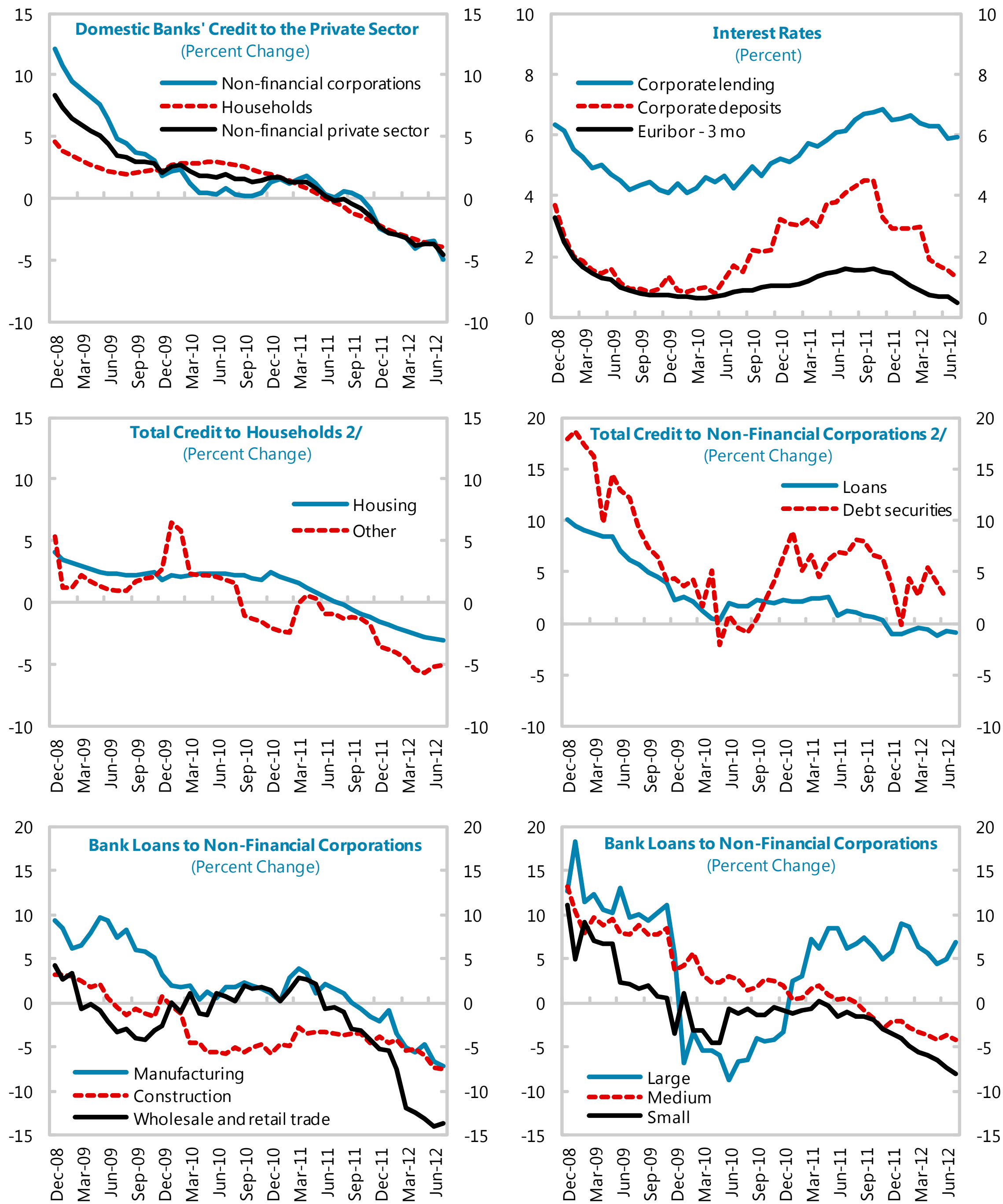
Sources: EC; ECB; and IMF

Figure 4. Portugal: Balance of Payments Developments



Source: INE, Banco de Portugal, Eurostat; and IMF calculations

Figure 5. Portugal: Financing of the Economy, 2008-July 2012 1/

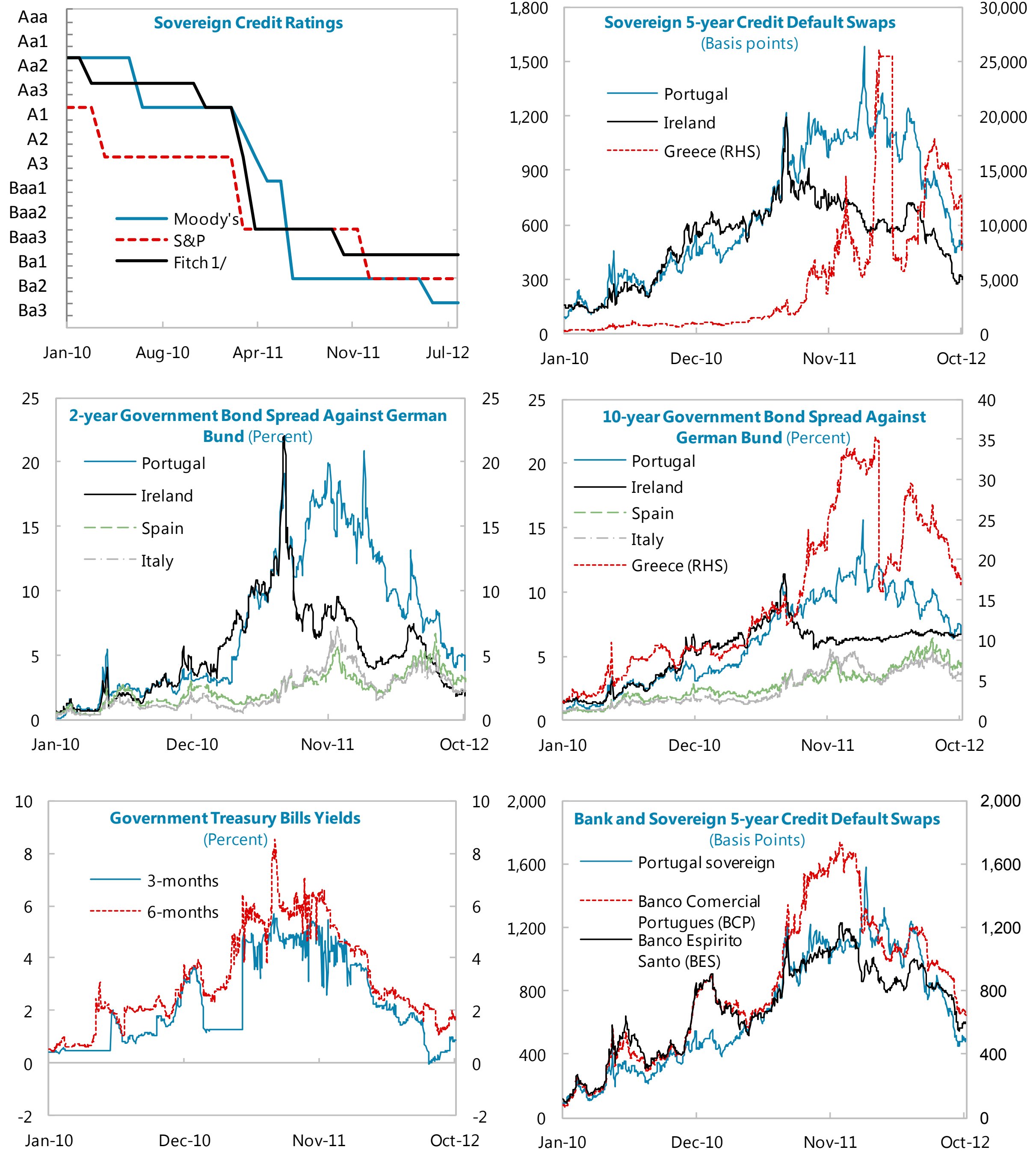


Source: Banco de Portugal.

1/ Credit and loan figures are adjusted for securitisation operations and monthly transactions (calculated using the outstanding amounts corrected of reclassifications, write-offs/write-downs, exchange rate changes and price revaluations). Whenever relevant, figures are additionally adjusted for credit portfolio sales, as well as for other operations with no impact on non-financial corporations' effective financing.

2/ Total credit granted to residents by resident and non-resident entities is reported on a consolidated basis and includes loans, debt securities and trade credits.

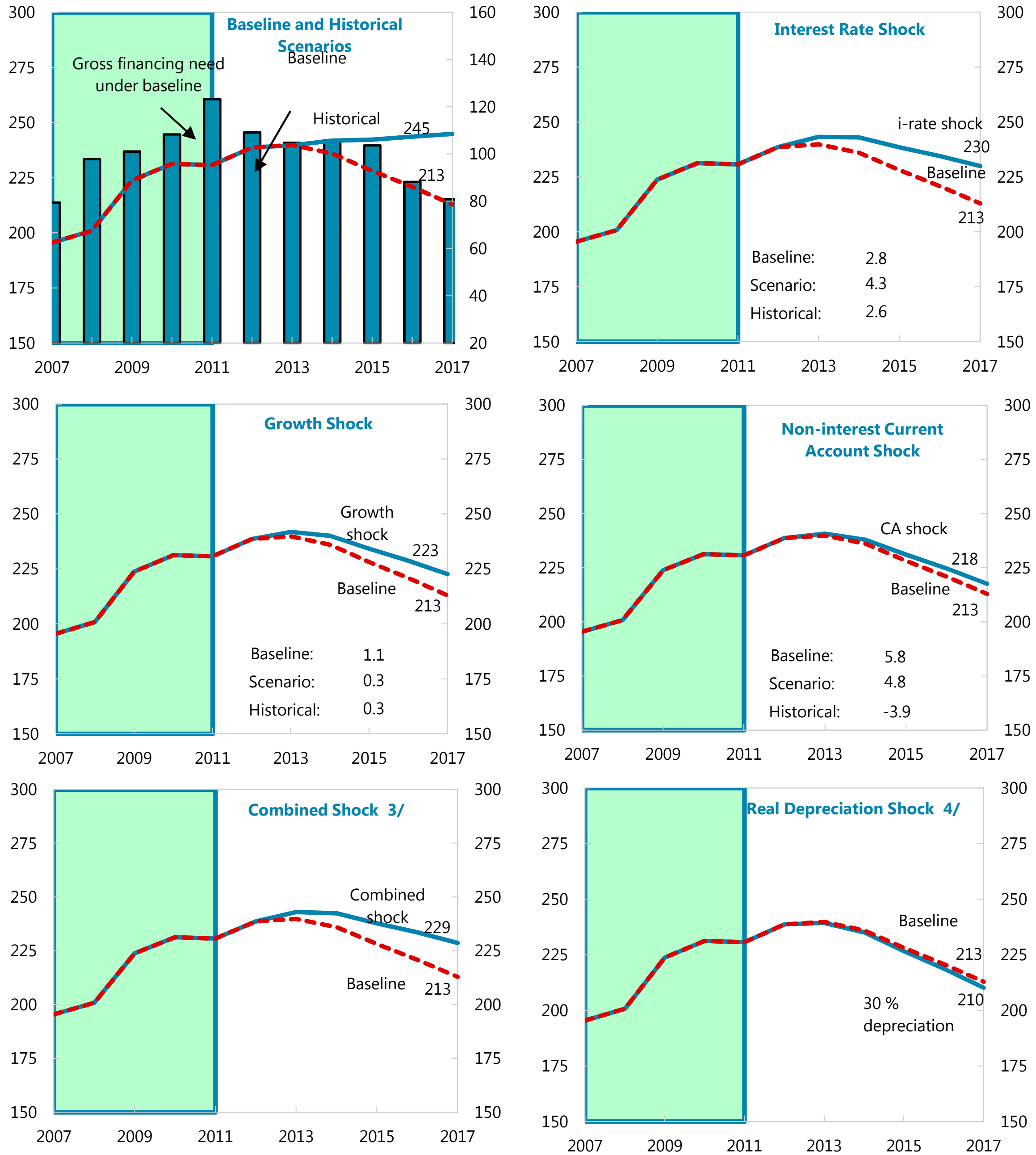
Figure 6. Portugal: Financial Indicators



Sources: Bloomberg; and IMF staff calculations.
1/ Rating used is the LT Foreign Currency Issuer Default

Figure 7. Portugal: External Debt Sustainability: Bound Tests[1/ 2/]

(External Debt in Percent of GDP)



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

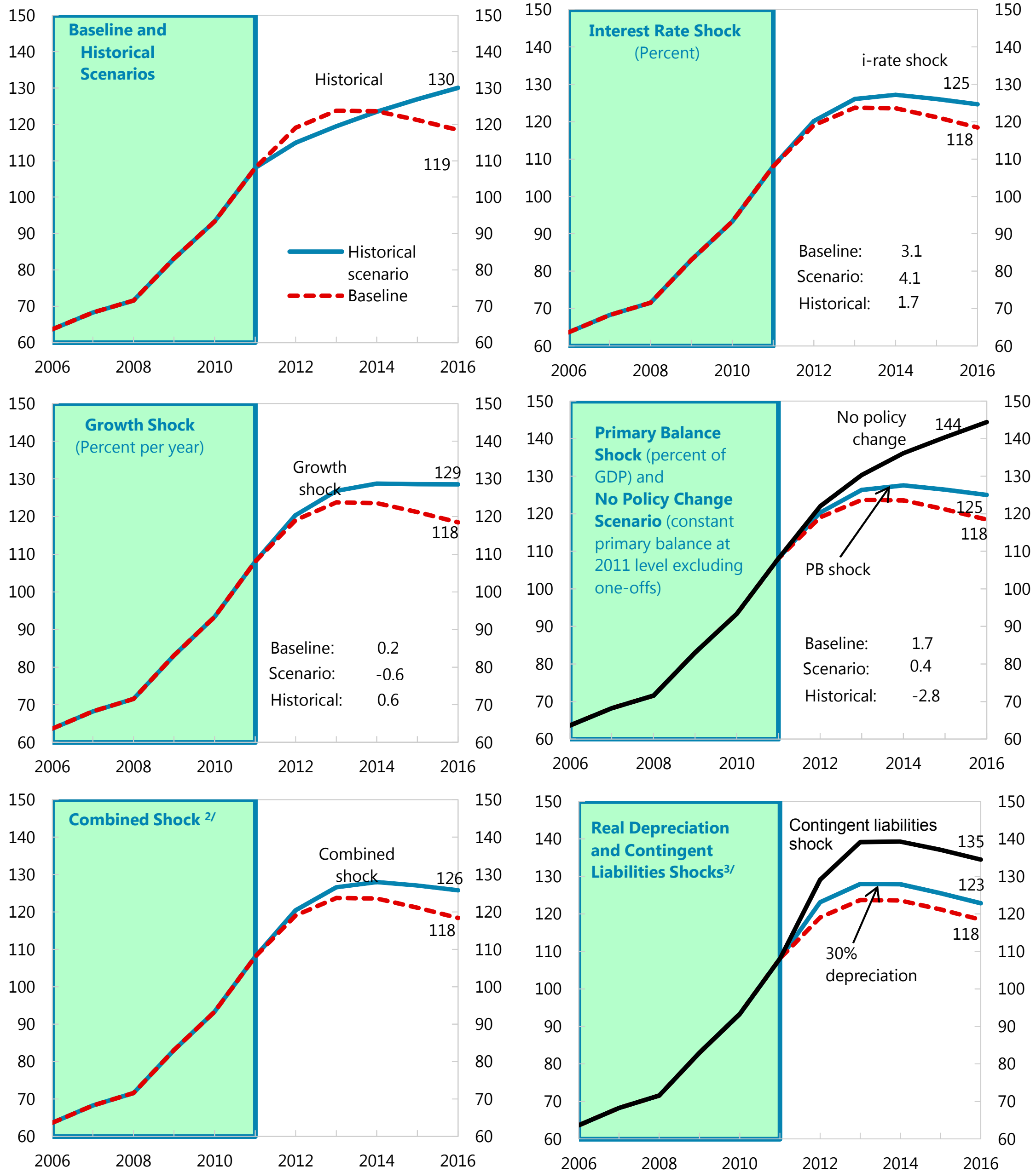
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks, except the interest rate shock which is a permanent one standard deviation shock. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being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

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to growth rate, and current account balance, and 1/2 standard deviation shock to the real interest rate.

4/ One-time real depreciation of 30 percent occurs in 2010.

Figure 8. Portugal: Government Debt Sustainability: Bound Tests[1/]
(Percent of GDP)

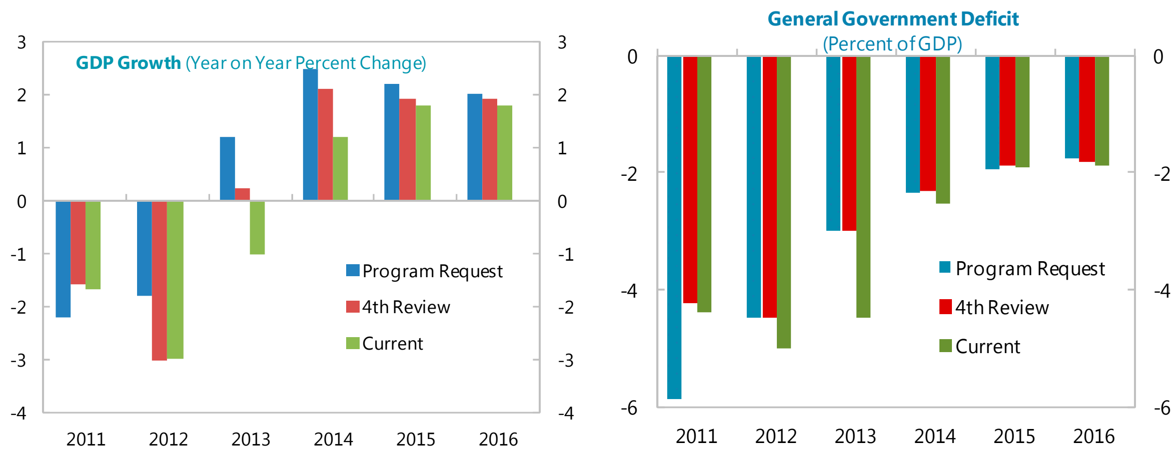


Sources: International Monetary Fund; country desk data; andIMF staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being 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).

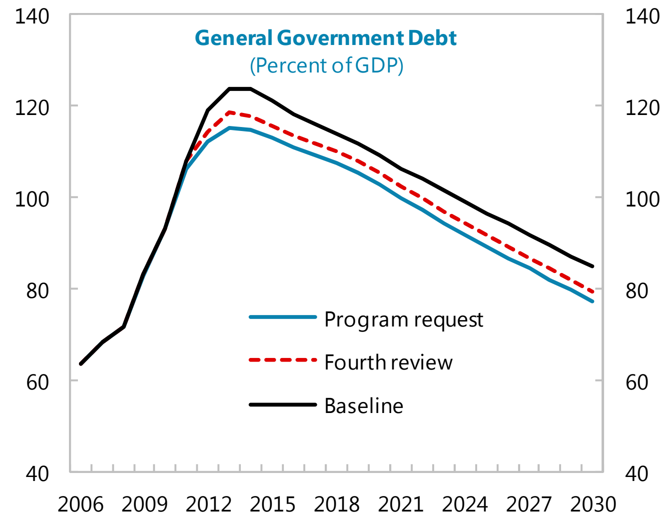
APPENDIX I. PUBLIC DEBT SUSTAINABILITY ANALYSIS (DSA)

A. Introduction and Summary

1. **This appendix updates earlier analysis of Portugal's public debt**. Under the new baseline, public debt will peak at a higher level—at 124 percent of GDP compared with the 118 percent projected at the time of the fourth program review in July—and one year later, in 2014.[1] This deterioration reflects slower-than-expected pace of fiscal adjustment, protracted recession that now extends into 2013, and more conservative privatization receipts.



2. **Notwithstanding the upward shift in the debt trajectory, conclusions of the earlier debt sustainability exercises remain broadly unchanged.**[2] From the upcoming peak, debt is projected to decrease gradually and return to its pre-crisis level by 2030.

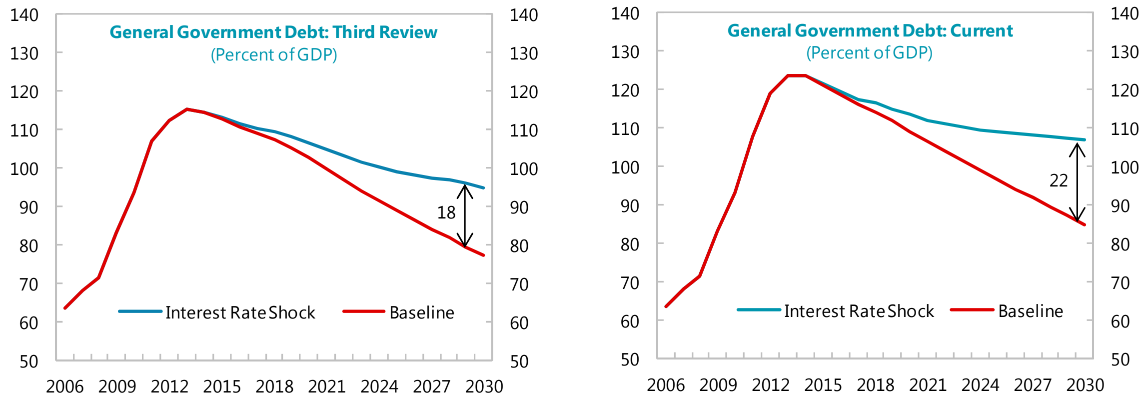


3. Due to the elevated debt levels, however, **the baseline becomes even more sensitive to growth and interest rate assumptions.** In particular, an interest rate shock applied to the third

[1] At the time of the EFF request in May 2011, public debt was projected to peak at 115 percent of GDP in 2013.

[2] See the IMF Country Reports No. 12/77 and 12/179.

review baseline (IMF Country Report 12/77) raises the debt-to-GDP ratio by 18 percentage points in the medium term.[3] In contrast, the same shock applied to the current baseline raises the debt-to-GDP ratio by 22 percentage points over the same period. Under such conditions, continued fiscal discipline and strong reform effort remain of paramount importance.



Sources: National Authorities; and IMF staff estimates.

B. Baseline Projections

4. **The growth projections for 2013 and 2014 were revised downward in light of worsening economic outlook.** Compared to the fourth program review, growth in 2013 and 2014 is now lower by a cumulative two percentage points, with Portugal getting close to its potential growth rate of two percent only in 2015. The assumption of the two-percent potential growth is fairly conservative. It is only marginally higher than the average growth during the pre-crisis euro years (1999–2007) of 1.8 percent and reflects Portugal's closing of the competitiveness gap and very slow convergence of productivity to average euro area levels. Price dynamics reflect gradual convergence of inflation to the long-term ECB objective of 2 percent

5. **Similarly to the fourth program review, the baseline assumes that Portugal returns to markets in mid-2013 at yields on medium- and long-term debt of about 7 percent.** These yields are then assumed to decline gradually to 5 percent over the next four years and remain stable thereafter, resulting in real effective interest rate of about 3 percent in the medium term. Recent market trends support this assumption, with the yields falling for most of 2012 and now at their lowest level since the program began.[4]

6. **Full implementation of the programmed large—10 percentage points—cumulative improvement in the structural primary balance underpins the projected debt dynamics.** As of end-2012, about two-thirds of that improvement will have been

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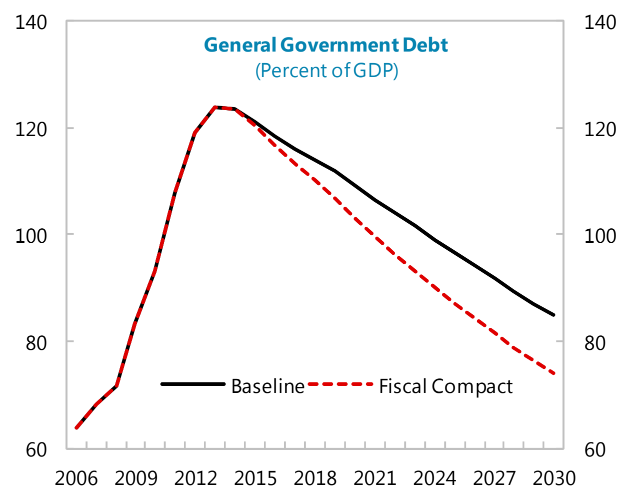
[3] The comparison is to the third review, because this particular simulation was not conducted for the fourth review.

[4] As of late September, yields were close to five percent on the two-year bonds and nine percent on the ten-year bonds, down from their respective heights of 20 and 18 percent earlier in the year.

achieved. In addition, the baseline assumes that policies are broadly unchanged thereafter, with the structural primary surplus stabilizing at 3¼ percent of GDP. About two thirds of the required adjustment is expected to be completed by end-2012; strong implementation of the agreed fiscal consolidation measures remains key going forward.

7. **Under these assumptions, debt peaks at close to 124 percent of GDP in 2014 and then declines gradually to 85 percent of GDP in 2030.** As before, the decline is driven by the fact that primary surpluses (at above 3 percent of GDP) exceed the projected real interest rate – growth differential of one percentage point. By 2030, Portugal's debt-to-GDP ratio is expected to be comparable to its pre-crisis levels (83 percent in 2009).

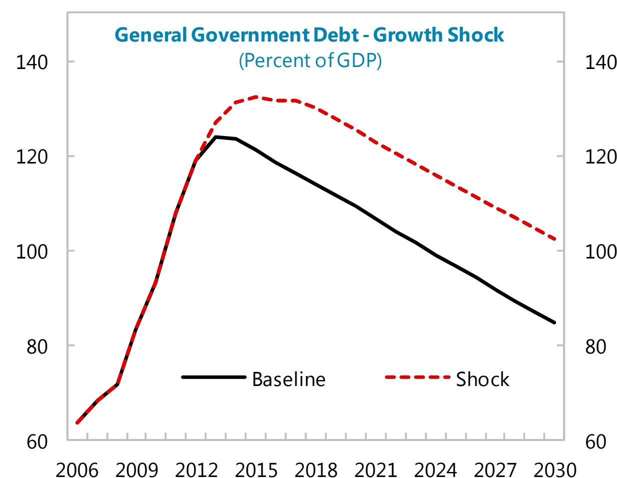
8. **Fiscal adjustment implied by Portugal's current medium-term budget framework and the new European "fiscal compact" is even more ambitious than the baseline.** Portugal's current medium-term budget framework law implies that, starting in 2015, the structural deficit cannot exceed 0.5 percent of GDP. In contrast, the structural deficit under the baseline is never below 1 percent of GDP. Should the authorities adhere to the "fiscal compact" targets, debt will decline at a faster rate in the medium term, reaching 74 percent of GDP in 2030, full 11 percentage points below the baseline.



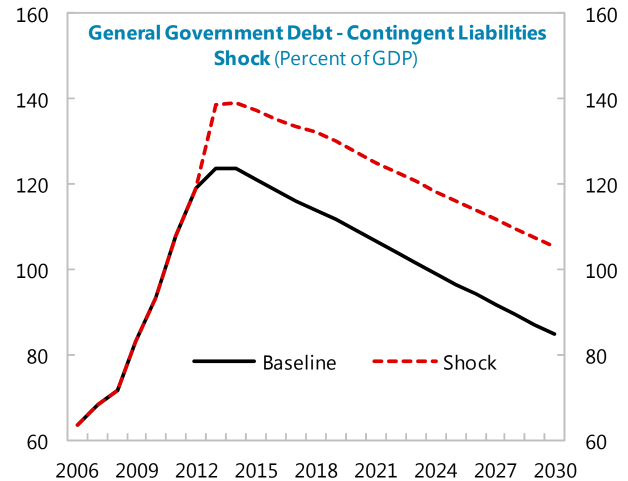
C. Sensitivity Analysis

9. **The elevated debt levels exacerbate risks.** This section considers the impact of several plausible shocks—lower growth, higher interest rates, and realization of contingent liabilities—on Portugal's debt outlook.

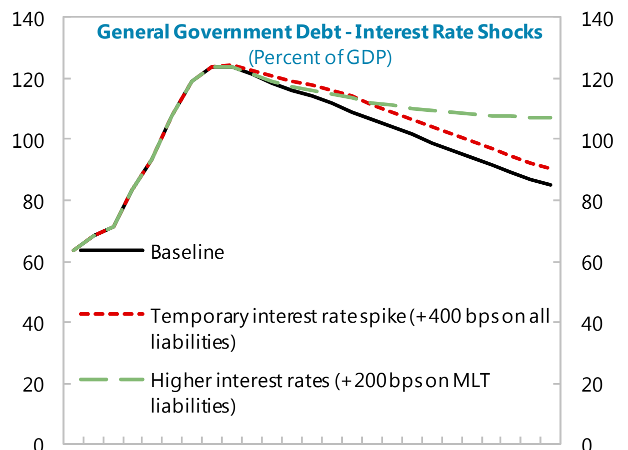
10. **Should recession become protracted, Portugal's debt outlook will deteriorate considerably.** Assuming a five-percentage-point cumulative decline in growth in 2013–15 and an unchanged nominal primary expenditure path yields debt peaking at 132 percent of GDP in 2015 and then declining gradually to 103 percent of GDP in 2030.



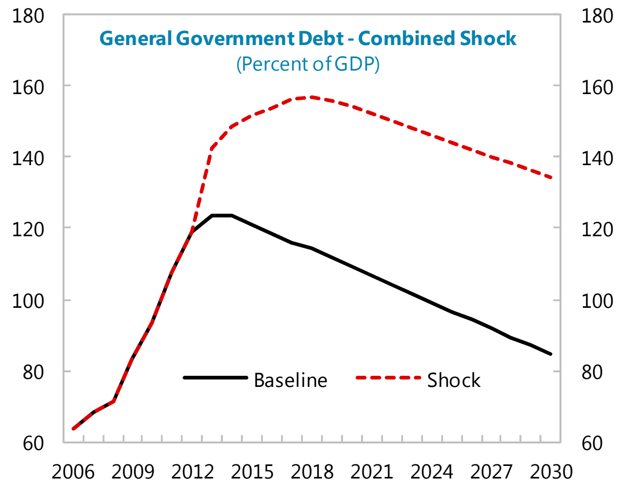
11. **Realization of large contingent liabilities will affect the debt outlook in a similar fashion.** Following the discussion in IMF Country Report 12/77, a 15-percent of GDP contingent liability shock is applied to the baseline. This results in a very sharp increase in debt-to-GDP ratio to 139 percent in 2013 and 2014 and the subsequent decline to 105 percent in 2030.



12. **Higher interest rates do not lead to higher peak debt, but raise the debt-to-GDP ratio in the medium term and, in the case of a permanent shock, slow the rate of debt decline.** Two shocks are considered: a temporary interest rate spike (by 400 bps during 2013–15 only) on all liabilities and a permanent 200 bps increase in interest rates on medium- and long-term debt.[5] Both scenarios assume no policy response. Under the former scenario, debt trajectory essentially mimics the baseline, but on a slightly higher level. Under the latter scenario, the rate of debt decline slows down markedly, stabilizing at 107 percent of GDP in 2030.



13. **A combined shock—lower growth, realization of contingent liabilities, and a temporary interest rate spike—renders Portugal's debt dynamics unsustainable.** Under this scenario, the debt-to-GDP ratio remains above 134 percent in the medium term.



[5] A permanent 200 bps increase in interest rates on all liabilities was also considered, but the results were virtually indistinguishable from those for the latter scenario above.

D. Conclusion

14. **Portugal's debt will remain sustainable under normal conditions.** This result hinges on successful implementation of the large fiscal adjustment and return to trend growth by 2015. Given the country's high debt levels, some of the plausible shocks could lead to unsustainable outcomes, in which case swift policy response will be of the essence.

APPENDIX II. PORTUGAL: LETTER OF INTENT

Lisbon, October 14, 2012

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

Dear Ms. Lagarde:

1. The attached Memorandum of Economic and Financial Policies (MEFP) describes the progress made in recent months towards the objectives laid out in our program supported by the Extended Arrangement. It also updates previous MEFPs and highlights the policy steps to be taken in the months ahead.

2. While we remain strongly committed to the program's policies and objectives, the challenging domestic and external environment is weighing on program performance. The fiscal outlook has deteriorated considerably, reflecting mainly the impact of the economic rebalancing on tax bases and revenue performance (see paragraphs 1 and 3 of the MEFP). Although spending has been tighter than envisaged in the program, a large fiscal gap has now emerged and the initial program targets are no longer achievable. As a result—and in spite of having met the end-June quarterly performance criteria on the general government cash deficit and debt—we estimate that the end-September target on the general government cash deficit has been missed (see Table 1).

3. We have started to settle the stock of existing domestic arrears and have advanced the implementation of the new commitment control systems. Nevertheless, the underlying arrear position has continued to deteriorate—although with smaller increases in recent months, resulting in further breaches of the related indicative target under the program. The operational restructuring of SOEs is being successfully implemented and we are assessing options to strengthen their long-term financial viability. Our policy efforts to preserve financial stability have continued, and further steps have been taken to promote competitiveness, growth, and employment. All the structural benchmarks for the fifth review were met.

4. While the program strategy remains appropriate, a recalibration of the fiscal path is needed at this difficult juncture to avoid imposing too large a social and output cost (see MEFP paragraph 5). Additional corrective measures will be implemented this year to limit the deficit to 5 percent of GDP in 2012. The 2013 Budget will aim at a deficit of 4.5 percent of GDP and will be underpinned by permanent measures designed to limit the impact of fiscal consolidation on growth and the poorest segments of the population. We are implementing the new law on commitment control in order to avoid further accumulation of domestic arrears. Special attention is being given to local governments and the health sector where the main challenges are concentrated.

5. The achievement of an orderly deleveraging of the economy remains a key objective under our program and we are developing alternative options to facilitate credit to productive firms, in particular SMEs, by fostering the diversification of financing alternatives. The bank capital augmentation exercise due by June 2012 has been successfully completed and we will continue to closely monitor compliance with capital requirements and take prompt and appropriate actions if needed.

6. We are implementing the deep structural reforms already committed to under the program, and we will intensify efforts in areas with high potential to create jobs. For the fifth review, we present a new initiative to substantially streamline licensing requirements and procedures to create a business-friendly environment that should help spur new investment and relieve the heavy regulatory burden on small and medium firms. Building on the good results already secured in our privatization program, we will broaden its scope, releasing more resources to the private sector.

7. On the basis of the strength of the policies defined in this letter, and in light of our performance under the program, including the corrective measures already taken as a prior action for this review, we request the completion of the fifth review under the Extended Arrangement, the sixth purchase under the arrangement in the amount of SDR 1,259 million, as well as a waiver of nonobservance of the end-September cash deficit performance criterion and a waiver of applicability of end-September debt performance criterion.

8. We remain confident that the policies described in the current and previous MEFPs are adequate to achieve the objectives under the program. We stand ready to take additional measures should they be needed to meet the objectives of the economic program and will consult with the IMF, the European Commission, and the ECB, in advance of any necessary revisions to the policies contained in this letter and attached Memorandum.

9. This letter is copied to Messrs. Juncker, Rehn, and Draghi.

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

ATTACHMENT I. PORTUGAL: MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

October 14, 2012

I. MACROECONOMIC OUTLOOK

1. **GDP growth and inflation for the year as a whole are expected to remain in line with the program framework.** In the second quarter of 2012, real GDP contracted by 1.2 percent over the previous quarter, with a strong contribution of net exports offsetting the deterioration in domestic demand. More recently, confidence indicators have been steady, albeit at historically low levels, and labor market adjustment has continued. Output is expected to contract by 3 percent in 2012. Despite weaker domestic demand and falling unit labor cost, headline consumer price inflation is expected to average 2¾ percent in 2012, mainly reflecting the remaining effects of the tax measures in the context of the fiscal consolidation effort.

2. **External adjustment is proceeding rapidly.** The current account deficit has improved by five percentage points of GDP over the past year, and nine points from the trough in late 2008, with exports making the largest contribution to the improvement. Sustained adjustment will be needed to reduce Portugal's very large net external debts. Despite the weakening external environment, growing exports to non euro area trade partners with better growth prospects over the next year will help maintain some momentum. Over the medium-term, we are committed to ensuring the sustainability of the strong performance to date through a reform program that facilitates the adjustment of relative prices across our economy, enabling our firms to become more competitive, grow and create employment.

II. ADVANCING FISCAL ADJUSTMENT

3. **The downside risks to revenue collections highlighted at the time of the Fourth Review have fully materialized.** These developments have become particularly apparent since May, after weak performance under the quarterly VAT regime became visible and the 2011 final tax returns proved disappointing. Significant tax and social contributions revenue deviations—of about 2 percent of GDP compared to the supplementary budget—have now emerged, reflecting the following factors:

- *Changes in the macroeconomic environment*. The faster-than-expected rebalancing of growth away from domestic demand and imports, more intense labor shedding, and the lower prices and wages have weighed on tax and social security contribution bases and receipts, and the ex-post yield of the various tax measures.

- *Unfavorable composition effects.* The squeeze in incomes has prompted a re-allocation toward lower tax brackets and tilted consumption in favor of less tax-yielding goods.

- A small part of the deviation is explained by one-offs and other factors.

4. **Despite tight spending controls and favorable one-off factors, these developments have opened a significant gap with respect to the fiscal targets.** Notwithstanding an increase in unemployment benefits, expenditure has been under very tight control, with large savings on employee compensation. Moreover, lower net interest payments, the reprogramming of EU cohesion funds, and a large receipt expected from the airport concession will help offset the revenue deviation. In spite of this, the 2012–13 fiscal deficit objectives—of 4½ percent of GDP in 2012 and 3 percent of GDP in 2013—are no longer achievable.

5. **In light of this, the fiscal path under the program needs to be recalibrated.** At the current juncture, the additional measures necessary to reach the initial program objectives would entail large output and social costs. Some degree of front-loading is, however, still necessary to maintain confidence and the credibility of fiscal policy. In order to strike a balance between these two objectives, we intend to contain the deficit to 5 percent of GDP in 2012 and 4½ percent of GDP in 2013. The fiscal consolidation needed to achieve the SGP's fiscal objective—of reducing the deficit to below 3 percent of GDP—would then be completed by 2014, with the projected deficit of 2½ percent of GDP. In spite of the wider deficits, the debt peak (about 124 percent of GDP in 2014) would be contained by the broadening of the scope of the privatization program (see MEFP paragraph 15).

6. **We are taking a number of measures to limit the fiscal deficit in 2012 to 5 percent of GDP.** We have frozen some of the 2012 Budget appropriations and frontloaded a broadening of the public sector contributions base, an increase in the tax on investment income, and a stamp duty on high value properties, generating savings of about 0.2 percent of GDP. In addition, the measures affecting social benefits described below will be frontloaded for 2012; these measures are expected to generate resources of about 0.1 percent of GDP over two months.

7. **Fiscal measures of the order of 3¾ percent of GDP are necessary to achieve the new 2013 deficit target.** This includes 3 percent of GDP of consolidation measures, as well as measures to accommodate the fiscal effect of the Constitutional Court ruling on some articles of the 2012 Budget Law (¾ percent of GDP).

8. **The fiscal measures will be designed with a view to limiting their impact on growth and protecting the poorest segments of the population.** They will also aim at advancing toward our medium-term objectives of making the public sector more efficient, attracting investment, and boosting private sector activity. This includes refocusing expenditure on the key tasks of the public sector and moving toward a more effective tax system. Most of the measures will be implemented in the context of the 2013 Budget, which will be submitted to Parliament on October 15 (prior action). The main measures include:

On the expenditure side:

- *Compensation of public employees.* Savings of about 0.4 percent of GDP will be generated through (i) an acceleration in the reduction of the number of government sector employees, including cuts in short-term contracts, (ii) a reduction in overtime, and (iii) cuts in non-wage compensation.

- *Social transfers.* We will improve the targeting of, and scale down, social programs and pension benefits and apply the recent reform of unemployment benefits to all future unemployed. Savings of the order of ¾ percent of GDP are expected from these measures.

- *Health sector reform* will proceed according to plans, generating savings of 0.3 percent of GDP, of which about two-thirds on pharmaceutical products.

- *The ongoing SOE operational restructuring* and a *further reduction in capital spending in public enterprises* will allow for further savings of about 0.2 percent of GDP.

On the revenue side:

- *We will reduce the number of PIT tax brackets to 5 and increase the average effective rates,* aligning our PIT system with European standards. In addition, *a* surcharge of 4% on the part of taxable income above minimum wage *will be imposed* at least until the end of the program and until permanent expenditure cuts to offset its elimination can be identified. These measures will generate some 1½ percent of GDP in additional revenue, more than offsetting the measures to accommodate the fiscal effect of the Constitutional Court ruling—reinstatement of the 13th public sector wage and slightly above one month of pension. Social benefits will be delinked from tax benefits.

- *We will further reduce the debt- bias in the CIT system* by limiting interest deductibility and update a number of excise rates (0.1 percent of GDP).

- *Property taxes.* We will work toward completing the taxable property valuation (see MEFP paragraph 18) (0.3 percent of GDP).

Given the implementation risks related to such a large adjustment, we stand ready to introduce contingency measures, as needed, during the course of 2013.

9. **We will launch a comprehensive expenditure review to identify potential sources of additional savings to reach our medium-term fiscal objectives.** We are fully committed to stabilizing the general government structural deficit below ½ percent of GDP by 2015. To achieve this objective, a further consolidation—of about 2¼ percent of GDP in primary

structural terms—will be necessary in 2014–15. Savings will be generated mainly through expenditure cuts to be specified by mid-February 2013.

III. CONTAINING FISCAL RISKS

A. Public Financial Management

10. **We continue to press ahead with our PFM reforms with a particular focus on halting arrears accumulation.** We have intensified efforts to implement the new commitment control systems over the past months. The new software complying with the law has been rolled out to all national health system (HNS) entities. In parallel, we have concluded negotiations on the €1.5 billion debt settlement program for the health sector in line with the announced strategy. We reaffirm our strong commitment to halting the accumulation of new arrears in hospitals. We will also continue to work closely with local governments to ensure that the commitment control systems have been effectively implemented across all municipalities. Any disbursement under the €1 billion credit line (PAEL) will only be made after IGF has certified the full working functionality of the commitment systems. Given that the Autonomous Region of Madeira has not yet fulfilled the program requirement to revise its arrears settlement strategy, we will ensure that no claims will be paid before such a document is finalized and all arrears validated by IGF.

11. **We have finalized our PFM strategy document (mid-September structural benchmark), which outlines our reform priorities over the next three years.** We remain committed to adapting our legislation to the new European Union fiscal governance rules by end-2012. We will focus on further reducing budgetary fragmentation, notably by streamlining the autonomous funds (SFA) sector. With a view to increasing the central government's general revenues, we will deepen this reform, reviewing the classification of SFA's own revenues, and those of other budgetary entities, by end-September 2013.

B. State-Owned Enterprises

12. **Our efforts to restore financial viability to state-owned enterprises are beginning to pay off.** We now expect to exceed our objective of reaching operational balance for the state-owned enterprises (SOE) sector on aggregate by the end of 2012. Several SOEs—including in the problematic transport and infrastructure sectors—already reached operational balance in the first half of the year, and others are performing better than expected. While achieving further gains in operational balances will be challenging, we remain committed to furthering financial discipline in these firms. With further reductions in costs to be achieved over the remainder of the year and in 2013, some SOEs will be in a position to start reducing their debts over the medium-term. A new law reforming the governance framework for SOEs will soon come into force, giving the Ministry of Finance increased control over their finances. Firms consolidating in government will not be able to borrow from the private sector, and borrowing by those not consolidating will be subject to prior approval, ensuring unsustainable debt burdens will not be built up in future. The law

also allows for improved monitoring of SOEs' financial operations, including local government SOEs.

13. **Nonetheless, financial risks stemming from SOEs remain significant.** With high existing debts, operational balances continue to be too low to cover interest payments in many firms, resulting in still-rising debt. Even with further restructuring, restoring financial viability to some of these firms will require managing excessive historical debt burdens. Despite unfavorable market conditions, we are exploring options for selling SOE assets and repurchasing debt, respecting our financing constraints, and continue to actively manage liabilities falling due to avoid unbudgeted financial support.

14. **We are expanding the privatization program.** Privatizations are advancing. Nonbinding offers have already been received for the airline, TAP, and are expected by end-October for the airport concessionaire, ANA. We expect final decisions to be taken by end-2012, with the financial completion of these transactions in early 2013. Interest in both companies has been strong. In the first quarter of 2013, we expect to advance with the privatizations of the postal company CTT once the universal service provision concession in this sector is granted. We also expect to proceed with the privatization of the waste management operations of the water company Águas de Portugal in the first quarter of 2013, and we are developing a strategic plan by the end of 2012 with other stakeholders—notably local governments—to restructure the broader water sector. We have sought strategic advice on preparing a sale or concession of a television channel and radio station belonging to RTP. The sale of the rail cargo firm CP Carga is expected in the second quarter of 2013. Finally, and while the bulk of eligible assets have already been considered, we are indentifying further public companies and assets that could be privatized.

C. Public-Private Partnerships

15. **Our PPP reform is entering its final phase.** Following the reform of the institutional and legal PPP framework, and the conclusion of the third-party report, we have concluded negotiations of the PPP subconcessions, which aimed at cutting capital and operational costs of about €1 billion (in NPV terms). This renegotiation will result in reduced availability payments starting in 2014. Looking ahead, by the sixth review we will prepare a detailed strategic plan to renegotiate the remaining PPP contracts. We aim to reduce the government's financial obligations, obtaining substantial upfront savings while minimizing the consequences for public debt. We will also work swiftly to ensure that the MOF's technical PPP unit is fully operational by end-December. We will not engage in any further contracts until the technical PPP unit and the new legal framework are in place and able to limit fiscal risks.

D. Revenue Administration

16. **We have been proactive in strengthening revenue administration (AT) to fight noncompliance.** A key reform to curb tax fraud and evasion will enter into force on

January 1st, 2013 with the following objectives: (i) invoicing will be mandatory across all sectors and transactions; (ii) businesses will be obliged to report the relevant content of invoices to a centralized VAT monitoring database; (iii) goods in circulation will be electronically monitored; and (iv) a tax incentive scheme to encourage taxpayers to ask for the issuance of invoices—notably in hard-to-tax sectors—will be launched. This model will enhance the AT's capacity to access information and enable automatic cross-checks. Moreover, we will enhance the exchange of information between AT and the Social Security Administration, especially by adopting a unified monthly return on withholding of wages and a single form on independent workers' annual income.

17. **We remain committed to implementing our reform agenda.** We are on track to meet the end-December structural benchmark on implementing the Large Taxpayer Office. On the judicial front, the task force of judges has increased the pace of its work on high-value tax cases while the State success ratio in the tax courts is increasing. We reaffirm our commitment to clearing the remaining tax cases. Finally, we will deepen our efforts to conclude the property evaluation process by year end, despite limited access to the buildings blueprints. In order to minimize fiscal risks under the program, we will ensure that the new value of all properties will serve as a basis for the tax levied in 2013.

E. Regional and Local Public Finances

18. **We have made significant progress regarding the local administration reform.** We have approved a law that establishes a new regime for local SOEs and we will start working towards the dissolution of all local SOEs that do not comply with legal requirements. We have also passed legislation with a view to streamlining management positions at the local level. Work on the reduction of the number of parishes is proceeding. Finally, our working group for the revision of the local and regional finance laws is advancing with the draft proposals, and has started discussions with external stakeholders. Despite a slight delay in the timetable, the submission of the draft finance laws to Parliament (end-December structural benchmark) remains on track.

IV. Preserving Financial Stability

19. **Orderly deleveraging of the economy remains a key objective under the program.** Eased liquidity conditions and strengthened capital buffers are helping alleviate risks of an excessive credit contraction. While the needed deleveraging process proceeds, it is crucial to ensure that the most productive segments are not subject to undue funding strains and can effectively support the economic recovery. To this purpose, we are taking measures to facilitate credit to productive firms, in particular SMEs, while continuing to ensure that these steps do not burden or pose risks to public finances. As part of these efforts, the Ministry of Finance, together with BdP and other stakeholders, have put forward a set of proposals and are currently evaluating different options to enhance information sharing and foster the diversification of financing alternatives to the corporate sector. In parallel, the

supervisory work of Banco de Portugal (BdP) is helping promote an orderly adjustment of banks' balance sheets. Recent initiatives to avoid evergreening and promote prompt restructuring of problem loans include new instructions by the BdP for banks to report restructured loans due to financial difficulties of the borrower, with the first report expected by end-November.

20. **Adequate bank liquidity remains critical to preserve financial stability.** The exceptional liquidity support provided by the Eurosystem is playing a pivotal role in easing liquidity pressures and mitigating potential constraints to bank lending. Portuguese banks are making significant use of the recent measures by the Eurosystem to support collateral availability. Going forward, we encourage banks to continue their efforts to strengthen collateral buffers on a sustainable basis. In parallel, to facilitate reallocation of liquidity among domestic banks, the BdP has recently launched a new platform for interbank unsecured lending, which is expected to be extended to secured transactions by the beginning of next year. We believe that these ongoing efforts can contribute to an orderly deleveraging of the economy, with a view to reduce banks' dependence on Eurosystem liquidity over the medium term.

21. **The bank capital augmentation exercise due by June 2012 has been successfully completed.** The envisaged capital augmentation measures, including the public injection of capital, have been completed as planned, allowing banks to meet the capital needs stemming from the EBA 2011 Capital Exercise, the Special On-Site Inspection Program (SIP), and the pension fund transfer. In line with EU rules, banks having received public capital support have been required to draw up restructuring plans, aimed at enhancing the banks' resilience. These measures are also expected to enable these banks to meet the Core Tier 1 program target of 10 percent by end-2012, which applies to all banks. BdP is closely monitoring compliance with the capital requirements, with a view to promptly take appropriate action if needed.

22. **As part of its regular supervisory activities, the BdP continues to update its evaluation of banks' impairment levels and assess the resilience of the banking sector.** The field work of a new onsite inspections program (OIP), launched last May by the BdP, has already started in the major banking groups and is on track. This initiative is part of BdP regular supervisory activities, which are currently focused on assets classes that are more sensitive to existing market conditions. In parallel, the BdP will continue to update its quarterly stress test exercise. In this context, banks will reflect the OIP findings in the implementation of the SIP recommendations on asset quality and stress testing methodologies by end-December 2012, with the update of the treatment of collective impairments expected to be finalized at the latest by end-June 2013.

23. **We remain committed to providing further support to the banking sector, if needed.** In the event new capital needs were to arise, we continue to encourage banks to seek private solutions. Nevertheless, resources from the Bank Solvency Support Facility (BSSF)

remain available to support viable banks if needed, in line with state aid rules and subject to strict conditionality aiming to avoid subsidizing private shareholders and prevent migration of private liabilities to the public sector balance sheet. The remaining resources in the BSSF will solely be utilized to provide public support, if needed, to the banking system.

24. **We are implementing the strategy for managing the distressed assets from Banco Português de Negócios (BPN).** We intend to outsource the management of the credits currently held by Parvalorem to a professional third party. We are finalizing the terms of reference for the mandate of the party managing the credits to ensure maximization of recoveries, while minimizing operational costs. The competitive bidding process to select the asset manager will be launched by end-October at the latest, with a view to complete the tender process by end-March 2013. We will also ensure timely disposition of the subsidiaries and the real assets in the other two state-owned SPVs. CGD's state guaranteed claim will be gradually settled in cash, according to the schedule agreed with the EC, ECB, and IMF. Any net recoveries realized on the assets will also be applied towards the settlement of CGD's claim.

25. **Progress is being made towards strengthening the early intervention and resolution framework.** We are finalizing the implementation of the measures necessary for completion of the new legislative framework for banking resolution. We have established the regulation governing the organization and operation of the resolution fund. The decree law on the banks' contributions to the resolution fund is expected to be approved by end-November. The BdP will have approved by then the two supervisory notices on recovery plans and bridge banks (end-October) and will finalize the supervisory notice on resolution plans by end-November. Moreover, we will swiftly transpose the new EU Directive on bank resolution as soon as it enters into force.

26. **We have concluded the improvements to the legal framework for corporate debt restructuring.** After the entry into effect of the amendments to the Insolvency Code in May 2012, we have adopted the conciliation framework (SIREVE) mediated by IAPMEI, a public entity, to facilitate extrajudicial corporate debt restructurings for viable SMEs which entered into effect on September 1, 2012. We will continue to step up actions to raise public awareness of the new restructuring tools.

27. **Resolving household sector indebtedness in an orderly fashion remains a key priority.** We continue monitoring the evolution of household indebtedness closely and are establishing a framework for financial institutions to engage in out-of-court debt restructuring for households which will enter into effect soon. A nationwide network of duly accredited structures will also be developed, based on existing structures, in order to provide financial advice to households in debt distress.

V. BOOSTING COMPETITIVENESS AND GROWTH

A. Promoting Employment

28. **Unemployment continues to be a priority concern, and we are delivering on commitments to support employment as the economy adjusts.** Our strategy focuses on effective active labor market policies. *Vida Ativa*, our new targeted training initiative, has reached out to over 150,000 unemployed, of which more than 50,000 are already involved in training. We have also stepped up our efforts towards activation by sending notifications to over 250,000 unemployed with good results: about 5,000 unemployed have been placed in jobs, and over 125,000 unemployed have been integrated in an occupational or other training program. We are conducting a real-time evaluation of the effectiveness of these targeted training programs and, based on the results, we will look to enlarge eligibility.

29. **Important reforms of labor market institutions are nearing completion.** The new Labor Code entered into force on August 1 and positions all workers and all firms to benefit from a more dynamic and efficient labor market, particularly as the cycle turns and hiring resumes.

- *By reforming the wage setting mechanism, we have reduced substantially the scope for large incumbent firms to unduly burden the competitive position of other firms in the sector.* We have formalized the criteria for extending collective agreements, ensuring that in sectors where employers' associations represent less than 50 percent of the total work force, collective agreements reached by those associations will not be extended to all firms in the sector. The government resolution defining these criteria and the modalities for their implementation was adopted on October 10 (structural benchmark).

- *We have made important efforts in reducing one of the highest levels of employment protection in Europe*. Building on the changes in the Labor Code regarding individual dismissals, and following the first step we took in November 2011, we will by mid-November 2012 lower severance payments further to 8–12 days per year of service, bringing them in line with relevant comparators in the euro area.

B. Business Environment: Slashing Licensing Requirements

30. **We are launching a comprehensive program to tackle excessive licensing procedures, regulations and other administrative burdens –a key bottleneck to economic activity.** These explicit and implicit barriers to the establishment, operation, and expansion of firms create substantial uncertainty, discourage investment and limit job growth. By alleviating these costs—which represent a particular burden for small and medium firms—we also hope to encourage foreign direct investment, with all its positive spillovers. To that end,

- We will start with a decisive first step—by end-June 2013 we commit to deal with the legacy of excessive licensing by carrying out a full inventory of all regulations at all levels of government, with a view to eliminating overlapping and redundant regulations.

- To prevent the problem from re-emerging in the future, we will study the feasibility of putting in place a "one-in, one-out" rule that prohibits the creation of a new regulation without the elimination of an existing regulation or regulations with an equivalent cost.

- By end-year we will put in place a working group (*Gabinete do Investimento*) to analyze and to fast-track planned existing investment opportunities unresolved or undecided for more than 12 months.

- We will advance the availability of zero-licensing procedures for industrial and commercial activities via an online portal, alongside work being done for firms in the services sector (see MEFP ¶32). A wide range of further changes to the licensing regime are described in the fifth update of the Memorandum of Understanding (MoU).

C. Product Markets, Competition, and Regulation Framework

31. **Through bold reforms in ports, we aim to reduce the port bill for exporters by 25–30 percent.** A landmark revision of the Ports Work Law, which was submitted to Parliament in September, substantially lowers wage costs and removes constraints to optimizing the use of labor. To ensure the transmission of lower unit labor costs to end-user costs of port services, we are revising incentives for port operators by adopting a new performance-based model for concession contracts as they expire, and we are looking to encourage entry of new operators. Finally, responding to exporters' concern, we will reduce by end-December fees on port use (*TUP-Carga*), aiming to lower these fees by 20 percent.

32. **Work on removing legal and administrative barriers to trade in the economically very significant services sector is well advanced.** We have accelerated the drafting of the needed legislation, and, as a result, over half of the amendments to sector-specific legislation have already been approved either by government or by Parliament and are now in effect. The remaining 23 amendments required to complete this effort will be submitted to Parliament by end-October 2012. We will step up the efforts to establish a well-functioning online platform (Point of Single Contact) which simplifies the procedures for establishing and operating firms in these sectors. In addition, we have submitted to Parliament a new horizontal framework law concerning the *professional bodies of highly regulated professions* (such as lawyers, accountants, architects), easing access to these professions and limiting anti-competitive practices.

33. **We are creating a strong and stable legal framework for regulation to ensure market efficiency and protect public interests.** Given the limited scope for greater competition through entry of new operators in a number of industries, particularly in energy and telecommunications, we recognize that strong, independent, and effective regulators are key to preventing anti-competitive outcomes, with the attendant effects on prices, innovation, and resource allocation. To that end, we are preparing a framework law for regulation that draws on the findings and recommendations of the recently completed expert report, benchmarking the responsibilities, resources, and independence of the main sectoral regulators against international best practices. The framework law will guarantee independence, as well as financial, administrative and management autonomy, benefitting from broad consultation with the regulatory bodies concerned. While this important law is being prepared, we will soon amend the statutes of the electricity regulator (ERSE) to give it the appropriate powers, independence, and autonomy ahead of full market liberalization in January 2013.

D. Judicial Reform

34. **We continue pushing ahead with targeted measures to reduce the backlogged enforcement cases.** Despite the challenges in addressing the backlog court cases, an additional 25,000 enforcement cases have been cleared, bringing down the total number by about 95,000 enforcement cases since November 2011. The inter-agency task forces have set quarterly targets for reviewing enforcement cases to be closed by mid-November 2012. To this end, we have stepped up our efforts by expanding the task forces to small claims court cases in specific courts. We will prepare revised draft bills to strengthen the legal and institutional framework for enforcement agents and to include a fee structure that incentivizes speedy enforcement by mid-November 2012 based on extensive consultation including IMF/EU technical assistance and informed by cross country experience and which will be approved by the government by end-February 2013. We continue overhauling the information system to facilitate the speedy processing of court cases.

35. **We are advancing the reforms to improve efficiency of the court system.** We have refined the comprehensive judicial roadmap to reduce the number of courts and streamline the court structure and the new draft Code of Civil Procedure to speed up the judicial process with extensive stakeholder consultation and also informed by IMF/EU technical assistance.

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

	Performance Criteria (unless indicated otherwise)										Indicative Targets
	Dec-11		Mar-12		Jun-12		Sep-12		Dec-12	Mar-13	Jun-13
	Program	Actual	Program	Actual	Program	Actual	Program	Actual			
1. Floor on the consolidated General Government cash balance (cumulative)	-10.3	-7.1	-1.9	-0.45	-4.4	-4.1	-5.9	-7.9	-9.0	-1.9	-4.5
2. Ceiling on accumulation of domestic arrears by the General Government (continuous indicative target) 1/	0	Not met	0	Not met	0	Not met	0	N/A	0	0	0
3. Ceiling on the overall stock of General Government debt	175.9	167.8	182.0	171.2	175.0	170.9	177.5	N/A	180.0	182.2	184.1
4. Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by the general government (continuous performance criterion)	0	0	0	0	0	0	0	0	0	0	0

1/ Domestic arrears for the purpose of the program remained broadly stable between end-March and end-July 2012. They increased by about €200 million between end-March and end-June, and decreased by about €200 million in July.

Table 2. Portugal: Structural Conditionality: Fifth Review Under the EFF

	Measure	Timing	Status
Prior action			
	Submit to Parliament the 2013 budget consistent with ¶5-9 of the MEFP.		
Structural Benchmarks			
A. Strengthen financial stability			
1	Make effective the amendments to the Corporate Insolvency Law to better support rescue of viable firms (after completing all necessary legislative and publication requirements)	Mid-June 2012	Met
2	Prepare a proposal for encouraging the diversification of financing alternatives to the corporate sector.	End-July 2012	Met
B. Enhance competitiveness and address bottlenecks to growth			
3	Submit to Parliament draft legislation defining the criteria for extension of collective agreements (including a majority representation threshold) and the modalities for their implementation.	End-Sept 2012	Met with delay
4	Prepare a proposal to implement identified best international practices in order to reinforce the independence of the main sectoral regulators.	End-Sept 2012	Met
5	Submit to Parliament a new Code of Civil Procedure to streamline and speed up the court procedures.	End-Nov 2012	
6	Submit to Parliament the bill to implement the judicial roadmap to improve the court structure.	End-Nov 2012	
C. Strengthen fiscal institutions and reduce fiscal risks			
7	Develop a PFM strategy covering the next three years, to be attached to the 2013 budget.	Mid-Sept 2012	Met
8	Revise and submit to Parliament the draft regional and local public finance law.	End-Dec. 2012	
9	Implement a full-fledged Large Taxpayer Office (LTO), to cover audit, taxpayer services, and legal functions concerning all large taxpayers, including the adoption of account managers.	End-Dec. 2012	

ATTACHMENT II. PORTUGAL: TECHNICAL MEMORANDUM OF UNDERSTANDING

October 14, 2012

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 2012, shall not include entities nor operations (including pension funds) that are re-classified into the General Government during 2012, but shall include those reclassified in 2011.[1]

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

[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. On this issue, see also paragraph 13.

- 5.2. Data on the cash balances of the other parts of General Government as defined in paragraph 4[2] 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.

- 5.5. Data on the revenues, operating expenses, capital expenditure, remuneration of personnel, EBITDA, and number of staff will be provided for state-owned enterprises (SOEs) on a quarterly basis, within 7 weeks after the end of each quarter. Aggregate data for the SOEs within the perimeter will be provided, with company-specific information for REFER, Estradas de Portugal, Metro de Lisboa, and Metro de Porto. Furthermore data for Comboios de Portugal and Parpública (outside the perimeter) will also be provided.

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 and beyond, 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

[2] 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.

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 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. **Adjustor.** The 2012 and 2013 quarterly floors on the consolidated general government cash balance will be adjusted for the cumulative amount of arrears settled in the context of the arrears clearance strategy. This includes the health sector arrears settled with the banks' pension funds transfers' resources, as well as local government arrears settled through the €1 billion credit facility created in May 2012.

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, accrued liabilities. Arrears are a subset of payables/creditors. For the purposes of the Program domestic arrears are defined as payables/creditors (including foreigner commercial 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—based on the same perimeter with respect to the entities covered. This also includes arrears that are being accumulated by the SOEs not included in the General Government.

11. **Supporting Material.** The stock of arrears will be measured through a survey. Reports on the stock of arrears of the General Government are being published monthly. 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, as well as the monthly amounts of (i) health sector arrears settled with the banks' pension funds transfers' resources, and (ii) local government arrears settled through the €1 billion credit facility created in May 2012.

12. **Adjustor.** The monthly change in the stock of arrears will be adjusted for any stock adjustment related to the arrears clearance strategy. This includes the health sector arrears settled with the banks' pension funds transfers' resources, as well as local government arrears settled through the €1 billion credit facility created in May 2012. This will allow monitoring the underlying flow of new arrears.

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

13. **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.

14. **Adjusters.** For 2012, 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 2011 general government debt of EUR183.33 billion. From 2013 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.

15. **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)

16. **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.

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

E. Bank Solvency Support Facility

18. The dedicated Bank Solvency Support Facility (BSSF) account will be maintained at the Bank of Portugal. As per previous review, resources for the BSSF will be agreed at each review and deposited in the dedicated account.

F. Overall Monitoring and Reporting Requirements

19. 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.

APPENDIX III. PORTUGAL: LETTER OF INTENT TO THE EUROPEAN COMMISSION AND THE EUROPEAN CENTRAL BANK

Lisbon, October 14, 2012

Mr Jean-Claude Juncker
President
Eurogroup

Mr Vassos Shiarly
Minister of Finance
Cyprus

Mr Olli Rehn
Vice President
European Commission

Mr Mario Draghi
President
European Central Bank
Dear Sirs,

The attached Memorandum of Understanding (MoU) describes the progress made in recent months towards the objectives laid out in our Programme. It also updates previous MoUs and highlights the policy steps to be taken in the months ahead.

While we remain strongly committed to the Programme's policies and objectives, the challenging domestic and external environment is weighing on Programme performance. The fiscal outlook has deteriorated considerably, reflecting mainly the impact of the economic rebalancing on tax bases and revenue performance and the more subdued growth projections. In spite of a rigorous budget implementation on the expenditure side, a large fiscal gap has now emerged and the initial programme targets are no longer achievable.

We have started to settle the stock of existing domestic arrears and have advanced the implementation of the new commitment control systems. Nevertheless, the underlying arrear position has continued to deteriorate—although with smaller increases in recent months, resulting in further breaches of the related indicative target under the Programme. The operational restructuring of SOEs is being successfully implemented and we are assessing options to strengthen their long-term financial viability. Our policy efforts to preserve financial stability have continued, and further steps have been taken to promote competitiveness, growth, and employment.

While the Programme strategy remains appropriate, a recalibration of the fiscal path is needed at this difficult juncture to avoid imposing too large a social and output cost. Additional corrective measures will be implemented this year to limit the deficit to 5 percent of GDP in 2012. The 2013 budget will aim at a deficit of 4.5 percent of GDP and will be underpinned by permanent measures designed to limit the impact of fiscal consolidation on growth and the poorest segments of the population. We endeavour to identify a set of measures to be used in case of deviations with respect to the 2013 target. We will aim at a deficit well below 3 percent of GDP in 2014. To this end, we are undertaking a comprehensive expenditure review

to identify the necessary measures to present a preliminary version by the sixth review in November. We are implementing the new law on commitment control in order to avoid further accumulation of domestic arrears. Special attention is being given to local governments and the health sector where the main challenges are concentrated.

The achievement of an orderly deleveraging of the economy remains a key objective under our Programme and we are developing alternative options to facilitate credit to productive firms, in particular SMEs, by fostering the diversification of financing alternatives. The bank capital augmentation exercise due by June 2012 has been successfully completed and we will continue to closely monitor compliance with capital requirements and take prompt and appropriate actions if needed.

We are implementing the deep structural reforms already committed to under the Programme, and we will intensify efforts in areas with high potential to create jobs. For the fifth review, we present a new initiative to substantially streamline licensing requirements and procedures to create a business-friendly environment that should help spur new investment and relieve the heavy regulatory burden on small and medium firms. Building on the good results already secured in our privatization programme, we will broaden its scope, releasing more resources to the private sector.

On the basis of the strength of the policies defined in this letter, and in light of our performance under the Programme, including the corrective measures already taken as a prior action for this review, we request the completion of the fifth review under the Economic Adjustment Programme, the release of the sixth instalment under the Programme in the amount of EUR 2 800 million.

We remain confident that the policies described in the current and previous MoUs are adequate to achieve the objectives under the Programme. We stand ready to take additional measures should they be needed to meet the objectives of the Economic Adjustment Programme and will consult with the European Commission, the ECB and the IMF in advance of any necessary revisions to the policies contained in this letter and attached Memorandum.

This letter is copied to Ms. Christine Lagarde.

Sincerely yours,

/s/	/s/
Vítor Gaspar	Carlos da Silva Costa
Minister of State and Finance	Governor of the Banco de Portugal

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

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

Fifth Update – October 14, 2012

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, the fifth update of the Memorandum of Understanding on specific economic policy conditionality (MoU) 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[1]

The first disbursement of financial assistance from the EFSM took place following the entry into force of the 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 Memorandum of Economic and Financial Policies (MEFP) and in this updated MoU, as well as Council Recommendations in the context of the Excessive Deficit Procedure.

The fifth quarterly review was carried out in September 2012. It assessed compliance with the conditions to be met by end-July and the need and scope for additional policy steps. This fifth update of the MoU reflects the findings of the fifth 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 or, where applicable, up to date of the mission.

If targets are missed or expected to be missed, additional action will be taken. The authorities commit to consult with the European Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF) on the adoption of policies falling within the scope of this updated Memorandum, allowing sufficient time for review. Staff of the EC, the ECB and the IMF will, in cooperation with the Portuguese authorities, monitor and assess progress in the implementation of the programme and track the economic and financial situation. Staff will also monitor whether the implementation and effects of measures taken by the Portuguese authorities fall short of the commitments of previous versions of the MoU; such commitments might be re-inserted. To this effect the authorities commit to provide all required information as soon as available. In areas where there are risks of significant delays in the implementation of policies under this programme the authorities in cooperation with the EC, the ECB and the IMF consider making use of technical assistance.

Prior to the release of the instalments, the authorities shall provide a compliance report on the fulfilment of the conditionality.

[1] On 8 April 2011, Eurogroup and ECOFIN Ministers issued a statement clarifying that financial support of the EU (European Financial Stabilisation Mechanism, EFSM) and the euro-area (European Financial Stability Facility, EFSF) 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 EFSF will contribute to the financial assistance. The Loan Facility Agreement on the EFSF financing contribution specifies that the disbursements thereunder are subject to the compliance with the conditions of this Memorandum.

1. Fiscal policy

Objective

The fiscal consolidation path under the programme is adjusted to accommodate the internal rebalancing of the economy, while safeguarding a steady decline of the debt-to-GDP ratio over the medium-term. The faster-than-expected rebalancing of growth away from domestic demand towards net exports and the more intense labour shedding has adversely affected tax revenues and the social security budget in 2012. Moreover, private domestic demand remains weak, with consumption tilted towards less-value added, lower tax-yielding goods. This reflects a correction of pre-crisis consumption excesses, which is good in the long run, but a drag on demand in the short run. Budgetary sustainability in the medium-term needs to be supported by a successful internal adjustment resulting in permanent competitiveness gains. The fiscal consolidation over the medium-term up to a balanced budgetary position will be maintained by containing expenditure growth. The consolidation will be achieved by means of high-quality permanent measures and minimising the impact of consolidation on vulnerable groups.

Fiscal policy in 2012

The planned 2012 general government headline deficit target of 4½ percent of GDP will be revised to 5 percent of GDP (EUR 8.3 billion) to partially accommodate the negative windfall from the deterioration in the macroeconomic outlook and facilitate the on-going internal adjustment of growth towards net exports alongside a sustained implementation of the budgetary and structural reform programmes. The SGP fiscal objective of reducing the budget deficit well below 3 percent of GDP will be achieved by 2014, with a projected budget deficit of 2½ percent of GDP in 2014.

1.1. The government will achieve a general government deficit of no more than EUR 8.3 billion (5 percent of GDP) in 2012.[2] **[Q4-2012]**

1.2. Throughout the year, the government will rigorously implement the Budget Law for 2012, as amended by the Supplementary Budget. Within the year, progress will be assessed against the (cumulative) quarterly ceilings for the consolidated general government cash balance in the MEFP, as defined in the TMU, without prejudice to full-year ESA-95 deficit targets. **[Q3 and Q4-2012]**

1.3. The revenue deviations compared to the 2012 supplementary budget (of about 2 percent of GDP) mostly explained by macro-economic developments will be partly off-set by lower net interest payments, the reprogramming of EU cohesion funds, interest gained on the bank recapitalisation support, a larger decrease in the wage bill expenditure, and a large receipt from the sale of a concession for the Lisbon airport. Moreover, the government will take additional measures to confine the deficit to 5% of GDP in 2012, as follows: i) some of the 2012 budget appropriations for investment projects not yet initiated will be frozen, stamp duties on high value properties will be raised, and tax rates on investment income will be

[2] In 2012, operations related to the banking sector support and restructuring strategy under the programme will not be considered for the assessment of compliance with the programme target for the general government deficit. Conversely, if during the sixth review there is an agreement that there are sufficient safeguards to prevent further accumulation of arrears and the implementation of the strategy for the arrears' settlement is on track, the accrual government balance objectives may be adjusted by the amount of settled arrears.

slightly increased, generating savings of about 0.1% of GDP; ii) another 0.1% of GDP of savings will be generated by frontloading some of the 2013 budget measures affecting social benefits; and iii) other measures generating savings in intermediate consumption and revenues from sales will be implemented in order to ensure the achievement of a budget deficit target of 5.0% of GDP in 2012.

Fiscal policy in 2013

1.4. The government will achieve a general government deficit target of no more than EUR 7.5 billion (4½ percent of GDP), revised upwards from 3 percent of GDP. **[Q4-2013]**

1.5. In addition to the effort necessary to close the fiscal gap carried forward from 2012, measures will be adopted to compensate the fiscal effects of the Constitutional Court's ruling on the 13th and 14th salaries and pensions. The 13th month public sector wage and 1.1 monthly pensions will be reinstated (about ¾% of GDP) and compensated by measures of equivalent budgetary impact, including the reform of the personal income tax structure. Throughout the year, the government will rigorously implement the Budget Law for 2013.

1.6. 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]**

1.7. Permanent consolidation measures of about 3% of GDP were identified and will be adopted with the 2013 budget law to reach the 4½ % of GDP deficit target in 2013. The measures listed below will be detailed and carried out with the 2013 Budget Law **[Q4-2012]**, unless otherwise specified:

Expenditure

1.8. Measures introduced in the 2013 Budget Law, other than the measures to compensate the fiscal effects of the Constitutional Court ruling, leading to a reduction in expenditure of at least 1.6 % of GDP in the following areas:

i. Wage bill: EUR 630 million. Decrease of at least 2 per cent (full-time equivalent) in the permanent staff of central, regional and local governments and decrease in the number of temporary positions in specific areas of public administration; reduction in overtime pay;

ii. Intermediate consumption: EUR 150 million. Reduction in operational cost of public administration, education and school network rationalisation, and operational cost of state-owned enterprises;

iii. Social transfers and subsidies, all economy, public and private: EUR 1170 million;

iv. Health sector: EUR 485 million;

v. Capital spending of public enterprises: EUR 200 million;

Revenue

1.9. Measures introduced in the 2013 Budget Law, other than the measures to compensate the fiscal effects of the Constitutional Court ruling, leading to an increase in revenue in the following areas:

i. Direct taxes: about ¾ % of GDP. The measures are aimed at: a) broadening the tax bases by reduction in personal income tax (PIT) benefits and tax deductions; b) reducing the tax brackets of the PIT and increasing the average tax rates in line with European standards, while delinking social benefits from tax benefits; c) introducing a surcharge on PIT; d) broadening of the corporate income tax (CIT) base; e) increases in investment income tax rate; f) base broadening by allowing taxation of social transfers;

ii. Consumption taxes: about 0.1% of GDP;

iii. Property taxes: about 0.4% of GDP. Broadening of the property taxation base by completing the update of all property values and introducing stamp tax surcharges for high-value property;

iv. Social contributions: about 0.1% of GDP.

1.10. The government will look for ways to increase the weight of the expenditure reduction in the overall consolidation package of 3% of GDP to be included with the 2013 budget in order to ensure a medium-term growth-friendly fiscal adjustment tilted towards the expenditure side.

1.11. In the framework of 2013 budget proposal, the government will prepare a set of contingency measures, predominantly on the expenditure side, to use in the course of 2013 in case of need, given possible implementation risks.

Fiscal policy in 2014

1.12. The government will achieve a general government deficit of no more than EUR 4.3 billion (2½ percent of GDP) in 2014. **[Q4-2014]**. To achieve this objective, further consolidation measures of about 1¾ % of GDP will be necessary in 2014. Savings will be generated through expenditure cuts (about 4 bn EUR over 2014-15). A comprehensive expenditure review to fully specify the additional sources of savings will be carried out by the time of the sixth review and measures will be fully specified by mid-February 2013 in time for the seventh review. The fiscal consolidation plans for 2014-15 will be fully detailed in the 2013 Stability Programme.

1.13. 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]**

2. Financial sector regulation and supervision

Preserve financial sector stability; maintain liquidity and support a balanced and orderly deleveraging in the banking sector; ensure adequate financing and working capital for the productive sectors; strengthen banking regulation and supervision; optimise the process for recovering the assets transferred from BPN to the three state-owned SPVs; streamline state-owned Caixa Geral de Depósitos; complete 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.

2.1. *Maintaining liquidity in the banking sector*

Encourage banks to strengthen their collateral buffers on a sustainable basis and to take full advantage of the broadening of the range of eligible collateral for the purpose of Eurosystem

re-financing. The Banco de Portugal (BdP), in close cooperation with the ECB, will continue to monitor closely the liquidity situation of the banking system and stands ready to take the appropriate measures to maintain sufficient system liquidity. **[Ongoing]** A new platform for interbank unsecured lending has been launched and the BdP is expected to extend it to secured interbank lending by the beginning of next year.

Deleveraging in the banking sector

2.2. The banking system should in the medium run eliminate its funding imbalances. Monitor the banks' implementation of the funding plans aiming at an indicative loan-to-deposit ratio of about 120% in 2014. It is important that the pace and composition of deleveraging should not jeopardise the provision of appropriate credit to finance productive investment and working capital in the private sectors of the economy, not least SMEs. Fiscal adjustment and an attendant reduction in the public sector's financing are crucial for reconciling potentially conflicting objectives. In addition, the BdP will implement the measures taken to discourage evergreening of doubtful loans with a view to facilitating an effective adjustment of bank balance sheets respecting EU state aid rules. In this context, banks are identifying and reporting recently restructured loans due to debtors' financial difficulties and the first report by the BdP is expected by **end-November 2012**. These steps will be taken without burdening or posing risks to public resources. Banks' funding and capital plans and broader credit developments will continue to be monitored closely. There is room for the necessary deleveraging to take place in an orderly manner and it is crucial that the pace and composition of the deleveraging remain consistent with the macroeconomic framework of the programme. **[Ongoing]**

Capital buffers

2.3. Ensure that the programme target of a Core Tier 1 ratio of 10% by **end-2012** target is reached including through the monitoring of the restructuring plans banks having received public capital support were requested to draw up, aiming at enhancing the banks' resilience.

2.4. BdP is closely monitoring compliance with the capital requirements for all banks, with a view to promptly take appropriate action if needed. **[Ongoing]**

2.5. Remain committed to provide further support to the banking system, if needed. Resources from the Bank Solvency Support Facility (BSSF) are available in line with state aid rules to further support viable banks, subject to strict conditionality. Avoid subsidizing private shareholders and prevent further migration of private liabilities to the public sector balance sheet. In the event new capital needs were to arise, banks are encouraged to seek private solutions. **[Ongoing]**

Caixa Geral de Depósitos (CGD)

2.6. Continue to streamline the state-owned CGD group.

Banking regulation and supervision

2.7. The BdP will continue to strengthen its supervisory organisation, optimise its supervisory processes and develop and implement new supervisory methodologies and tools. The field work of a new onsite inspections program (OIP), launched in May 2012 by the BdP has already started in the major banking groups. This initiative is part of BdP regular supervisory activities, which are currently focused on assets classes that are more sensitive to existing market conditions.

2.8. In addition, the BdP is stepping up the monitoring of banks, including via ad hoc audits. **[Ongoing]**

2.9. BdP will remain committed to close coordination with home and host country supervisors, both within and outside the EU. **[Ongoing]**

Monitoring of bank solvency

2.10. The BdP will continue to monitor on a **quarterly** basis the banks' potential capital needs with a forward looking approach under stress conditions. In this context, banks will reflect the OIP findings in the implementation of the SIP recommendations on asset quality and stress testing methodologies by **end-December 2012**, with the update of the treatment of collective impairments expected to be finalized at the latest by **end-June 2013.**

Banco Português de Negócios

2.11. Gradually settle CGD's state guaranteed claim on the SPVs in cash, according to the schedule agreed with the EC, ECB and IMF. Any recoveries on the assets held by the three state-owned SPVs will also be used to promptly repay CGD. **[Ongoing]**

2.12. Outsource the management of the credits currently held by Parvalorem to a professional third party, with a mandate to gradually recover the assets over time. Select the party managing the credits through a competitive bidding process, to be launched by **end-October 2012,** at the latest, and with a view to complete it by **end-March 2013**. Include proper incentives to maximise the recoveries and minimise operational costs into the mandate. Ensure timely disposition of the subsidiaries and the assets in the other two state-owned SPVs.

Bank resolution framework

2.13. The early intervention, resolution and deposit guarantee framework has been strengthened. The authorities are asked to conclude the implementing measures. In particular, the following actions will be taken: (a) setting-up of the resolution fund with a view to ensuring its funding arrangement through the approval of a decree-law on the banks' contributions to the resolution fund by **November 2012**; (b) adopt supervisory notices on recovery plans by **end-October 2012;** (c) adopt resolution plans regulations by **end-November 2012,** taking into account, to the extent possible in view of the deadline, the EBA recommendations and templates; (d) adopt rules applicable to setting-up and operation of bridge banks in line with EU competitions rules by **end-October 2012**. Give priority to the review of the recovery and subsequent resolution plans of the banks that are of systemic importance.

2.14. The legislator will closely follow the process of adoption of the EU Directive on resolution and revise the national resolution framework as soon as the Directive enters into force. **[Ongoing]**

Corporate and household debt restructuring framework

2.15. Establish a framework for financial institutions to engage in out-of-court debt restructuring for households and implement an action plan to raise public awareness of the restructuring tools. **[Ongoing]**

Monitoring of corporate and household indebtedness

2.16. Continue the monitoring of the high indebtedness of the corporate and household sectors through the quarterly reports. **[Ongoing]**

Encouraging the diversification of financing alternatives to the corporate sector

2.17. The Ministry of Finance, the BdP, and other stakeholders, have put forward a set of preliminary proposals to encourage the diversification of financing alternatives to the corporate sector[3].

i. Develop and evaluate the different options put forward with a view to set priorities. **[Ongoing]**

ii. Consider in this exercise also the measures to facilitate access to finance for SMEs **[Ongoing]** and assess the effectiveness of EU-compatible government-sponsored export credit insurance schemes with a view to take appropriate measures to promote exports **[Q1-2013]**.

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 including SOEs, PPPs, foundations, associations; re-focus their activities to core public policy objectives and enhance their cost efficiency and fiscal sustainability; streamline the budgetary process, including by adopting new financing laws at regional and local level; strengthen risk management, accountability, reporting and monitoring of all parts of the general government. Government action will build on the recommendations provided by the IMF/EU technical assistance missions.

Public Financial Management framework

Reporting and Monitoring

3.1. Publish a comprehensive report on fiscal risks **each year as part of the 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. Technical assistance will be provided if necessary.

3.2. Publish a tax expenditure report **each year as part of the budget**. The report will define a clear methodology to estimate and to evaluate tax expenditures, in line with international best practices. The report will cover central, regional and local administrations.

3.3. Prepare, in consultation with the EC and the IMF, a dedicated document, which will accompany the budget report, assessing reform progress in the area of public financial management, including the reduction of budget fragmentation and delineating next steps over the next three years. **[Q3-2012]**[4]

3.4. Reduce the number of Serviços e Fundos Autónomos (SFA) in view of reducing budget fragmentation and improving efficiency in the general government. In particular, this reform will be deepened by reviewing the classification of own revenues to enlarge central government revenues. **[Q3-2013]**

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

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

Arrears

3.5. The stock of domestic arrears will be significantly reduced by the end of the programme period. A significant part of the existing arrears will be reduced as laid down in the strategy for the settlement of arrears. The Inspeção Geral de Finanças (IGF) will carry out inspections throughout the process to verify compliance of the commitment control system through a risk-based approach. **[Q3-2012]**

3.6. IGF will reinforce the verification of local governments' arrears claims and commitment control systems. Disbursements under the "*Programa de Apoio à Economia Local*" (PAEL) will only take place where IGF has certified the full functioning of the commitment control system. Transparency of the use of the credit line will be ensured through the monthly publication of the amounts lent, disbursed, and used to settle arrears and other liabilities by municipality in the framework of the PAEL. **[Ongoing]**

Budgetary framework

3.7. Publish a fiscal strategy document for the general government annually in **April**. The document will be in compliance with the requirements of the Stability and Growth Pact and 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.

3.8. Review the Budget Framework Law to take account of the reinforced EU fiscal framework and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (fiscal compact). The revised law will also accommodate the developments in the regional and local financing laws. **[Q4-2012]**

3.9. Define in detail the 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 after modification of the Budget Framework Law. **[April-2013]**

<u>Regional and local budgetary frameworks</u>

3.10. The government will ensure that the measures to implement the new budgetary framework at central government level will also be applied at regional and local level. Adequate structures of monitoring, fiscal reporting, and commitment control will be put into place. **[Ongoing]**

3.11. The budgetary frameworks at local and regional levels will be considerably strengthened, in line with recommendations by the IMF/EC technical assistance mission of July 2011 and the new EU fiscal policy framework. A draft proposal to revise the regional finance law and the local finance law will be discussed with EC/IMF/ECB by **[Q3-2012]** and submitted to Parliament by **[Q4-2012]**[5]. They will include the following main elements:

i. fully adapt the local and regional budgetary frameworks to the principles and rules in the 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

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

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 (ii) a contingency reserve is included under the overall current expenditure envelope as a buffer against negative revenue surprises or erroneous expenditure planning, and (iii) the revised legal and institutional PPP framework is applied (see below);

ii. strengthen fiscal accountability, in particular by: (i) tighter financial requirements for regional 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 2011 technical assistance mission. This reform should follow international best practices;

iii. limit the scope for lower tax rates in the Autonomous Regions vis-à-vis the rates applied in the mainland and ensure that the resulting additional revenues from increasing the regional rates are used as a priority for fiscal consolidation.

iv. 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.

3.12. Create a working group with representatives from the Ministry of Finance, the Autonomous Regions and the local authorities to prepare a proposal for common revenue forecasting guidelines for subnational governments. **[Q3-2012]**

3.13. Proceed with identifying data needs to support the revenue projections, balancing the need to preserve tax secrecy and the elaboration of sound forecasts by subnational governments. **[Q3-2012]**

3.14. The Government's financial arrangement with the Autonomous Region of Madeira (RAM), which is in full compliance with the Memorandum of Understanding, will be implemented. The Portuguese Government will monitor progress of implementation by RAM and present the results on a quarterly basis in advance of the reviews of the Memorandum of Understanding **[Ongoing].**

Public Private Partnerships

3.15. The renegotiation of PPP sub-concession contracts was completed; the final results of the agreements will be reported to EC, ECB and IMF. Based on the study to assess the costs and benefits of renegotiating any PPP contract to reduce the government financial obligations, the government will develop a detailed strategic plan **before the sixth review** for the renegotiation of PPPs in view of obtaining substantial fiscal gains, while minimising the debt burden, and ensure a sustainable reduction in government liabilities. **[Q4-2013].**

3.16. The government will further work towards implementing the PPP framework law and making the new technical unit in the Ministry of Finance fully operational. No PPP will be launched until this new legal and administrative framework is fully effective. **[Ongoing]** Regions will be encouraged to design a similar framework for assessing fiscal risks derived from PPP, concessions and other public investments, as well as for monitoring their execution. **[Q4-2012]**

3.17. The annual PPP report will provide a comprehensive assessment of the fiscal risks stemming from PPPs and concessions. The report will provide information and analysis at sectoral level and an analysis of credit flows channelled to PPPs through banks (loans and securities other than shares) by industry and an impact assessment on credit allocation and crowding out effects. This particular element will be done in liaison with the Banco de Portugal. The report will serve as input to the fiscal risks assessment for the budget. **[Q3-2013]**

State-owned enterprises

3.18. SOEs with commercial activity will reach operational balance by **end of 2012**. This will be achieved by substantially reducing operational costs and raising revenues. To this end the government is implementing the comprehensive SOEs strategy by reviewing the revenue structure and service provision of SOEs, with numerical targets on cost reductions, including measures to realign wages, reduce employment, and additional measures as appropriate. **[Q4-2012]** The authorities will inform the EC, IMF and ECB on progress before the **sixth review**. The government is further assessing options for managing the heavy debt load of SOEs, including Parpública. **[Ongoing]**

3.19. The government submitted to Parliament a draft law to strengthen the governance of SOEs in accordance with international best practices. It reviews the existing shareholder approach, giving the Ministry of Finance a decisive role in financial matters of the enterprises, including monitoring of local SOEs. This 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. It will include the prohibition for SOEs within the general government to incur new debt with the private sector. No additional SOEs will be created until this law is adopted. **[Ongoing]**

3.20. Equivalent measures on operational results, debt, restructuring and governance will be taken at the local and regional levels, while respecting their administrative autonomy as foreseen in the law. The annual and quarterly SOEs reports will assess progress towards achieving these objectives for central and local SOEs. Each Autonomous Region will provide similar annual reports. These will serve as inputs to the fiscal risks analysis in the budget. **[Ongoing]**

Privatisation

3.21. The government is implementing its privatisation programme under the new framework law for privatisation. The privatisation plan targets front-loaded proceeds of about EUR 5 billion through the end of the programme. The sale of GALP and the small remaining stake in REN on the free market have been delayed until market conditions improve. The privatisation or concession of the cargo handling subsidiary of CP (CP Carga) will be concluded by the **second quarter of 2013**. The tenders for the privatisation of the national air carrier (TAP) and the airport operator Aeroportos de Portugal (ANA) were launched in the third quarter, with a view to final decisions by end-2012 and the financial completion of these transactions in **early 2013**. The privatisation of Correios de Portugal (CTT) will be launched, once changes underway in regulation of this sector have their full impact, in order to complete the sale in 2013. The sale or concession of a television channel and radio station belonging to RTP and concessions for transport operators in Lisbon and Porto upon completion of restructuring of the public transport firms in these cities are being considered.

CGD's health insurance will be sold in 2012 and the process to sell its insurance arm (Caixa Seguros) to a final buyer is ongoing. The privatisation programme will be expanded to include additional companies and assets for sale or concession in 2013.

3.22. With a view to introducing private capital and management in the water company Águas de Portugal (AdP), a strategy will be prepared. This strategy will include considerations of the competitive and regulatory environment and organisational consequences. **[Q4-2012]**

3.23. The government will work together with the municipalities and regional governments in order to identify the scope for further privatisation, by preparing an inventory of their assets, including real estate. **[Q4-2012]** Progress will be reported in the **sixth review.**

Revenue administration

3.24. The Government is concluding the implementation of the undergone merger of the tax administration, customs administration and the information technology service (DGITA) in a single entity, *Autoridade Tributária e Aduaneira* (AT) by **Q4-2012**.

3.25. Following the creation of *Autoridade Tributária e Aduaneira* (AT), the focus in 2012 will be to merge central and support functions and reduce the number of branches. The reform will be deepened in **2013** by targeting a business function-type structure. In particular, the following elements will be implemented:

i. review the experience with the task force of tax judges for cases with value above EUR 1 million and assess the need to establish special chambers within the tax tribunals to handle such cases **[mid-November 2012]**;

ii. reducing the number of municipal offices by at least 20 per cent 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 per cent 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**;

iv. publish quarterly reports on recovery rates, duration and costs of tax cases starting from **Q4-2012** within four months after the end of the relevant quarter.

3.26. To strengthen control and simplify compliance, exchange of information between the collection units of the Tax Authority and the Social Security administration will be significantly strengthened by means, among others, of a unified monthly tax return covering withholding information **[Q1-2013]** as well as a unified form on Independent Workers annual revenue **[Q2-2013]**.

3.27. The government will address the bottlenecks in the tax appeal system by progressing with clearing cases worth above EUR 1 million [**Q4-2012]** with the support of the tax court judges.

3.28. With the aim of curving down fraud and evasion, the Government has approved a reform on the invoicing system in Portugal that will enter into force on 1st January 2013. The reform implies mandatory invoicing across all sectors and transactions, a centralized VAT monitoring database, a system to electronically monitor goods in circulation and a tax incentive for final consumers to ask for invoices in hard-to-tax sectors. An evaluation report of the measures will be prepared **[Q2-2013].**

3.29. Also as part of the development of a modern tax compliance management framework, a fully-fledged Large Taxpayer Office (LTO) will be operational by **[Q4-2012]**[6].

Public administration

Central, regional and local administration

3.30. Conclude the public administration restructuring programme (PREMAC). The final report, comprising the internal organisation and the roster of each entity, including the reallocation of human resources, will be presented in **[Q3-2012].**

3.31. Based on the cost/benefit analysis on foundations, the central, regional or local administration responsible for each foundation or its financial support will decide accordingly whether to maintain, reduce or extinguish them in respect of the new legislation. The government will promote that the same objective is achieved by regions. **[Q3-2012]**

3.32. The approach on foundations – the compulsory census and the subsequent analysis, adjusted as needed - will also be applied to associations and extended later to other public and quasi-public entities across all levels of government. **[Q4-2012]**

3.33. Reorganise local government administration. There are currently 308 municipalities and 4,259 parishes. The government will reorganise and significantly reduce the number of such entities. 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. **[Q3-2012]**

3.34. Building on the study carried out by the inter-ministerial working group for territorial issues an identification of potential duplication of activities and other inefficiencies between the central administration, local administration and locally-based central administration services will be made by the **sixth review.** Based on this analysis, reform the existing framework to eliminate the identified inefficiencies. **[Q4-2012]**

Shared services

3.35. 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. complete the implementation of the strategy of shared services in the area of financial resources (GeRFIP). **[Q1-2013]** GeRFIP will also be implemented in the Autonomous Region of Madeira and in the Autonomous Region of Azores **[Q4-2013]**;

ii. fully implement the strategy of shared services in the area of human resources (GeRHuP) in the Ministry of Finance's entities **[Q4-2012]**, with the exception of the Tax Authority for which this is scheduled for **end-June 2013**. Other Ministries will follow in 2013. The Autonomous Region of Madeira will implement GeRHuP gradually;

iii. 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 in line with the "Overall Strategic

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

plan to rationalise and reduce costs on ICT in Public Administration". **[Q4-2012]**

3.36. 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

3.37. The 2012 budget promotes flexibility, adaptability and mobility of human resources across the administration, including by providing training and requalification where appropriate. In addition, the mobility schemes, namely geographic mobility and the regulation on mutual agreement on contract termination, will be reinforced as an instrument to manage human resources across administrations. The human resource instruments (geographic mobility, special mobility and overtime compensation rules) are to be applied to all sectors of Public Administration, including teachers and health professionals. **[Ongoing]**

3.38. Limit staff admissions in public administration to achieve annual decreases in 2012–2014 of 2 per cent per year (in full-time equivalents) in the staff of central administration and 2 per cent in local and regional administrations (in full-time equivalents); including a significant reduction of fixed-term contracts. The government will ensure the implementation of 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. **[Ongoing]**

3.39. The government will prepare a comprehensive review of wage scales in the general government, to identify unwarranted differences in remuneration between the public and the private sector for similar types of qualifications. **[Q4-2012]** The comprehensive study of SOEs will follow in **Q2-2013**.

3.40. Acceleration the convergence of the system of social protection for staff that are in the Regime de Proteção Social Convergente (RPSC) to the rules of Regime Geral de Seguança Social. **[Q4-2013]**

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 overall public spending on pharmaceutical to 1.25 percent of GDP **by end 2012** and to about 1 per cent of GDP in 2013; 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

3.41. The revision of NHS moderating fees (*taxas moderadoras*) will result in additional revenues of EUR 150 million in 2012 and an additional 50 million in 2013. **[Q4-2012]**

3.42. 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 foresees that the overall budgetary cost of existing schemes - ADSE, ADM (Armed Forces) and SAD (Police Services) - will be reduced by 30 per cent in 2012 and by further 20 per cent in 2013

at all levels of general government. The system would become self-financed by 2016. The costs of these schemes for the public budget will be reduced by lowering the employer's contribution rate to 1.25% in 2013 and by adjusting the scope of health benefits. **[Q3-2012]**.

Pricing and reimbursement of pharmaceuticals

3.43. Enact legislation which automatically reduces the prices of medicines when their patent expires to 50 per cent of their previous price. **[Q4-2012]**

3.44. The government implements an annual revision of prices of medicines and of countries of reference in order to achieve cost savings. Second price revision to be published in **January 2013**.

3.45. The government will monitor monthly pharmaceutical expenditures and ensure that the overall public pharmaceutical expenditure does not exceed the target of 1.25 per cent of GDP in 2012 and 1 per cent of GDP in 2013. **[Ongoing]**

Prescription and monitoring of prescription

3.46. Continue to improve the monitoring and assessment system of doctors' prescription behaviour regarding medicines and diagnostic in terms of volume and value and vis-à-vis prescription guidelines and peers. Feedback continues to be provided to each physician on a regular basis (e.g. quarterly), in particular on prescription of costliest and most used medicines. **[Ongoing]**

3.47. Continue to devise and enforce a system of sanctions and penalties, as a complement to the assessment framework **[Ongoing]**. Assess the possibility of establishing agreements with private sector physicians for the application of prescription rules as applied in the NHS.

3.48. Strictly monitor the implementation of the legislation making it compulsory for physicians at all levels of the system, both public and private, to prescribe by International Non-proprietary Name (INN) to increase the use of generic medicines and the less costly available product. An implementation report will be published by **December 2012**.

3.49. Continue to publish prescription guidelines with reference to medicines and the realisation of complementary diagnostic exams on the basis of international prescription guidelines, audit their implementation and integrate them in the electronic prescription system. A first set of guidelines is introduced in the e-prescription system by **Q2 2013.**

3.50. The government will produce a report assessing the effectiveness of the enacted legislation aimed at removing 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. **[Q1-2013]**

3.51. The above measures should aim at gradually and substantially increasing the share of generic medicines to at least 30 per cent of all outpatient prescription (in volume) in 2012. Targets for substantial further increases in 2013 will be agreed in the **sixth review.**

Pharmaceutical retailers and wholesalers

3.52. The Government will produce an intermediate assessment of the savings related to the revision of the calculation of profit margins for wholesale companies and pharmacies. **[Q3-2012**].

3.53. If the revision does not produce the expected reduction in the distribution profits of at least EUR 50 million, an additional contribution in the form of an average rebate (pay-back) will be introduced, which will be calculated on the mark-up. The rebate will reduce the new mark-up on producer prices further by at least 2 percentage points on pharmacies and

4 percentage points on wholesalers. The rebate will be collected by the government on a monthly basis through the Centro de Conferência de Facturas, preserving the profitability of small pharmacies in remote areas with low turnover. **[Q4-2013]**

Centralised purchasing and procurement

3.54. Reinforce the centralised acquisition of vehicles, utilities, external services and other cross functional goods and services by all entities included in the NHS, in order to reduce costs through price volume agreements and fighting waste. A detailed action plan will be published by **November 2012.**

3.55. INFARMED will continue implementing the uniform coding system and a common registry for medical supplies. **[Ongoing]**

3.56. Take further measures to increase competition among private providers and reduce by an additional 10 percent the overall spending of the NHS with private providers delivering diagnostic and therapeutic services (with particular reference to dialysis and rehabilitation). Regularly evaluate and if necessary revise (at least every two years) the remuneration paid to private providers with the aim of reducing the cost of more mature diagnostic and therapeutic services. **[Q4-2012]**

3.57. 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. Assess the possibility of implementing the compulsory use of a formulary in all hospitals to monitor the stock and flows of hospital medicines and medical supplies and monitor compliance with central purchasing. **[Ongoing]**

3.58. Conduct an analysis of the market characteristics of relevant areas of service provision such as dialysis and the pharmacies sector in view of ensuring competition and fair prices in private markets. **[Q4-2013]**

Primary care services

3.59. As part of the reorganisation of health services provision and notably the concentration and specialisation of hospital services and the further development of a cost-effective primary care service, the Government reinforces measures aimed at further reducing unnecessary visits to specialists and emergencies and improving care coordination. **[Ongoing]** This will be done 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. Extend performance assessment to the other primary care units (UCSPs). Make sure that the new system leads to a reduction in costs and more effective provision;

ii. setting-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;

iii. moving human resources from hospital settings to primary care settings and reconsidering the role of nurses and other specialties in the provision of services;

iv. updating patients' registration lists and the national register in order to increase by at least 20 per cent the maximum number of patients per primary care/family doctor for health centres and by 10 per cent for the USF.

Hospital services

3.60. Implement the strategy to clear arrears in the health sector, within the overall strategy for settling and avoiding the re-emergence of arrears. Ensure standardised and tight control procedures for all health sector entities to ensure expenditure commitments stay within the budget allocated to each entity and therefore prevent the re-emergence of arrears. **[Q3-2012]**

3.61. Hospital SOEs will 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. **[Q4-2013]**

3.62. Implement measures aimed at achieving a reduction of at least EUR 200 million in the operational costs of hospitals **in 2012**. This is to be achieved through the reduction in the number of management staff, concentration and rationalisation in state hospitals and health centres with a view to reducing capacity. **[Q4-2012]**

3.63. Continue the publication of clinical guidelines and set in place an auditing system of their implementation. **[Ongoing]**

3.64. On the basis of the comprehensive set of indicators, produce regular annual reports comparing hospital performance (benchmarking). Establish a web-portal with publicly available information. The first report is to be published **by end 2012** and its results should be used to establish targets for less performing hospitals. **[Q4-2012]**

3.65. Continue work to ensure full interoperability of IT systems in hospitals, in order for the ACSS to gather real time information on hospital accounting and activities and to produce monthly reports to the Ministry of Health and the Ministry of Finance. **[Ongoing]**

3.66. Continue with the reorganisation and rationalisation of the hospital network through specialisation, concentration and downsizing of hospital services, joint management (building on the Decree-Law 30/2011) and joint operation of hospitals. The aim is to adjust hospital provision within the same health region, notably in the presence of newly established PPP hospitals, adjust the activity of some hospitals from curative care towards areas such as rehabilitation, long-term and palliative care and revise emergency and transplantation structures. These improvements aim at eliminating unnecessary duplication, achieving economies of scale and deliver additional cuts in operating costs by at least 5 percent in 2013 while improving the quality of care provided. A detailed action plan is published **by 30 November 2012** and its implementation is finalised **by end-2013**. Overall, from **2011 to 2013**, hospital operational costs must be reduced by at least 15 per cent compared to 2010 level. **[Q4-2012]**

3.67. Annually update the inventory of all health staff and 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. **[Q2-2013]**

3.68. Update the current legal framework applying to the organisation of working time of healthcare staff, including introduction of rules to increase mobility within and across Health Regions, adoption of flexible time arrangements and review of payment mechanisms for emergency work, the prevention regime and per call payments, notably by aligning overtime remuneration in the health care sector with the general legal framework recently adopted. In this context, overtime compensation should be reduced by 20% in 2012 and another 20% in 2013.**[Q4-2012]**

Regional health authorities

3.69. Improve monitoring, internal control and fiscal risks management systems of the Administrações Regionais de Saúde. **[Q4-2012]**

Cross services

3.70. Roll-out the system of patient electronic medical records and ensure access to all relevant health care facilities. **[Ongoing]**

3.71. Reduce costs for patient transportation by one third compared to 2010. **[Q4-2012]**

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 raising the quality of human capital and facilitate labour market matching.

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

Unemployment benefits

4.1. Following the reform of the unemployment benefit system (Decree-law 64/2012 and Decree-law 65/2012 of 15 March) - which introduces a declining profile for unemployment benefits, reduces the maximum monthly amount of benefits, reduces the maximum unemployment benefits duration and increases coverage by reducing the contribution period for eligibility and by extending the system to a clearly-defined category of self-employed - the government will prepare by **Q4-2012** an analysis on benefit dependency and long-term unemployment with a view to assessing whether further measures are needed to address possible deficiencies by **Q1-2013**.

Employment protection legislation

4.2. 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. **[Ongoing]**

4.3. Severance payments **[Ongoing]**. Following the entry into force of law n. 53/2011 concerning the reform in the severance payments for new hires in line with the MoU (which reduces severance payments to 20 days per year of work for both open-ended and fixed-term contracts, while introducing a cap of 12 months of pay and eliminating the 3 months of pay

irrespective of tenure for permanent contracts, and makes compulsory the partial financing of severance payments via a compensation fund) and the entry into force of law n. 23/2012 (which aligns the level of severance payments to current employees), the government will further reduce severance payments and implement the compensation fund to partly finance severance payments. Until the fund is operational, the employers remain responsible for the total of severance payments. In consultation with social partners, the Government will, submit to Parliament by **Q3-2012** draft legislation aiming at:

- aligning the level of severance payments with the EU average of 8–12 days;
- implementing the compensation fund for severance payments allowing the severance pay entitlements financed from the fund to be transferable to different employers by means of the creation of notional individual accounts.

4.4. Following the changes to the dismissal rules as stated in law n. 23/2012, the government will prepare a report on the effects of these changes on relevant labour market indicators by **Q3-2013**.

Wage setting and competitiveness

4.5. The government will promote wage developments consistent with the objectives of fostering job creation and improving firms' competitiveness with a view to correcting 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 **[Ongoing]**;

ii. ensure wage moderation by using the available discretion in the current legislation of not extending collective agreements until clear criteria are defined as foreseen by point 4.5(iii);

iii. 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 quantitative indicators. To that purpose, the government will take the necessary steps to collect data on the representativeness of social partners. Based on this data, a collective agreement subscribed by employers' associations representing less 50 percent of workers in a sector cannot be extended. When that threshold is reached a decision on extension will have to take into consideration the implications on competitiveness of firms in the sector. Draft legislation defining criteria for extension and modalities for their implementation will be submitted to Parliament or published as a Council of Ministers resolution by **Q3-2012**[7], with a view to entering into force by **Q1-2013**;

iv. prepare an independent review by **Q4-2012** on:

   - how the tripartite concentration on wages can be reinvigorated with a view to defining norms for overall wage developments that take into account the

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

evolution of the competitive position of the economy and a system for monitoring compliance with such norms;

- o the desirability of shortening the survival (sobrevigência) of contracts that are expired but not renewed (art 501 of the Labour Code).

4.6. The Government will promote wage adjustments in line with productivity at the firm level. Following the implementation of the organised decentralisation (which creates the possibility for collective agreements to define conditions under which works councils can negotiate functional and geographical mobility, working time arrangements and remuneration) and the decrease of the firm size threshold to 150 workers for unions to delegate power to conclude collective agreements to works councils, the government will, by **Q1-2013,** assess in a report the effects of these measures and how they are being applied in collective agreements. If needed, an action plan will be prepared in consultation with the social partners by **Q2-2013** to ensure that works councils are given the possibility to negotiate wages at firm level.

Active labour market policies

4.7. 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. Following the preparation of a report assessing the effectiveness of ALMPs and the publication of the Council of Ministers Resolution n.20/2012, which sets a plan to improve ALMPs, including the role of Public Employment Services (PES) , the Government by **Q4-2012** will present a report:

i. detailing expenditures and sources of financing of the different ALMPs;

ii. assessing the role played by the job counselling/ job search assistance and activation/sanctions systems in facilitating the transition out of unemployment;

iii. reviewing the implementation of the Council of Ministers Resolution n. 20/2012 regarding the reorganisation of the PES and other ALMPs;

iv. proposing specific action to improve the effectiveness of training measures in light of the results of the report assessing the effectiveness of employment and training measures.

Education and training

4.8. 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). Following the progress made until Q4-2011, the government will continue to improve the system with a view to having an operational management tool by **Q3-2012;**

ii. in line with the action plan to improve the quality of secondary education the Government, by **Q3-2012**, will: (i) implement the legislation to promote trust

agreements with public schools and report about progress; (ii) define and implement a simple formula-based funding framework comprising performance evaluation criteria and accountability for public schools and schools under autonomy agreements; (iii) present an assessment of the new inspection model;

iii. in line with action plan on vocational and educational training (VET) the Government will present a progress report on: (i) ways to promote the involvement of businesses in the provisions of traineeships [**Q3-2012**]; (ii) action taken to reorganise modalities for the provision of VET, improve the quality and attractiveness of VET, and to enhance students' orientation and career guidance [**Q4-2012**]; (iii) the establishment of "professional schools of reference". **[Q1-2013]**

5. Goods and services markets

Objectives

Reduce entry barriers in network industries and sheltered sectors of the economy such as services and regulated professions so as to increase competition and reduce excessive rents. These measures should help improving the competitiveness of the Portuguese economy by lowering input prices, raising productivity and improving the quality of the products and services provided. This should contribute decisively to the social balance of the programme by reducing unwarranted sector protection and rents so that all segments of the society participate in the burden sharing of the needed adjustment.

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 the tariff debt; 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. Fully transpose the Third EU Energy Package. In particular, adopt the law on the penalty system of the regulator and of the decree-laws transposing the electricity and gas directives by **Q3-2012.** To ensure the National Regulatory Authority's independence, autonomy and all powers foreseen in the package, adopt by **[Q3-2012]** the new regulators' bylaws agreed in July 2012, consulting the EC/ECB/IMF if changes are introduced**,** and ensure that they are effective before end of year in time for the liberalisation of the electricity and gas market [**Q4-2012**]. Progress towards this end will be monitored during the **sixth review**.

5.2. Take measures to accelerate the establishment of a functioning Iberian market for natural gas (MIBGAS), through regulatory convergence and the harmonisation of the tariff

structures in Portugal and Spain. In particular, in accordance with the roadmap of 30 September 2011 agreed with the Spanish authorities, the regulators of each country will:

i. present proposals to harmonise the tariffs for access to the interconnection networks taking into account the outcome of the public consultation conducted in January 2012 **[Q3-2012];**

ii. prepare a report analysing and developing options to improve the harmonised mechanism for capacity allocation and congestion management of cross-border flows with Spain, including the introduction of virtual reverse flows and other mechanisms allowing smaller players to make efficient use of the LNG Sines facility **[Q1-2013];**

iii. apply a harmonised allocation and congestion management mechanism to all the interconnection capacity between Portugal and Spain, in line with the EU network codes and guidelines in this respect **[Q1-2013].**

5.3. Clarify the national legal framework with respect to the scope of competencies of the logistics operator and define based on a cost-benefit analysis a way of convergence of the existing two platforms for electricity and natural gas. **[Q4-2012]**

Ensure sustainability of the national electricity system

5.4. Conclude the measures approved in the Council of Ministers on 17 May 2012 to reduce excessive rents and to address the sustainability of the national electricity system. Cost reduction measures address the following compensation schemes: power guarantee, special regime (renewables - excluding those granted under tender mechanisms – and cogeneration), CAE's (power purchase agreements) and CMECs, and will reduce policy cost by at least EUR 1275 million in Net Present Value (NPV)[8] **[Q3-2012]**. The updated estimation of cost reductions that will be achieved as well as progress towards elimination of the tariff debt (defice tarifário) by 2020 will be presented and assessed in the **sixth review**.

5.5. Conclude the announced measures to limit the policy costs embedded in CMECs and PPAs by **October 2012**. In particular, as an element in revising the rate of return to bring it in line with the cost of capital at the moment the CMEC compensation was defined plus, if warranted, a risk premium of the assets that the mechanism remunerates: (i) reduce the CMEC annuity discount rate from 7.55% to 5% (yielding a NPV of EUR 120 million) in a legally certain manner; and (ii) set a compensation for the extension of exploitation licences of the power plants in Sines and Pego[9] yielding NPVs of EUR 55-75 million and EUR 30-50 million respectively, providing details on the valuation methodology leading to these figures. The updated estimation of cost reductions that will be achieved will be presented and assessed in the **sixth review**.

5.6. Present a report on the CMEC scheme including the foreseen annual compensation amounts to each beneficiary and past payments since 2007 and the forecast of future payments. The report will also describe the process for the extension of the concession of the public hydro resource by the former CAE hydro power plants, its correspondent economic valuation, and the rationale for the direct award instead of a tender process. The report will

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[8] Computed using a discount rate of 7.55% back to June 2012.

[9] Pego power plant compensation will not be included when determining the reduction of the rate of return of the CMEC.

assess and consider all the information available within the governmental and the official bodies (General Directorates, Regulator, State representative in the contracts). **[Q3-2012]**

5.7. Conclude the announced measures to limit the policy costs of renewables under the special regime - excluding those granted under tender mechanisms, in particular (i) the compensation to be paid by the generators (yielding a NPV of EUR 85 to 103 million); and (ii) the introduction of a maximum duration for the feed in tariff in small hydro plants (yielding an NPV of EUR 200 to 250 million). The updated estimation of cost reductions that will be achieved will be presented and assessed in the **sixth review**.

5.8. Accelerate convergence to market-based pricing for co-generation operators in parallel with electricity market developments under the EU internal electricity and gas market legislation. The remuneration scheme for co-generation will be further revised to improve efficiency of the support system in ensuring continued guaranteed access of operators to electricity networks and markets with the calculation of explicit subsidies based on relevant price factors in the context of a competitive electricity market. The revision should ensure that the design of the support scheme allows a dynamic correlation between electricity market prices and the efficiency premium when the values of avoided externalities are not adequately reflected in electricity and other factor prices. This revision will be undertaken in line with the framework of the transposition of the energy efficiency directive **[Q1-2013]**. Ensure through annual audits that plants not fulfilling the requirements for co-generation do not receive the support, and report on the progress. **[Q2-2013]**

5.9. 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 **Q3-2012** and **Q3-2013**.

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

<u>Telecommunications and postal services</u>

Objectives

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

Telecommunications

5.11. Ensure an efficient, objective, transparent and non-discriminatory mechanism for the designation of the universal service provider(s), in compliance with the Court of Justice ruling of 7 October 2010. Re-negotiate the concession contract with the undertaking currently providing the universal service, by reducing the scope of the services covered, so as to exclude the universal service and launch a new tender process for designation of universal service provider(s). **[Q3-2012]**

5.12. Following the corrective measures already taken, monitor the competitive situation in the telecommunications sector, in particular wholesale and retail broadband access, and mobile origination charges. **[Ongoing]**

Postal services

5.13. Following the transposition of the Third Postal directive, further liberalise the postal sector by amending the decree-law laying down the framework of the concession contract and renegotiating the amendment of said contract with CTT, in order to reflect the new law (Law 17/2012) transposing the Third Postal Directive; ensuring in particular that the current designation period for the universal service provision is shortened to 2020 and that investment needs and return on investment are taken into account when setting new designation periods. **[Q3-2012]**

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.

Strategic Plan for Transport

5.14. Implement the Strategic Plan for Transport for 2011–2015 **[Q4-2012]**, namely:

i. continue the reforms in the transport SOEs to achieve their EBITDA balance, by focusing efforts on the reduction of operational costs;

ii. reduce the forecast debt burden of Estradas de Portugal through the reduction of PPP contracts' scope still in the construction phase, revision of shadow-toll schemes and the adjustment of the CSR (Road Service Contribution) to the inflation level. Analyse additional measures to further reduce the forecast debt burden of Estradas de Portugal;

iii. attract new low-cost airline companies and/or routes, making use of the existing infrastructures;

iv. focus the investment priorities in projects that present a positive cost-benefit ratio and contribute to the competitiveness of Portuguese exports, namely in the port and freight rail sectors;

v. reform the transport and infrastructures' regulatory framework in order to improve the effectiveness, efficiency and independence of the entities regulating the transport sector. **[Q1-2013]**

5.15. Present a long term vision of the transport system and a list of actions to improve its efficiency and sustainability **[Q4-2012]**. It will specifically include an assessment of the existing rail, road and port networks and present a set of investment priorities for the 2020 and 2030 horizons, taking also into account TEN-T networks, with an estimate of the financial needs and the foreseen sources of financing **[Q2-2013]**.

Railways sector

5.16. Continue with the transposition of the EU Railway Packages and in particular:

i. ensure that the rail regulator enjoys the independence required under the EU rail Directives, in particular regarding the rules of appointment and dismissal of the director of the rail regulator. Strengthen the capacities of the railway regulator to fulfil its regulatory mandate effectively, including by exploring

synergies with other transport regulators in the context of the revision of national regulatory agencies. **[Q4-2012]**;

ii. continue to implement the plans to bring the infrastructure manager to operational balance, in particular by reducing operational costs by at least 23 per cent in 2012 compared to 2010 **[Q4-2012].** On the revenue side, track access charges for freight services should not be increased in order to prevent a deterioration of the competitiveness of rail freight services. Reintroduce incentives to REFER to reduce costs and access charges. Provide annual progress reports on the implementation of balancing revenues and expenditures **[Q2-2013]**;

iii. ensure that the new Public Service Obligation (PSO) contracts concluded on rail passenger transport respect EU legislation including Regulation (EC) No 1370/2007, and in particular provide a detailed breakdown of state contributions for each line under PSO **[Q3-2012].** Develop administrative capacity for a stepwise introduction of competitive tendering of PSOs starting with some suburban services. Ensure that the awarding authority has the required level of independence and competence and guarantees fair conditions of tendering **[Q4-2012]**;

iv. extend the performance scheme on infrastructure charges to other operators **[Q4-2012]**;

v. review and render more effective the yield management on long-distance passenger ticket prices. **[Q1-2013]**;

vi. to prepare the privatisation of the freight branch of the state-owned rail operator, carry out an analysis for transferring part or whole of CP Carga's rolling stock to a rolling stock operating company **[Q2-2013]**;

vii. ensure that the rail terminals currently owned by CP Carga are transferred to another entity that will guarantee non-discriminatory access to all rail freight operators. **[Q4-2012]**; Plans will be presented and assessed in the **sixth review**.

Ports

5.17. In cooperation with EC/IMF/ECB prepare and submit to Parliament a revised 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. **[Q3-2012]** The revised legal framework is expected to come into force by **[Q4-2012].** A review of the overall savings generated and the impact of the introduction of the law on port usage cost will be made by **August 2013**.

5.18. Take further steps to improve the governance model of the ports system with the objective to enhance the competitiveness and the efficiency of ports in line with the Strategic Plan of Transport 2011-2015. The Government will deliver and enforce policies that ensure strong integrated policy-making, strategic planning and surveillance functions common to all ports in the country. Moreover, policy decisions will be taken and enforced so that (i) efficiency gains and cost-savings are passed through to port customers; and (ii) concession-holders of terminals and land facilities in ports respect minimum performance criteria. **[Q4-2012]**

Road pricing

5.19. Adopt the necessary legislative amendments in order to achieve full compliance with Directive 1999/62/EC (Eurovignette Directive) and the EU Treaty and, in particular, to guarantee non-discriminatory application of tolling schemes to non-resident road users **[Q4-2012].** After the deadline of this measure, rebates in tolling schemes that pursue compelling reasons of territorial and social cohesion may only be applied if their compliance with the EU law is demonstrated.

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

5.20. Further to the adoption of a significant number of amendments to the sector specific legislation, complete the adoption of the outstanding sectorial amendments necessary 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. Adopt the remaining required amendments and submit them to Parliament by **[October 2012]** in view of approval by **[January 2013]**.

5.21. Adopt the necessary sector-specific amendments in the areas of construction and real estate to make both regimes fully compatible with the Services Directive and with the Treaty on the Functioning of the European Union. 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). For real estate, submission to the Parliament took place on 1 August in view of approval by **[Q3-2012]**. For construction services, submit to Parliament by **[Q3-2012]** in view of approval by **[Q4-2012]**.

Professional qualifications

5.22. Improve the recognition framework on professional qualifications, in particular through the adoption of the executive order (portaria) on the services providers' prior declaration alongside the entry into force of amendment to Law 9/2009. **[Q3-2012]**

Regulated professions

5.23. Review and reduce the number of regulated professions and in particular eliminate reserves of activities on regulated professions that are no longer justified, through adoption by the Parliament of the law for professions where regulation does not involve a professional body (Ordens or Câmaras) by **[October-2012]**. Following the final report by the Comissão de Regulação do Acesso a Profissões (CRAP), launch by **[Q1-2013] a** second phase investigation of the review of regulated professions to eliminate unjustified requirements by **[Q2-2013].**

5.24. Further improve the functioning of the regulated professions (such as accountants, lawyers, notaries) for which regulation involves a professional body (Ordens or Câmaras) by carrying out a comprehensive review of requirements affecting the exercise of activity and

eliminate those not justified or proportional, including: (i) adopting the measures included in 5.22 and 5.23; (ii) eliminating restrictions to the use of commercial communication (advertising), as required by the Services Directive. To achieve the two conditions above the government has, following the public consultation, submitted a draft horizontal legal framework to Parliament in view of approval by **[Q3-2012]**. Upon enactment, the professional bodies will make the necessary changes in their statutes by **[Q4-2012]**.

Administrative burden

5.25. Continue the simplification reform effort by:

i. adapting the content and information available at the Point of Single Contact (PSC) for the 44 amended regimes to ensure conformity with the Services Directive and for those that have not required amendments so far by **[January 2013]** and make available online forms for the completion of procedures by **[Q1-2013]**. Constantly adapting the content and information available at the PSC to the remaining 24 sector-specific regimes that are about to be adopted to ensure conformity with the Services Directive (see 5.20 and 5.21 above) at the latest 1 month after the adoption of each sector-specific regime, clearly differentiating information on requirements applicable to established providers and to cross-border ones, and by making available online forms and extend on-line procedures for all sectors covered by the Services Directive no later than 2 months after adoption of the sector-specific regime;

ii. adapting the content and information available at the PSC for the 13 regimes approved to ensure conformity with the Professional Qualifications Directive by **[January 2013]** and online forms by **[Q1-2013]**. Constantly adapting the content and information available at the PSC to the new legislation to be adopted to ensure conformity with the Professional Qualifications Directive at the latest 1 month after the adoption of amendments mentioned in 5.22, clearly differentiating information on requirements applicable to established providers and to cross-border ones, and by extending on-line forms and procedures for each profession no later than 2 months after adoption of amendments;

iii. making available in PSC on-line procedures for the registration, installation, modification, occupation of public space regimes, and closing up of restaurants, bars and other establishment for the 5 municipalities (Porto, Águeda, Abrantes, Portalegre and Palmela) covered by "Zero Authorisation" pilot project (DL 48/2011) by **[Q4-2012]**. Foster collaboration from municipalities in providing the content for the working hours map for the stores and establishments services and advertisement regimes for which they have full competence to make the PSC operational **[Q4-2012]**; Identify and classify municipalities where the availability of those procedures through the PSC would have the most significant economic impact by **[November-2012]** to prepare for the extension of this tool to major municipalities by **[January-2013]**. Make 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 by **[Q2-2013]**. The platform will be available to all levels of administration, including all municipalities **[Q2-2013];**

iv. extending PSC to services not covered by the Services Directive **[Q4-2013]**;

v. extending the "Zero Authorisation" project to other services sectors of the economy **[Q4-2013]**.

5.26. Submit an updated detailed work programme of AMA to fulfil 5.25 by **[October 2012]** and to be regularly updated on a **monthly** basis.

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.

Property taxation

6.1. The government will continue to step up the appraisal of the taxable value of the housing stock. In particular, the measures will: (i) ensure that the taxable value of all property in 2012 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). **[Q4-2012]**

6.2. The government will gradually rebalance property taxation towards the recurrent real estate tax (IMI) and away from the transfer tax (IMT), while considering the socially vulnerable. **[Q3-2013]**

Comprehensive review of the housing market

6.3. Following the adoption of the amendments to the New Urban Lease Act Law 6/2006 and the Decree Law which simplifies the administrative procedures for renovation, the government will undertake a comprehensive review of the functioning of the housing market with the support of internationally-reputed experts. The review will determine whether the new legal provisions adopted are sufficient to make the housing market more dynamic and, if necessary, will propose new policy measures. **[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.

Court backlog

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

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

7.2. Implement targeted measures to achieve steady reduction of the backlogged enforcement cases. In particular, set quarterly targets for closing enforcement cases and prepare quarterly reports on implementation status, by inter-agency task forces with the fourth report to be completed by **mid-November 2012**.

7.3. Present a revised draft bill for enforcement agent's framework (i) strengthening the authority and financing structure of the oversight body and enhancing the accountability of enforcement agents, and (ii) to include a fee structure that incentivises speedy enforcement to be further refined by extensive consultation including with the IMF/EU technical assistance by **mid-November 2012** which will be approved by the government by **end-February 2013**.

Management of courts

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

7.4. Having submitted an initial draft bill on judicial reform **mid-August 2012** it will be further refined by extensive consultation by **end-September 2012**. Submit a Bill to implement the judicial reform roadmap to Parliament by **end-November 2012**[10].

Alternative dispute resolution for out-of-court settlement

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

7.5. Submit the Bill to improve the Justices for Peace regime to Parliament by **end-November 2012**.

Civil law cases in the courts

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

7.6. Having prepared an initial draft of the new Code of Civil Procedure by 6 July 2012, it will be further refined by extensive consultation by **end-September 2012**. By **end-November 2012** [11] submit to Parliament the Code of Civil Procedure which addresses the key areas for improvement, including (i) to consolidate legislation for all aspects of enforcement cases before the court, (ii) to give the judge the power to expedite cases, (iii) to restrict the administrative burdens for judges, (iv) to enforce statutory deadlines for court processes and in particular injunction procedures and debt enforcement and insolvency cases and (v) to establish a single judge procedure for small claims, and taking into account stakeholder consultation and comparative law analysis.

Budget and allocation of resources

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

7.7. Publish quarterly reports on recovery rates, duration and costs of corporate insolvency cases starting from **[Q3-2011]**, within four months after the end of the relevant quarter.

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

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[10] Structural benchmark in the Memorandum of Economic and Financial Policies.

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

processes; improve effectiveness of existing instruments dealing with export promotion and access to finance and support the reallocation of resources towards the tradable sector.

Competition and sectoral regulators

7.8. 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 **[Ongoing]**. The Portuguese State will ensure that CGD alienates its participation in Galp. **[Q3-2012]**

7.9. 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 privatisation operation and thus used in such a proportionate manner that privatisation's implementing laws will not set or allow holding or acquisition caps beyond the privatisation transaction**. [Ongoing]**

7.10. Monitor the inflow of cases and report on the functioning of the specialised court for Competition, Regulation and Supervision, assessing the situation in terms of risk of potential court backlogs. **[Q4-2012]**

7.11. Following up on the adoption of the executive order (*portaria*) concerning the transfers of payments from regulators to the Competition Authority and the report prepared under measure 7.12 (i), the financing model of the latter will be re-examined resulting in a technical proposal by **[Q1-2013]** to be implemented by **[Q2-2013].** Given the enlarged scope of action of the Competition Authority, review with key stakeholders the conditions for the proper execution of its mandate. **[Q3-2012]**

7.12. Building on the independent report on the main National Regulator Authorities, the government will prepare a framework law for regulators in broad consultation with the Regulator Authorities. This law will establish a regulatory environment that protects the public interest and promotes market efficiency. The law will guarantee the Regulator's independence and financial, administrative and management autonomy to exercise their responsibilities, in full compliance with EU law. The law will also contribute towards the effectiveness of the competition authority in enforcing competition rules therefore supporting and complementing the effect of the recently adopted competition law. The framework law will be submitted to parliament by **[Q1-2013].**

Public procurement

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

7.13. Submit a report analysing the effectiveness and impact of the amendments to the revised Public Procurement Code as well as of the enhanced role of the Court of Auditors in ensuring compliance with public procurement rules by **[Q1-2013]**.

Business environment

7.14. Make operational the procedures for requesting VAT exemptions for exporting firms and to simplify procedures associated with indirect exports as part of the "Simplex Exports" programme. **[Q4-2012]**

7.15. As a follow up to the report delivered on access to finance and internationalisation of companies, present an action plan with measures to facilitate access to finance and to export markets for companies, in particular for SMEs. **[Q3-2012]**

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

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

Licensing environment

Objectives

The government is launching a new comprehensive programme to tackle excessive licensing procedures, regulations and other administrative burdens in the economy. These explicit and implicit barriers represent a major obstacle for economic growth in Portugal. Companies face substantial costs and uncertainty which affect investment decisions, thus limiting job creation. Furthermore, these barriers affect small and medium-sized enterprises in a disproportionate way because they have fewer resources to surpass these obstacles, deteriorating the competitive environment. Foreign investment is also affected disproportionally because national companies have information advantages. The various new initiatives laid out below cover all families of licenses and will have a substantial impact in the business environment. The reviews of the legal regimes of environment and territory planning and of industrial and commercial licencing aim at ensuring their mutual compatibility.

Regulatory simplification

7.18. To deal with the legacy of excessive licences procedures and other administrative burdens, carry out a full inventory and an analysis of the costs of all regulations in the economy (at central, regional and local levels). **[Q2-2013]** On the basis of the analysis the government will devise a roadmap for a regulatory simplification.

7.19. To prevent future growth in excessive licenses and regulations, study the feasibility of a rule that prohibits at all levels of government the creation of a new regulation generating costs for businesses without the elimination of an existing regulation or regulations with an equivalent cost. The feasibility of such rule will be decided by **[Q1-2013]** with a view of being in place by **[Q2-2013]**.

7.20. Create a working group to analyse and fast-track applications for the licensing of planned investment projects which are left unresolved or undecided for more than 12 months **[Q4-2012]**.

Environment and territory planning

7.21. In consultation with the relevant stakeholders, review the legal regimes at all levels of Government in the area of territorial planning, in order to increase and facilitate the establishment of investors while at the same time limiting urban sprawl. In particular, review the following legal regimes, in the area of territorial planning:

i. new Base Law of Soil and Territorial and Urbanism Planning (Lei dos Solos), that should be aligned with the new Industrial Licensing regime (measure 7.24 ii) **[Q4-2012]**;

ii. National Ecological Reserve/ Risks (REN): (1) Changes to Decree-Law 166/2008 (RJREN); (2) Publication of strategic orientations regarding modifications of REN's municipal delimitations; (3) Revocation of Ordinance 1356/ 2008 (Compatible REN actions); 4. Joint Dispatch of the Secretaries of State of Environment and Territorial Planning and of Internal Administration in order to determine the creation of Risk Sectorial Plan **[Q4-2012]**;

iii. review the legal regimes of the Territorial Management Instruments (RJIGT) and of the related regulations **[Q4-2012]**;

iv. diploma for the regularization of activities not in accordance with Territorial Management Instruments **[Q4-2012]**

v. diploma for the harmonization of Territorial Planning Regional Plans – new generation **[Q4-2012]**

vi. review the Legal Regime for Urbanism and Building (RJUE) , that should be aligned with, the new Industrial Licensing regime (measure 7.24 ii) **[Q1-2013]**

7.22. Increase a nationwide land registration system (registo cadastral) to allow a more equal (perequitativa) distribution of benefits and costs in the execution of urban planning. The government will:

i. implement a Legal Regime of Land Registration (registo cadastral) **[Q4 2013]**;

ii. create a diploma on Land Registration and Land Registration Experts **[Q4-2013]**;

iii. review the cartography for plans regime **[Q4-2013]**, and the diploma on Cartography (Q4-2013);

iv. enforce the Council of Ministers Resolution 56/2012 by **Q4-2013**, to collect all land registration procedures, currently scattered in various departments.

7.23. Change the legal regime for Environment Impact Evaluation in order to increase the speed and effectiveness of this regulation and reduce associated monetary and time costs. **[Q4-2012]**.

Industrial Licensing

7.24. Implement the new Industrial Licensing regime by means of:

i. fully implement the approved Programme of Responsible Industry ("PIR - Programa da Indústria Responsável" **[Q2-2013]**;

ii. review the following legal norms and regimes that are crucial for a successful implementation of the approved System of Responsible Industry ("SIR - Sistema da Indústria Responsável"):

a. implement zero licensing procedures for Type 3 and Type 2 industries **[Q4 2012]**, including fully integration of these procedures in the one-stop shop ("Balcão do empreendedor"). Implement fast-track procedures for Type 1 industries **[Ongoing]**;

b. define and establish the Zones of Responsible Enterprises (ZER – Zonas da Indústria Responsável) by **[Q1-2013],** which will allow the installation of industries in areas previously licensed with all industrial, building and environmental provisions required by national and European law;

c. create and define standardized industrial licenses **[Q1-2013]**;

d. ensure that the new Industrial Licensing is aligned with, and strengthened by, the review of the New Base Law of Soil and Territorial and Urbanism Planning while at the same time limiting urban sprawl (measure 7.21 i) **[Q4-2012]**;

e. ensure that the new Industrial Licensing is aligned with, and strengthened by, the review of the Legal Regime for Urbanism and Building (RJUE - measure 7.21 vi) **[Q1-2013].**

Commercial licensing

7.25. Review the commercial licensing regime. Approval of a new legal regime for commercial actives and establishment of the Program for the Competitiveness of Commerce and Services activities ("Programa para a Competitividade do Comércio e Serviços), which will simplify and condense in a single law more than 20 dispersed existing legal regimes **[Q4-2012]**.

Geology

7.26. Reviewing the geological licensing regimes, including:

i. revision of the legal regime concerning the licensing of mining and geological production and investment in line with international best practices in this field **[Q4-2012]**;

ii. simplify the legal and bureaucratic procedures pertaining to mining and geological investments, especially in terms of assessment, search, development, and production activities **[Q4-2012].**

Tourism

7.27. Review the Licensing in Tourism regime:

i. eliminate or transforming into a voluntary regime the mechanism of prior communication in the Regime for Urbanism and Building **[Q1-2013]** Simplify the legal regime for touristic establishments **[Q4-2012];**

ii. expand the range of ex post control mechanisms in urban operations, significantly reducing administrative procedures and costs for developers **[Q4-2012];**

iii. simplified and transparent requirements on the classification of the several types of touristic establishments (number of stars) **[Q4-2012]**;

iv. review of the sanction legislation on the touristic establishments regime as a way to fight informal touristic economy, giving more powers to ASAE (Authority for Economic and Food Safety). **[Q4-2012]**

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International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Fifth Review Under an EFF Arrangement with Portugal, Approves €1.5 Billion Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the fifth review of Portugal's performance under an economic program supported by a 3-year, SDR 23.742 billion (about €28.2 billion) Extended Fund Facility (EFF) arrangement. The completion of the review enables the immediate disbursement of an amount equivalent to SDR 1.259 billion (about about €1.5 billion), bringing total disbursements under the EFF arrangement to SDR 18.402 billion (about €21.8 billion).

The Executive Board also approved a request for waivers of applicability and nonobservance of the end-September 2012 performance criteria.

The EFF arrangement, 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.

After the Board discussion, Ms. Nemat Shafik, Deputy Managing Director and Acting Chair, said:

"Reflecting the authorities' strong policy efforts, fiscal and external imbalances have significantly narrowed and sovereign spreads have declined. Nonetheless, a weaker external outlook and rising unemployment have increased risks to the attainment of program's objectives. Additional efforts are necessary, with the support of euro-area partners, to further advance fiscal consolidation and boost long-term growth.

"In the face of weaker revenues, the revised fiscal targets strike an appropriate balance between advancing the required fiscal adjustment and supporting growth. However, with debt now set to peak at about 124 percent of GDP in 2014, room for maneuver has diminished. A prompt completion of the planned expenditure review would help rebalance the adjustment effort, which currently is predominantly based on revenue measures.

“Structural reforms are critical to underpinning durable fiscal consolidation. Significant progress has been achieved in strengthening tax administration and public financial management, and in reforming SOEs. However, additional efforts are necessary, including by comprehensively implementing the new expenditure commitment rules, monitoring tax compliance, maintaining tight budget constraint on state-owned enterprises, and reducing costs of public-private partnerships.

“The authorities have a strong track record in preserving financial stability, and have taken important steps in recapitalizing banks and strengthening the supervision and resolution frameworks. Exceptional support from the Eurosystem and recent ECB decisions should also prove helpful in ensuring sufficient liquidity to banks. However, risks need to be monitored carefully and access to credit by small and medium-sized enterprises should be preserved.

“Significant progress has been made on structural reforms, including by reducing distortions in labor, housing, and product markets, as well as on judiciary reform. However, these reforms may take time to bear fruit. Alternative policy options should be considered to increase competition in the non-tradable sector, which would facilitate the external adjustment and improve long-term growth prospects.”

Statement by Arrigo Sadun, Executive Director for Portugal and

José Cardoso, Advisor to Executive Director

October 21, 2012

1. Overview

The IMF staff presents an accurate report of the current state of the Portuguese program. The program provides an adequate framework to address the imbalances accumulated in the Portuguese economy. It is a very demanding and persistent effort. The Portuguese authorities are strongly committed to the implementation of the program. All end-June performance criteria and structural benchmarks for the review were met. However, the end-September performance criterion on the government deficit was missed (end-September is the test date for the 6th Review, but the Board discussion took place after end-September). Therefore, there was a need to adjust the fiscal consolidation path to avoid excessive economic and social costs that could be detrimental to the program's success.

The IMF staff report provides ample evidence that much progress has been achieved. The external imbalance has been corrected faster than anticipated, mainly due to strong export growth. Portuguese firms have shown greater flexibility than expected. They have been able to diversify the destination of their exports, reducing the reliance on traditional European markets, and increasing exports to non-EU countries, such as Angola, US, China, and Brazil. The Portuguese authorities expect a current and capital account surplus in 2013, a more favorable projection than the IMF. If confirmed, it would be the first time for the last 20 years. This shows that the Portuguese economy is successfully making a transition from a growth model excessively based on domestic demand to a model based on exports. The staff's recommendations for more decisive actions to raise competitiveness, employment and potential growth are well taken, but the recent evolution of exports and the decline in unit labor costs in 2012 suggest that Portugal is already improving competitiveness, thus showing that being part of a monetary union is not an impediment for external rebalancing. The authorities are strongly committed to pressing ahead with our ambitious structural reform agenda to continue improving flexibility in labor and product markets that would lead to further benefits in the longer-term.

There has also been significant progress in reducing the debt levels of households and corporations. Portuguese banks are in a stronger financial position, as detailed below. Progress in the adjustment has resulted in enhanced credibility that, in turn, has led to a substantial improvement in the sovereign debt market. Better financing conditions seem to be spilling over to the private sector. An important development has been the issuance of debt by some large Portuguese firms in international bond markets at reasonable interest rates. However, nonperforming loans have continued to increase and bank lending rates remain at excessively high levels. The authorities are seeking ways to reduce the high borrowing costs (through dedicated credit lines to SMEs with state guarantees, the use of structural funds, and the use of equity funds created in the context of bank recapitalization) and are studying further initiatives to improve overall financing such as the creation of a specialized institution to finance innovative projects.

2. Fiscal Policy

An important decision taken during this review, (already approved by the Eurogroup and the Ecofin), was the decision to revise upward the limits to the budget deficit (5.0 percent in 2012, 4.5 percent in 2013 and 2.5 percent in 2014). As explained in the staff report, the new path strikes a better balance between the need to contain debt accumulation and imposing an excessive burden on the economy. The new limits will help the economy to achieve a virtuous cycle of increased credibility, access to finance, and the recovery of economic activity and employment. The targets will also help to avoid excessive social costs from the adjustment. In this regard, the government is stepping up its social dialogue to preserve the broad consensus and support for the program.

The State Budget for 2013 has been submitted to Parliament on October 15th (prior action) and is an important milestone on this path towards the recovery of credibility.

According to the staff report, in 2013 the primary balance will be close to equilibrium, but in structural terms the primary balance will show a surplus of around 2 percent of GDP. In the period 2011-2013, the fiscal adjustment in Portugal will be around 7 percentage points of GDP in structural terms. This development is unprecedented in the Portuguese economy. To comply with the agreed limit for the deficit in 2013, the authorities are taking consolidation measures of around 3.2 percent of GDP.

On the revenue side, the 2013 budget includes the increase in personal income taxes, property taxes, and taxes on investment income. We are implementing a reform of the personal income tax, which will include a reduction of brackets and tax deductions. A surcharge will also be applied.

On the expenditure side — and in order to take into account a Constitutional Court ruling — only up to one salary of public workers and up to 90 percent of a monthly payment of pensions will remain suspended. This suspension will not apply to monthly wages below EUR 600, and it will progressively apply to monthly wages between EUR 600 and EUR 1100. These are important features to protect the most vulnerable groups of the population.

At the level of public administration, compensation of employees will be curbed by cutting the number of permanent employees by 2 percent, through the non-renewal of a substantial amount of fixed-term contracts and the reduction in compensation for overtime. There will be rationalization of General Government expenditure. Building on the results of a study by an international auditor concerning PPPs, the authorities concluded the negotiation of PPP sub-concessions, which resulted in capital cost reductions. The renegotiation process of the remaining PPP contracts will ensue, based on the established strategy, and taking advantage of the PPP Technical Unit that is being established in the Ministry of Finance. There will be cuts in the transfers to foundations. The restructuring of the SOE sector will continue. The authorities are also making changes to social benefits, with the aim of ensuring that the increasingly scarce resources of the state are directed to those who need it most effectively, extending means testing. There will also be substantial savings in Health and Education.

The progress done so far has resulted in the gradual build-up of trust and credibility in international markets, improving the prospects for a return to full bond market financing. Portugal has been able to issue T-bills at declining interest rates. In the latest auction in October, the rates paid at 12 and 18 month maturities were around 2 and 3 percent respectively. Importantly, a bond swap done in early October allowed to significantly reduce refinancing risk by swapping 39 percent of the bonds maturing in September 2013 for a bond maturing in October 2015, thus representing an important step in the path toward full bond market access.

3. Financial Sector Policies

The resilience of the banking sector has been considerably reinforced throughout the year. Progress has been noteworthy on several fronts.

First, the liquidity position of the banking sector has been strengthened, on the backdrop of decisive non-conventional measures taken by the ECB and of continued trust displayed by the depositor base. Banks have further strengthened their collateral buffers, despite adverse external conditions. To facilitate redistribution of liquidity among domestic banks, Banco de Portugal developed a new platform for interbank unsecured lending which started operating on September 3rd. The secured segment of the domestic interbank money market is expected to be operational by early 2013.

Second, the solvency of the banking system has been significantly reinforced. This was achieved through a decrease of risk-weighted assets — given the nature of the ongoing deleveraging process — through an increase in core own funds and, in the case of two banks, by resorting to the Bank Solvency Support Facility (BSSF) established under the program, in an amount close to EUR 5 billion (of the EUR 12 billion available in the Facility). This allowed banks to fulfill their regulatory capital requirements, including the European Banking Authority's capital exercise. The most recent stress test exercise, conducted by Banco de Portugal *in tandem* with the quarterly Funding and Capital Plans, confirmed the resilience of all participating banks. This exercise revealed the importance of the capital increases carried out in June 2012, as banks were able to absorb the severe adverse scenario and still keep a core tier 1 ratio clearly above 6 percent.

Third, the supervision of the banking system and the regulatory framework continued to be strengthened. Several initiatives are worth highlighting in this respect. First, with a view to discouraging evergreening of problematic loans, Banco de Portugal published an Instruction aimed at ensuring the identification in the banks' information systems of restructured credits due to financial difficulties of the borrower. Early insights from this work are expected in the forthcoming weeks. Second, as part of Banco de Portugal's regular supervisory activities, a new on-site inspections program has been launched and the field work has already started in all the eight largest banking groups, with first conclusions expected by November. Finally, draft proposals concerning (i) Bridge Banks, (ii) Recovery Plans; (iii) the Resolution Fund Regulation and (iv) Contributions to the Resolution Fund by the participating institutions have already been completed.

The continuation of a balanced deleveraging process continues to be a central goal for banks over the medium term. This process aims at ensuring a sustainable funding structure over the medium term, which is instrumental to ultimately regain access to international financial markets. This deleveraging process should be consistent with the adjustment of economic agents' balance sheets. In particular, it should ensure that the most dynamic and productive segments of the economy maintain access to the domestic credit market.

In the context of an unprecedented economic contraction, total credit granted to private non-financial corporations (including loans, debt, and trade credit) has decelerated gradually from mid-2011 onwards, but still records year-on-year rates of growth around zero. Non-domestic sources of financing have contributed decisively to this dynamics. There is however high heterogeneity in the flow of credit to the economy, as credit is only increasing for large firms. Some of this heterogeneity is inescapable, given the required sectoral restructuring of the Portuguese economy. However, the fact that domestic loans are contracting at a strong pace, in particular to SMEs, suggests that stronger action is needed to reduce financing constraints. In particular, the diversification of sources of financing remains of the essence for the sustainable recovery of the Portuguese economy. Authorities have been working on several proposals in this regard. First, the setting-up — in a European context — of a vehicle to reduce the weight of legacy mortgage credit in banks' balance sheets. This would allow banks to immediately deleverage through a stock adjustment — without impacting on the financing of the economy — instead of relying on a gradual restraint on new loans, in particular as regards non-financial corporations. This would also reduce funding pressures which are currently impacting on deposit rates and being transmitted to the cost of new lending. Further, it would allow banks to restructure the asset side of the balance sheet, by potentially promoting new lending flows to the most productive and dynamic firms in the economy. Overall, it would contribute to a smoother functioning of the monetary transmission mechanism in the euro area. Another proposal being explored is the development of a dedicated public financial institution in the context of the forthcoming EU financial package. This proposal aims at enhancing the mix between grant-based financing and the use of financial instruments, in order to maximize the financing of viable non-financial corporations and to promote EU regional development goals.

Progress on all these fronts is essential to preserve financial stability in the Portuguese economy. This should also contribute to an efficient adjustment of the Portuguese economy going forward. Notwithstanding, the Portuguese banking system still faces important challenges, stemming in particular from the exacerbated uncertainty on a supranational level and from the downside risks still facing the Portuguese economy.

4. Structural Reforms

The new labor law approved by Parliament will promote a competitive economy with an increasingly flexible and dynamic labor market. Furthermore, the Portuguese authorities recognize the need to decentralize wage bargaining and decrease market segmentation. The decline in unit labor costs in the Portuguese economy is a reflection of the significant steps already taken to this end. Of particular importance to the whole economy is the ambitious

law presented to Parliament concerning port work which aims at the significant reduction of barriers in this crucial and historically inflexible sector.

As for the product market, the Portuguese authorities have continued the substantial work already undertaken in addressing excessive rents in network industries. After eliminating the power guarantee scheme, the authorities concluded the agreements with the wind energy sector and revised the calculation of cogeneration, establishing more efficient mechanisms and reducing the cost to end users. Further steps to reduce excessive rents were taken on the telecommunications and pharmaceutical sectors.

Following the approval of a new competition law and the establishment of the new Competition Court, a new regulatory architecture is nearing completion with the regulatory framework law currently under discussion. The authorities have reaffirmed their commitment to enlarge the scope of the privatization program to develop a more open and competitive Portuguese economy.

Reforming the judicial system is critical to improve business environment. The new Insolvency Code came into effect and the law governing the new Extrajudicial System for Recovery of Viable Companies (SIREVE) was published. A new Arbitration Law created a task-force of judges for high value pending tax cases and proposed a number of measures to eliminate the backlog of enforcement cases. Additionally, the new judicial map and the Code of Civil Procedure were subject to extensive public scrutiny and resulted in draft laws that are being concluded.

Moreover, a new ambitious initiative on licensing reform was presented with the objective of simplifying and reducing procedures, and removing excessive regulations and other administrative burdens to the economy. These barriers represent a major obstacle for economic growth in Portugal. This initiative covers all families of licenses and will have a substantial impact in the business environment.

The first signs of an opening up of international financial markets to longer-term financing of the Portuguese government and of large companies and financial markets this autumn provides some optimism for a gradual improvement of financial conditions in the economy. The malfunctioning transmission mechanism of monetary policy and the fragmentation of the European financial system continue to pose important challenges for Portuguese firms. The resolution of these problems, which have a European dimension, would reduce obstacles to the competitiveness of Portuguese companies and facilitate the adjustment under the program.