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**Assessment of the 2011 national reform programme and stability programme for
PORTUGAL**

Accompanying the document

Recommendation for a

COUNCIL RECOMMENDATION

**on the National Reform Programme 2011 of Portugal and delivering a Council Opinion
on the updated stability programme of Portugal, 2011-2014**

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1. INTRODUCTION

In 2010, Portugal's GDP grew a rate of 1.3%. This positive growth rate was, however, largely due to exceptional factors that boosted exports and private consumption. The latter particularly benefited from anticipatory effects of the VAT increase in July 2010 and January 2011. Notwithstanding the significant growth contribution of external trade, Portugal lost 0.9% in export market share in 2010. Price and cost developments clearly indicated that Portugal was not gaining competitiveness at a sufficiently fast rate to redress its current account deficit, which was high at 10% of GDP last year. Similarly, fairly robust private consumption benefitted from temporary factors, such as relatively low inflation due to falling energy prices. Moreover, at the end of last year, expectations of increases in indirect taxes led to some front-loading of expenditure. The weak overall economy and the steep increase in unemployment spilled into large government deficits, which exceeded 10% of GDP in 2009 and 9% in 2010, up from 3.5% in 2008.¹

Portugal has seen unemployment consistently grow during the recession, peaking at 11.2%. The young (22.4% in 2010) and the older generations (7.7%) are more exposed to unemployment than the EU average. The long-term unemployed currently represents more than 55% of the total unemployed. This is likely to have a detrimental impact on the general skills level of the unemployed and reveals deep structural problems in the Portuguese labour market. In line with joblessness, employment continued to weaken, with the employment rate reaching the lowest level in a decade (70.5% in 2010), while still being above the EU average (68.6%).

Recently, unfavourable developments in public finances and a bleak outlook for economic growth led to a deterioration of confidence and rising pressures in sovereign bond markets. In parallel, the banking sector, which is heavily dependent on external financing, became increasingly cut off from market funding and resorted extensively to funding from the Eurosystem. The government stepped down after failure to achieve parliamentary approval for the Stability Programme in late March. In the wake of consecutive downgrades of Portuguese sovereign bonds, interest rates reached levels that were no longer compatible with long-term fiscal sustainability. As a result, Portugal requested international financial assistance from the European Union and the International Monetary Fund (IMF) on 7 April. Negotiations between the Portuguese authorities and a joint mission of the Commission, the IMF and the ECB led on 3 May to an agreement on an Economic Adjustment Programme for the period 2011-14.

2. MAIN FEATURES OF THE ECONOMIC ADJUSTMENT PROGRAMME

On 17 May, the ECOFIN Council adopted the formal Decision allowing for financial assistance to Portugal.² The Programme includes external financing from the European Union, the euro-area Member States and IMF of up to EUR 78 billion and a commitment by Portugal to adopt far-reaching and frontloaded reforms in several areas.

The fiscal objectives of the Programme are ambitious but realistic. The government deficit is expected to attain 5.9% of GDP in 2011, 4.5% of GDP in 2012 and 3.0% in 2013, in line with the Excessive Deficit Procedure requirements. Government debt is expected to peak at around 108% in 2013 and start declining thereafter. Consolidation efforts are frontloaded,

¹ The 2010 deficit outturn was 9.1% of GDP, which compares with a target of 7.3% of GDP established last May. The large slippage was mainly due to a number of deficit-increasing one-off operations, notably the rescue costs of two troubled banks and the reclassification of two public-private partnerships (PPPs) within the general government sector. In addition, the reclassification of some state-owned enterprises (SOEs) will have a more durable impact on the deficit.

² insert URL

broad-based and supported by a wide range of measures to reduce expenditure and increase revenue. On the expenditure side, the measures include, inter alia, wage moderation in the public sector, lower transfers to local and regional administrations and SOEs, pensions' adjustment and lower capital expenditure. On the revenue side, some of the measures include the broadening the corporate and personal income tax bases by reducing tax deductions and special regimes, the convergence of personal income tax deductions applied to pensions and labour income, changes in property taxation, broadening of VAT bases by reducing exemptions and rearranging the goods subject to intermediate and reduced rates. Fiscal consolidation will be supported by flanking measures aimed at strengthening the fiscal framework improving all stages of the budgetary process including monitoring and control to contain fiscal risks. In addition, the Portugal will reap efficiency gains from a substantial reorganisation of its public administration at central, regional and local level.

Following the recommendations on the Memorandum of Understanding on Specific Economic Policy Conditionality, Portugal will publish a fiscal strategy document for the general government by end-August 2011 and annually thereafter in April for the Stability Programme. The document will specify 4-year medium-term economic and fiscal forecasts and 4-year costs of new policy decisions. Budgets will include a reconciliation of revisions to the 4 year fiscal forecasts attributable to policy decisions and parameter revisions e.g. policy decisions, changes in the macroeconomic environment).

Structural reforms cover a wide range of areas including the labour market, housing market, education, energy, transport, business environment, judicial system, services and healthcare. The approach to structural reforms is very frontloaded. Already in 2011, Portugal is expected to implement a first batch of measures aimed at strengthening labour market functioning by limiting severance payments and making working time arrangements more flexible. Portugal 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. In the energy sector and other network industries, Portugal will adopt measures to deepen the markets and promote competition and flexibility. For achieving renewable energy targets, non cost barriers have to be removed. Portugal will ensure that plans to boost energy efficiency are implemented in a cost-efficient way. Additional measures to promote competition and adjustment will be implemented in other areas, such as services housing markets, judicial system and business environment conditions.

Bank liquidity remains under pressure, even if the Portuguese banking system has weathered the crisis relatively well so far. On the back of the Programme, Banco de Portugal will monitor carefully the liquidity situation of the banking system and intervene if necessary. In particular, government guaranteed bonds maybe issued for an amount up to EUR 35 billion. During the Programme period, the banking sector will adopt a strategy of balanced and orderly deleveraging so as to eliminate its funding imbalances on a permanent basis. Furthermore, the bank solvency support mechanism will be endowed with resources of up to EUR 12 billion. At the same time, banks are requested to further strengthen their capital buffers by raising their Tier 1 capital ratio to 10% by end of 2012.

Of the total Programme envelope of EUR 78 billion, EUR 52 billion will be paid by the EU (split equally between contributions from the the European Financial Stabilisation Mechanism and the European Financial Stability Facility) with the IMF will cover the remaining EUR 26 billion. The Programme amount includes EUR 12 billion reserved for potential banking sector recapitalisation needs, whereas privatisation receipts are expected to reduce the financing needs over the Programme period by around EUR 5 billion. Portugal is expected to be able to

continue rolling-over part of its existing stock of short-term debt and to return to the long-term debt market in the second half of 2013. The Programme also provides for a financing buffer to provide for unexpected deviations from the Commission's baseline financing scenario.

3. PROGRAMME IMPLEMENTATION

The first programme review will take place in August 2011.

4. MONITORING, PROCEDURAL ISSUES AND GOVERNANCE

The National Reform Programme was prepared through consultation with the national parliament, social partners, regional and local actors and civil society in order to increase ownership of the Europe 2020 strategy at national level. The regional and territorial level was particularly active.

Regarding national targets, Portugal established national targets in the field of employment, R&D, education, energy and climate change and the fight against poverty for 2020. Mid-term targets were also established for 2014. A mid-term evaluation will take place in 2014 based on an external evaluation of results, in light of the intermediate targets set for that date.

The National Reform Programme will be permanently monitored per action line and target in the framework of the Europe Strategy Coordination Network 2020 set up by Portugal to that effect.

Table 1. Portugal Europe 2020 targets

Europe 2020 targets	Current situation in Portugal ³	Portuguese Europe 2020 target in the NRP
R&D investment (% of GDP)	1.5%	2.7-3.3%
Employment rate (%)	71.2%	75%
Early school leaving (%)	31.2%	10%
Tertiary education attainment (%)	21.1%	40%
Reduction of number of people in or at risk of poverty or exclusion	2.6 million people at risk of poverty or exclusion	200 000 people
Energy efficiency – reduction of energy consumption in MToe ⁴		Reduction in energy consumption: 6 Mtoe
Reduction in greenhouse gas emissions (from sources not covered by the Emission Trading System)	-3% ⁵	+1% ⁶
Renewable energy (% of total energy use)	23% (2008)	31%

³ Eurostat figures

⁴ As estimated by the Commission. MToe = Million tonnes of oil equivalent.

⁵ This quantity corresponds to the 2005-2008 evolution of the emissions not covered by the EU Emissions Trading System. As the scope of the Emissions Trading System evolved between 2005 and 2008, these emissions are estimated on the basis of the main relevant UNFCCC source categories (as opposed to the difference between total emissions and EU ETS verified emissions).

⁶ The national emissions limitation target defined in Decision 2009/406/EC (or "Effort Sharing Decision") concerns the emissions not covered by the EU Emissions Trading System. It is expressed as the minimum relative decrease (if negative) or the maximum relative increase (if positive) compared to 2005 levels.

ANNEX

Table I. Macro economic indicators

	1995-1999	2000-2004	2005-2008	2009	2010	2011	2012
Core indicators							
GDP growth rate	3,9	1,4	1,1	-2,5	1,3	-2,2	-1,8
Output gap 1	0,1	0,9	-0,4	-2,3	-0,8	-2,2	-3,2
HICP (annual % change)	2,6	3,3	2,6	-0,9	1,4	3,4	2,0
Domestic demand (annual % change) 2	4,8	1,2	1,3	-2,9	0,7	-5,7	-4,7
Unemployment rate (% of labour force) 3	6,1	5,3	7,8	9,6	11,0	12,3	13,0
Gross fixed capital formation (% of GDP)	25,4	25,5	22,5	19,9	19,0	17,8	16,9
Gross national saving (% of GDP)	20,2	17,0	12,2	9,2	9,2	10,3	11,5
General Government (% of GDP)							
Net lending (+) or net borrowing (-)	-3,8	-3,3	-4,2	-10,1	-9,1	-5,9	-4,7
Gross debt	54,4	53,4	66,6	83,0	93,0	100,9	105,6
Net financial assets	-29,0	-33,8	-44,4	-57,2	n.a	n.a	n.a
Total revenue	37,5	39,5	40,6	39,7	41,5	41,8	42,7
Total expenditure	41,3	42,8	44,8	49,8	50,7	47,7	47,4
<i>of which: Interest</i>	4,0	2,7	2,8	2,9	3,0	4,1	4,8
Corporations (% of GDP)							
Net lending (+) or net borrowing (-)	-1,8	-6,0	-7,3	-4,3	-3,9	-5,2	-4,4
Net financial assets; non-financial corporations	-132,1	-142,6	-152,6	-173,9	n.a	n.a	n.a
Net financial assets; financial corporations	-9,6	-8,0	-7,6	-0,9	n.a	n.a	n.a
Gross capital formation	13,9	14,6	14,3	12,0	11,4	11,0	9,9
Gross operating surplus	20,5	20,7	20,5	20,1	20,1	18,8	18,5
Households and NPISH (% of GDP)							
Net lending (+) or net borrowing (-)	1,9	2,2	1,9	4,6	4,1	4,8	4,9
Net financial assets	153,7	132,2	123,2	126,3	n.a	n.a	n.a
Gross wages and salaries	38,8	39,3	38,6	39,8	39,6	39,4	39,2
Net property income	7,0	5,9	6,8	5,7	6,5	6,7	6,9
Current transfers received	19,8	21,3	23,0	25,8	25,1	25,3	25,5
Gross saving	8,2	7,4	5,7	8,0	7,2	7,8	8,5
Rest of the world (% of GDP)							
Net lending (+) or net borrowing (-)	-3,7	-7,2	-9,7	-9,7	-8,5	-6,0	-3,8
Net financial assets	21,9	56,3	85,4	111,8	n.a	n.a	n.a
Net exports of goods and services	-8,3	-9,0	-9,1	-7,5	-7,2	-4,4	-1,7
Net primary income from the rest of the world	-0,4	-1,7	-2,8	-4,0	-3,4	-3,8	-4,2
Net capital transactions	2,4	1,8	1,3	1,1	1,3	1,5	1,5
Tradable sector	45,5	42,3	39,7	39,1	39,4	n.a	n.a
Non tradable sector	42,1	45,2	46,7	48,8	48,3	n.a	n.a
<i>of which: Building and construction sector</i>	6,1	6,5	5,9	5,3	5,3	n.a	n.a
Real effective exchange rate (index, 2000=100)	99,3	104,9	111,5	113,2	110,0	110,5	110,5
Terms of trade goods and services (index, 2000=100)	100,5	101,2	100,3	103,3	102,9	100,2	99,3
Market performance of exports (index, 2000=100)	107,9	99,5	93,8	98,2	98,3	99,7	100,2
Notes:							
1 The output gap constitutes the gap between the actual and potential gross domestic product at 2000 market prices.							
2 The indicator on domestic demand includes stocks.							
3 Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.							
Source:							
<i>Commission services' spring 2011 forecast</i>							

Table II. Financial market indicators

	2006	2007	2008	2009	2010
Total assets of the banking sector (% of GDP)	235.4	246.1	266.3	298.6	315.8
Share of assets of the five largest banks (% of total assets)	67.9	67.8	69.1	70.1	...
Foreign ownership of banking system (% of total assets)	22.5	23.6	22.7	23.1	...
Financial soundness indicators:					
- non-performing loans (% of total loans) ¹⁾	1.3	1.4	1.8	2.8	3.3
- capital adequacy ratio (%) ^{1) 2)}	11.8	10.4	9.4	10.5	10.2
- profitability - return on equity (%) ^{1) 3)}	19.9	18.7	5.6	7.3	8.2
Private credit growth (annual % change)	10.6	9.9	11.6	4.8	2.4
Residential property prices (y-o-y % change)	2.1	1.3	3.9	0.4	1.8
Exposure to countries receiving/repaying official financial assistance (% of GDP) ⁴⁾	4.5	5.2	9.8	12.8	14.4
Private debt (% of GDP)	155.3	166.9	179.6	190.3	188.8
Gross external debt (% of GDP)					
- Public	47.0	47.1	54.2	57.3	50.0
- Private	35.6	38.0	40.3	41.6	44.9
Long term interest rates spread versus Bund (basis points)*	15.3	20.8	53.5	98.9	265.3
Credit default swap spreads for sovereign securities (5-year)*	65.4	80.1	291.9

¹⁾ Break in the series in 2007 due to more comprehensive coverage.

²⁾ The capital adequacy ratio is defined as total capital divided by risk weighted assets.

³⁾ Net income to equity ratio.

⁴⁾ Covered countries are IE, EL, PT, RO, LV and HU.

* Measured in basis points.

Source:

Bank for International Settlements and Eurostat (exposure to macro-financially vulnerable countries), IMF (financial soundness indicators), Commission services (long-term interest rates), World Bank (gross external debt) and ECB (all other indicators).

Table III. Labour market and social indicators

Labour market indicators	2005	2006	2007	2008	2009	2010
Employment rate (% of population aged 20 - 64)	72.3	72.7	72.6	73.1	71.2	70.5
Employment growth (% change from previous year)	-0.3	0.5	0.0	0.5	-2.6	-1.5
Employment rate of women (% of female population aged 20 - 64)	66.0	66.3	66.3	67.0	66.1	65.6
Employment rate of men (% of male population aged 20 - 64)	78.7	79.2	79.1	79.4	76.5	75.4
Employment rate of older workers (% of population aged 55 - 64)	50.5	50.1	50.9	50.8	49.7	49.2
Part-time employment (% of total employment)	11.2	11.3	12.1	11.9	11.6	11.6
Fixed term employment (% of employees with a fixed term contract)	19.5	20.6	22.4	22.8	22.0	23.0
Unemployment rate ¹ (% of labour force)	7.7	7.8	8.1	7.7	9.6	11.0
Long-term unemployment ² (% of labour force)	3.7	3.9	3.8	3.7	4.3	5.7

Youth unemployment rate (% of youth labour force aged 15-24)	16.1	16.3	16.6	16.4	20.0	22.4
Youth NEET ³ rate (% of population aged 15-24)	11.2	10.6	11.2	10.3	11.2	:
Early leavers from education and training (% of pop. 18-24 with at most lower sec. educ. and not in further education or training)	38.8	39.1	36.9	35.4	31.2	:
Tertiary educational attainment (% of population 30-34 having successfully completed tertiary education)	17.7	18.4	19.8	21.6	21.1	:
Labour productivity per person employed (annual % change)	1.1	0.9	2.4	-0.5	0.0	2.9
Hours worked per person employed (annual % change)	0.0	-0.5	0.7	-0.7	0.4	1.1
Labour productivity per hour worked (annual % change; constant prices)	1.1	1.4	1.8	0.2	-0.5	1.8
Compensation per employee (annual % change; constant prices)	2.1	-0.9	0.4	1.4	2.7	0.5
Nominal unit labour cost growth (annual % change)	3.6	0.9	1.2	3.8	3.5	-2.0
Real unit labour cost growth (annual % change)	1.0	-1.8	-1.6	1.8	3.4	-3.3
Notes:						
¹ According to ILO definition, age group 15-74)						
² Share of persons in the labour force who have been unemployed for at least 12 months.						
³ NEET are persons that are neither in employment nor in any education or training.						
Sources:						
Comission services (EU Labour Force Survey and European National Accounts)						

Table II. Labour market and social indicators (continued)

Expenditure on social protection benefits (% of GDP)	2004	2005	2006	2007	2008
Sickness/Health care	6.81	6.93	6.73	6.42	6.48
Invalidity	2.32	2.26	2.29	2.26	2.14
Old age and survivors	10.53	11.02	11.35	11.34	11.93
Family/Children	1.19	1.18	1.18	1.19	1.27
Unemployment	1.27	1.33	1.27	1.15	1.05
Housing and Social exclusion n.e.c.	0.22	0.24	0.27	0.28	0.28
Total	22.3	23.0	23.1	22.6	23.2
of which: Means tested benefits	2.42	2.51	2.13	2.10	2.29
Social inclusion indicators	2005	2006	2007	2008	2009
Risk-of-poverty or exclusion ¹ (% of total population)	26.1	25.0	25.0	26.0	24.9
Risk-of-poverty or exclusion of children (% of people aged 0-17)	28.8	25.5	26.9	29.5	28.7
Risk-of-poverty or exclusion of elderly (% of people aged 65+)	33.2	32.2	30.0	27.7	26.0
At-Risk-of-Poverty rate ² (% of total population)	19.4	18.5	18.1	18.5	17.9
Value of relative poverty threshold (single HH per year) - in PPS	4944	5160	5352	5700	5652
Severe Material Deprivation ³ (% of total population)	9.3	9.1	9.6	9.7	9.1
Share of people living in low work intensity households ⁴ (% of people aged 0-59 not student)	5.9	6.6	7.2	6.3	6.9
In-work at-risk-of poverty rate (% of persons employed)	11.5	10.4	9.3	11.3	10.3
Notes:					
¹ People at-risk-of poverty or social exclusion (AROP): individuals who are at-risk-of poverty (AROP) and/or suffering from severe material deprivation (SMD) and/or living in household with zero or very low work intensity (LWI).					
² At-risk-of poverty rate: share of people with an equivalised disposable income below 60% of the national equivalised median income.					
³ Share of people who experience at least 4 out of 9 deprivations: people cannot afford to i) pay their rent or utility bills, ii) keep their home adequately warm, iii) face unexpected expenses, iv) eat meat, fish, or a protein equivalent every second day, v) enjoy a week of holiday away from home once a year, vi) have a car, vii) have a washing machine, viii) have a colour tv, or ix) have a telephone					
⁴ People living in households with very low work intensity: Share of people aged 0-59 living in households where the adults work less than 20% of their total work-time potential during the previous 12 months.					
Sources:					
For expenditure for social protection benefits ESSPROS; for social inclusion EU-SILC.					

Table IV. Product market performance and policy indicators

Performance indicators	2001-2005	2006	2007	2008	2009	2010
Labour productivity ¹ total economy (annual growth in %)	0.7	1.2	2.8	0.0	0.3	2.9
Labour productivity ¹ in manufacturing (annual growth in %)	2.1	2.5	4.5	0.6	n.a.	n.a.
Labour productivity ¹ in electricity, gas, water (annual growth in %)	8.0	1.7	2.0	n.a.	n.a.	n.a.
Labour productivity ¹ in the construction sector (annual growth in %)	-1.0	-0.6	1.1	-2.5	-4.8	n.a.
Patent intensity in manufacturing ² (patents of the EPO divided by gross value added of the sector)	0.3	0.5	0.3	n.a.	n.a.	n.a.
Policy indicators	2001-2005	2006	2007	2008	2009	2010
Enforcing contracts ³ (days)	n.a.	577	577	577	547	547
Time to start a business ³ (days)	n.a.	8	7	6	6	6
R&D expenditure (% of GDP)	0.7	1.0	1.2	1.5	1.7	n.a.
Tertiary educational attainment (% of 30-34 years old population)	14.8	18.4	19.8	21.6	21.1	n.a.
Total public expenditure on education (% of GDP)	5.5	5.3	5.3	4.9	n.a.	n.a.
	2003	2005	2006	2008	2009	2010
Product market regulation ⁴ , Overall (Index; 0=not regulated; 6=most regulated)	1.6	n.a.	n.a.	1.4	n.a.	n.a.
Product market regulation ⁴ , Retail (Index; 0=not regulated; 6=most regulated)	2.8	n.a.	n.a.	3.0	n.a.	n.a.
Product market regulation ⁴ , Network Industries ⁶ (Index; 0=not regulated; 6=most regulated)	2.8	2.7	2.6	2.4*	n.a.	n.a.
Notes:						
¹ Labour productivity is defined as gross value added (in constant prices) divided by the number of persons employed.						
² Patent data refer to applications designated to the European Patent Office (EPO). They are counted according to the year in which they were filed at the EPO. They are broken down according to the inventor's place of residence, using fractional counting if multiple inventors or IPC classes are provided to avoid double counting.						
³ The methodologies, including the assumptions, of this indicator is presented in detail at the website http://www.doingbusiness.org/methodology .						
⁴ The methodologies of the Product market regulation indicators are presented in detail at the website http://www.oecd.org/document/1/0,3746,en_2649_34323_2367297_1_1_1_1,00.html . The latest available product market regulation indicators refer to 2003 and 2008, except for Network Industries.						
⁶ Aggregate ETCR.						
*figure for 2007.						
<i>Source :</i>						
<i>Commission services, World Bank Doing Business (for enforcing contracts and time to start a business) and OECD (for the product market regulation indicators).</i>						