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Portugal: Request for a Three-Year Arrangement Under the Extended Fund Facility

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

- The staff report, prepared by a staff team of the IMF, following discussions that ended on May 5, 2011 with Portuguese officials on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 17, 2011 and discussed by the IMF Executive Board on May 20. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF
- Letter of Intent*
- Memorandum of Economic and Financial Policies*
- Technical Memorandum of Understanding*
- LOI & Memorandum of Understanding on Specific Economic Policy Conditionality (European Commission and European Central Bank)*
- A Press Release summarizing the views of the Executive Board as expressed during its May 20, 2011 discussion of the Staff Report*
- A statement by the Executive Director for Portugal

* These documents have been released already and are also included in this report.

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

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INTERNATIONAL MONETARY FUND

PORTUGAL

Request for a Three-Year Arrangement Under the Extended Fund Facility

Prepared by the European Department in Consultation with Other Departments

Approved by Poul M. Thomsen and Martin Mühleisen

May 17, 2011

Executive Summary

Background:

- Portugal suffers from deep-rooted structural problems—including low productivity, weak competitiveness, and high debt—that severely undermine potential growth.
- Euro adoption led to lower savings by both the public and private sectors and a rapid rise in non-tradable activity and relative prices.
- Over the past year, concerns about fiscal sustainability have pushed up sovereign spreads to post-euro record highs with sovereign access to markets becoming increasingly restricted.
- Bank funding conditions have also deteriorated sharply, loan portfolios are weakening, and large scale corporate sector bankruptcies are possible.
- PM Socrates resigned on March 23 and general elections have been called for June 5. The authorities requested EU/IMF assistance on April 8.

Main elements of the program:

- The program incorporates a comprehensive strategy and a balanced policy mix by focusing on structural reform to boost growth, adopting a credible fiscal stabilization path (supported by structural fiscal reform), and safeguarding financial stability and preventing a credit crunch.
- In the attached letter, the authorities request a 3-year arrangement under the Extended Fund Facility (EFF), with exceptional access in an amount equivalent to SDR 23.742 billion (2,305.7 percent of quota or €26 billion) under the emergency financing mechanism. IMF financing would complement assistance by the EU of €52 billion.
- Fiscal policy strikes a balance between re-gaining credibility and debt stabilization, and limiting adverse impacts on growth. The pace of fiscal consolidation is in line with EDP requirements but slower than original plans.
- The resilience of the banking sector is being enhanced by increasing capital requirements through market-based solutions, supported by a fully funded capital backstop facility. Safeguards to help ensure adequate banking system liquidity are strengthened.
- Central to restoring sustainability is a bold structural reform agenda which focuses on increasing competition, reducing labor costs, and boosting employment and productivity.
- Major opposition parties have publicly supported the overall objectives and key policies of the program.

Discussions. They took place on April 10–May 5, 2011 with the Minister of Finance, Governor of the Bank of Portugal, and other Cabinet Ministers; and staff in these and other ministries. The mission also met private banks, think tanks, employer associations, labor unions, and opposition parties. The staff team comprised P. Thomsen (head), H. Samiei, P. Kunzel, M. Zermeño, I. Vladkova Hollar, C. Piatakovas (all EUR); S. Nardin, G. Rice (both EXR); J. Harris, A. Khan, A. Lemgruber (all FAD); Y. Liu (LEG); R. Baqir, A. Piris, (both SPR); and O. Frecaut, M. Souto (both MCM). Mr. Sadun (OED) attended some of the meetings and Mr. Cardoso (OED) most of the meetings.

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I. Background

1. **Portugal's economic imbalances have increased considerably since its entry into the Euro area (Figure 1).** The significant fall in interest rates associated with euro adoption boosted non-tradable sectors and caused a significant real appreciation, created large fiscal and external imbalances, and lowered savings. Key weaknesses include:

- **Loss of competitiveness and a high current account deficit.** Portugal's ULC-based REER has appreciated by close to 20 percent since 1995, reflecting nominal wage growth in excess of the euro area average (by about 19 percent), and increasingly also a substantial slowdown in labor productivity. Profitability in the non-tradable sector has risen, diverting resources from the tradable sector and resulting in large and sustained current account deficits.

- **Unsustainable fiscal deficit.** Potential convergence benefits were not reaped as the expansion in primary current expenditure since 1994 (over 8 percent of GDP) outpaced the declining interest costs (3 percent of GDP). Social benefits and health costs were the key drivers. As a result public debt as a share of GDP rose from about 48 percent in 2000 to 93 percent in 2010. Non-transparent operation of state-owned enterprises (SOEs) and public-private partnerships (PPPs) have further increased fiscal risks. Important pension reforms in 2007, however, reduced the expected fiscal impact of ageing to well below the Euro area average.

- **High financial and corporate sector indebtedness.** Banks are extremely leveraged, with the highest loan-to-deposit ratio in the Euro Zone. The debt to GDP ratio of the private sector is also amongst the highest in Europe. Private sector gross debt exceeds 260 percent of GDP and the net (negative) international investment position exceeds 100 percent of GDP. However, compared with other periphery countries, a real estate bubble has largely been absent.

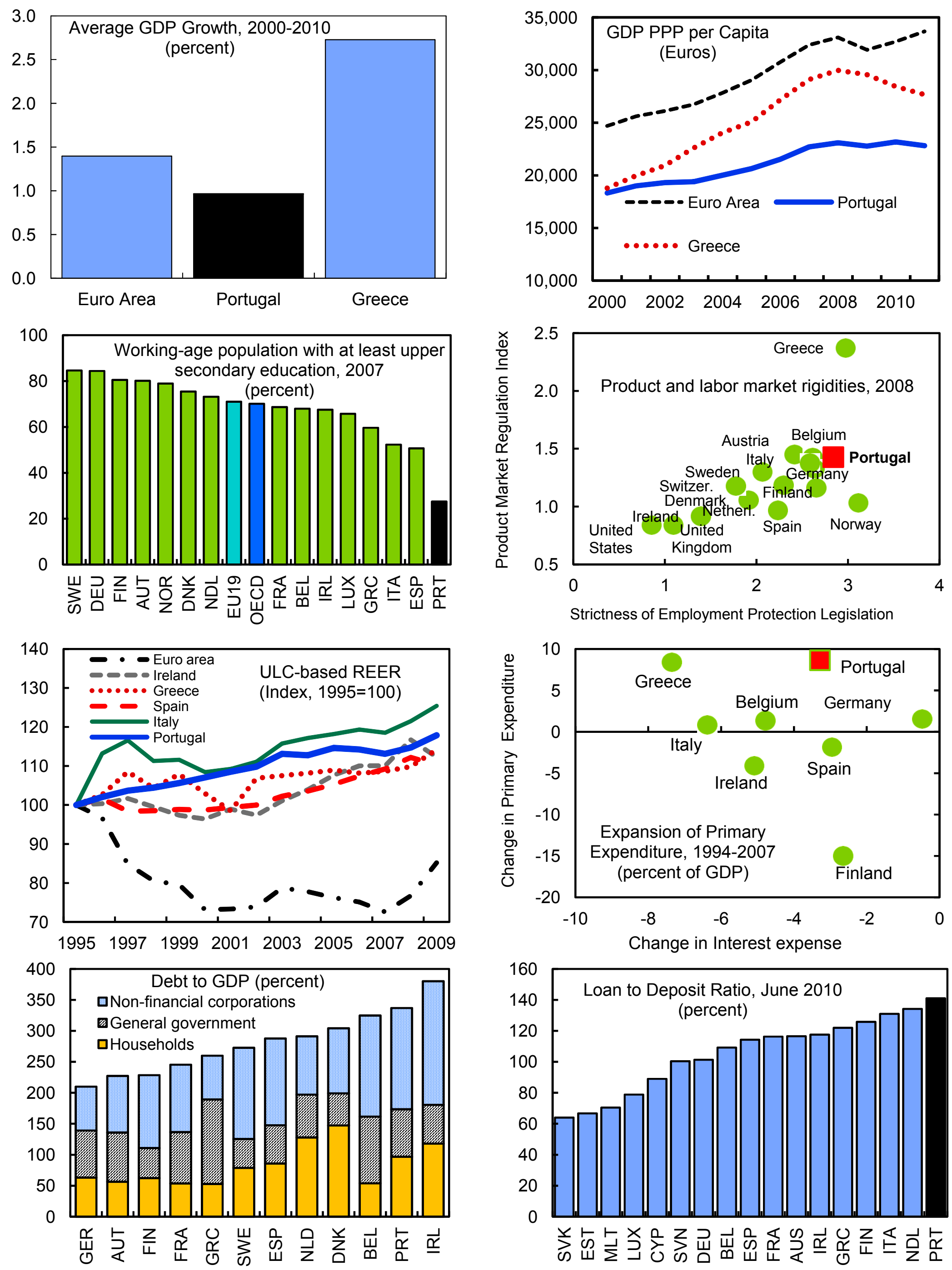
2. **Deep-rooted structural deficiencies have intensified Portugal's growth and competiveness problems.** Above all, impediments to competition and heavy protection in the non-tradable sector have pushed up costs, encouraged rent-seeking activities in the sector, and, importantly, inhibited development of the tradable sector. Moreover, labor market rigidities (especially as regards wage setting, unemployment benefits, and severance pay) and a large stock of low-skilled labor have contributed to high unemployment and low productivity growth. Furthermore, slow judicial process, weak court management, and severe backlog of cases have created serious obstacles to efficient economic activity. As a result, growth has averaged only 1 percent since 2000 and the per-capita income gap relative to the Euro area average has widened.

II. Recent Economic Developments

3. **GDP growth has slowed notably.** Real GDP increased by 1.3 percent in 2010 as the economy rebounded from the global crisis and as large liquidity support from the ECB partially offset disappearing wholesale funding for banks. GDP growth, however, weakened sharply in the last quarter of 2010 as private consumption contracted, and the preliminary

estimate for Q1 2011 (-0.7 percent qoq) suggests continued deceleration, with a weakening in domestic demand, particularly consumption, more than offsetting export growth.

Figure 1. Background to the Proposed Program



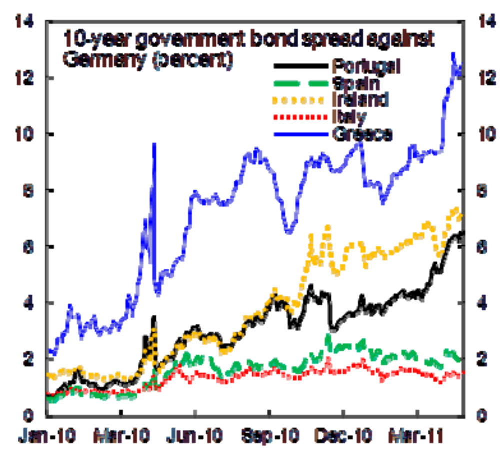
Sources: IMF, *World Economic Outlook*; OECD; Eurostat; and IMF staff calculations.

4. **The current account deficit remains high.** Exports have been relatively buoyant, but high imports prevented a significant adjustment in the current account deficit in 2010, which at 9.9 percent of GDP was only marginally lower than in 2009.

5. **Little progress was made in reducing the fiscal deficit in 2010.** Corrective actions were delayed until mid-year and were not fully implemented, in part because of a weak fiscal framework. The headline deficit of 9.1 percent of GDP—compared to 10.1 percent of GDP in 2009—would have been even higher if not for a one-off transfer of the Portugal Telecom's pension fund (of 1.6 percent of GDP) to the State. The deficits in both 2009 and 2010 were raised as a result of reclassifications of some SOEs and PPPs into the general government, as agreed by the authorities and Eurostat. These and other reclassifications raised the 2010 public debt by over 10 percent of GDP to 93 percent of GDP.

6. **The 2011 budget entails a significant tightening.** The tightening is estimated to amount to 5.7 percent of GDP, reflecting primarily a cut in public sector wages by 5 percent on average and an increase in the value-added standard tax rate by 2 percentage point. On the strength of those measures, staff projects a deficit of 5.9 percent of GDP in 2011, down significantly from last year—in particular if adjustment is made for the one-off transfer from Portugal Telecom—but still well short of the budget target of 4.6 percent of GDP.

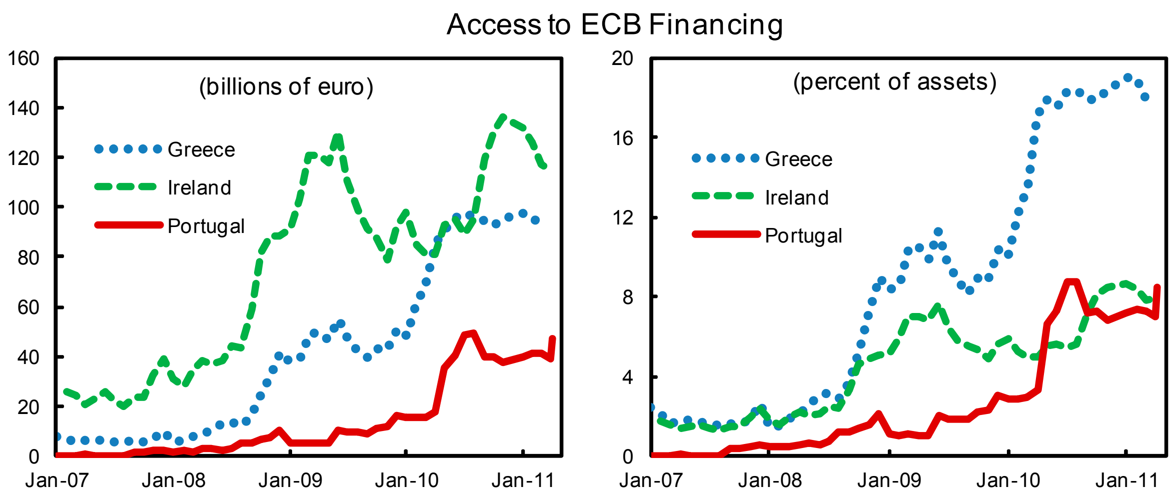
7. **Government funding costs have increased to post-euro record highs.** Portuguese 10-year spreads over Bunds increased to 650 basis points in early May. Moreover, as market access tightened, the government has increasingly resorted to shorter-term security issuance, resulting in a significant build-up of short-term securities in domestic banks' portfolios. The government also resorted to other types of financing, including a €1 billion private placement in early January, a five-year syndicated issue of €3.5 billion in February, and substantial short-term financing from domestic banks. Following the resignation of the government and the call for new elections, however, access to external financial markets has been virtually closed and participation of foreign investors in the domestic market has also decreased markedly.



Source: Bloomberg.

8. **While the financial system has weathered the crisis well so far, concerns about sovereign risk have put pressure on banks and the corporate sector.**

- **Funding risks for banks have increased substantially.** While bank deposits have remained fairly steady, distress in the sovereign debt market has spilled over into the bank wholesale market. This has caused a rapid tightening of the liquidity situation in the banking system because of banks' high loan-to-deposit ratios and the attendant large wholesale funding needs. As a result, recourse to ECB financing has increased in recent months to €48 billion (9 percent of banking sector assets) as of end-April 2011 (see text figure), and a drawdown in unused repo-eligible collateral to approximately €15 billion.



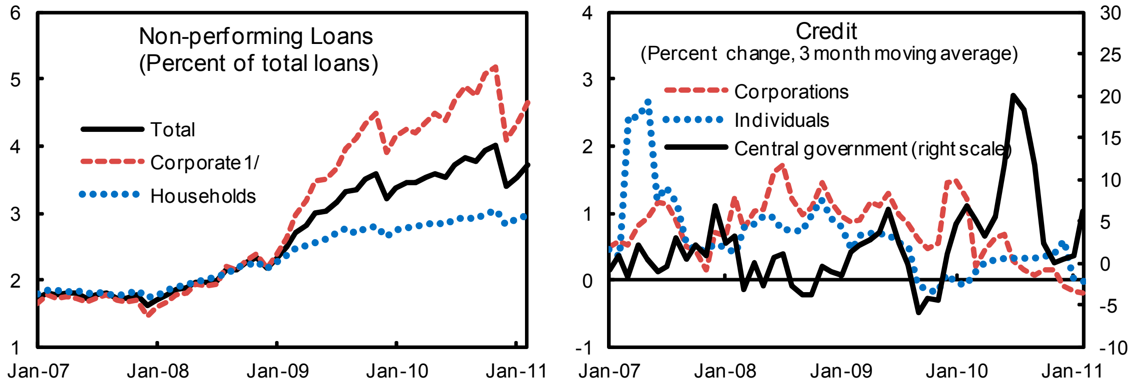
Sources: Banco de Portugal; and IMF staff calculations.

- **Credit to the corporate sector is contracting as banks have started to deleverage.** Increased funding strains and higher risk aversion has resulted in tighter credit policies over the past year, which translated into higher credit spreads, particularly for loans to non-financial corporations and long-term loans. Lending rates for corporates and consumer credit at short maturities have been rising and, at 6–7.5 percent, are well above European averages. At the same time, household credit growth fell to around 2 percent by end-2010 while corporate credit continues to decline in nominal terms this year, having already declined by 3 percent in 2010.

- **Reported capital is facing erosion and needs to be bolstered.** The reported overall capital adequacy ratio of 10.3 percent and a Tier 1 ratio of 8.3 percent at end-2010 were above regulatory requirements, but below those of other EU banks. Portuguese banks were not exposed to toxic assets or real estate bubbles and are still posting profits, but non-performing loans are rising sharply, particularly for the corporate sector (5 percent) and consumer credit (8.5 percent).[1]

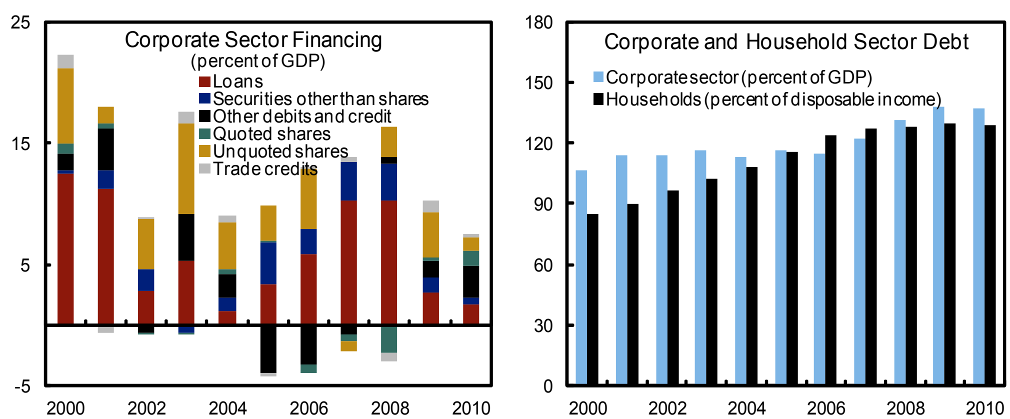
[1] NPLs related to some state-owned enterprises were reclassified to the general government in December 2010, effectively lowering the NPL ratio for corporate credit. While NPLs on consumer credit are fairly high, they represent only around 5 percent of the outstanding loan portfolio of banks, with household mortgage credit and credit to the non-financial corporate sector each accounting for about 40 percent of total loans. The local definition of NPLs refers to the past due part of loans, with the resulting ratios lower than in other countries in the region for the same level of loan delinquencies.

Asset Quality and Credit Growth



Sources: Banco de Portugal; and IMF staff calculations.
1/ The break in the series in December 2010 is the result of a reclassification of NPLs of state-owned enterprises.

- **Corporate and household sectors are highly susceptible to bank deleveraging.** With total liabilities amounting to nearly 140 percent of GDP, corporate financial indebtedness is amongst the highest in the Euro area. In addition, according to estimates of BdP, about 80 percent of liabilities of firms with financial debt are maturing within one year. Considering that bank loans account for over 50 percent of total financing, the corporate sector is, therefore, very vulnerable to domestic bank deleveraging. Household financial debt is also quite high (around 130 percent of disposable income or 96 percent of GDP), but debt servicing capacity has thus far been supported by a low interest rate environment, helping to keep NPLs low on household mortgages—over 90 percent of which are at variable rates. While risks are mounting, the current legal and institutional framework for addressing non-financial sector distress—including out of court procedures—remains inadequate. More generally, the judicial process remains inefficient and is mired with a severe backlog of cases that has cross-cutting impacts across fiscal, financial and real sectors.



Sources: Banco de Portugal; and IMF staff calculations.

III. PROGRAM STRATEGY AND MACROECONOMIC FRAMEWORK

A. Program Strategy

9. **Portugal faces immense economic challenges.** There is unanimity that low growth is the fundamental problem. The authorities' program will address this critical challenge with bold upfront measures to open the non-tradable sector to competition and reduce rent-seeking activities; restore competitiveness through an internal devaluation supported by labor market reform and fiscal policy; and improve the judicial system. In addition, the program aims to secure fiscal sustainability and bring the large private sector debt under control. The authorities, European partners, and staff agreed that to mitigate the adverse short-term impact of the required policies on growth, the pace of fiscal consolidation will be more balanced than earlier plans. Moreover, private sector deleveraging should be orderly to avoid adverse financial-real sectors feedback loops. The enormity of the problems, however, suggests that, notwithstanding these efforts, contraction in economic activity during 2011–12 is inevitable.

10. **The program addresses these challenges head-on while balancing risks.**

- **Enhancing competitiveness and growth.** In the absence of exchange rate policy, the program seeks an internal devaluation through front-loaded reforms to increase labor market flexibility, foster competition to exert downward pressure on non-tradable relative prices, and lower social security contributions to increase profitability in the tradable sector. These efforts will be complemented by measures to enhance productivity.

- **Instilling confidence and ensuring fiscal sustainability**. The fiscal consolidation strategy strikes a balance between the objective of restoring market confidence through a credible front-loading of measures and mitigating its impact on growth. To this end, the program targets an overall fiscal deficit of 5.9 percent of GDP in 2011, falling to 3 percent of GDP, with debt stabilizing by 2013. Consolidation will be supported by fiscal reforms to streamline the functioning of the public sector and reduce fiscal risks.

- **Safeguarding financial stability and avoiding excessively fast deleveraging.** Market-based solutions are being sought to boost capital positions of banks, restore confidence, and help banks progressively regain access to sustainable levels of wholesale market funding. At the same time, important safeguards will be incorporated into the program to limit the risk of severe private sector balance-sheet adjustment and ensure financial sector stability. In particular, with the support of the authorities, banks will take steps to strengthen their collateral buffers. In addition, a capital backstop mechanism to provide an additional safety net for banks will be set up, and the resolution framework for banks and corporates experiencing distress strengthened.

11. **Proposed financing under the program amounts to €78 billion.** The program provides the government with sufficient time to establish a strong track record of implementation, which should facilitate a return to market-based funding within two years at

reasonable rates. One-third of the total funding program will be covered through IMF financing (€26 billion or SDR 23.742 billion) and two-thirds (€52 billion) by European Union partners (see Section V on Program Design).

B. Macroeconomic Framework

12. **The economy is expected to contract in 2011–12.** The front-loaded fiscal adjustment and deleveraging of private sector balance sheets will suppress domestic demand and weigh on growth prospects in 2011–12. A cyclical rebound will lead to a strong recovery in growth in 2013–14, declining subsequently as potential growth is assumed to respond only gradually to structural reforms. Unemployment is projected to peak at 13 percent in 2012.

13. **Inflation is expected to be below the euro average over the medium term.** While indirect tax increases will exert one-off pressures on prices in 2011 and 2012, the effect will be mitigated by weak domestic demand. Over the medium-term, labor market reforms to lower unit labor costs and moderate private sector wage adjustments, as well as measures to increase competition in domestic markets, are expected to promote price competitiveness.

Portugal: Selected Macroeconomic Indicators, 2009-2016

	2009	2010	2011	2012	2013	2014	2015	2016
		(in percent of GDP, unless otherwise indicated)						
Real GDP (percent change)	-2.5	1.3	-2.2	-1.8	1.2	2.5	2.2	2.0
Consumer prices (percent change)	-0.9	1.4	3.5	2.1	1.4	1.5	1.5	1.6
Unemployment rate (percent)	9.6	11.0	12.1	13.4	13.3	12.0	10.8	9.8
General government balance	-10.1	-9.1	-5.9	-4.5	-3.0	-2.3	-1.9	-1.8
General government debt	83.0	93.0	106.4	112.2	115.3	115.0	112.9	111.0
Current account balance	-10.9	-9.9	-9.0	-6.7	-4.1	-3.4	-2.7	-2.2
Net IIP	-110.4	-107.5	-116.9	-123.3	-123.4	-121.4	-119.0	-116.4

Sources: Authorities and staff calculations

14. **The current account deficit is projected to narrow gradually.** The 11 percentage point cumulative decline in domestic demand projected over 2011–2013 will compress imports, particularly in 2011–12. Export growth is expected to remain robust over the forecast horizon, supported by implementation of competition-enhancing structural reforms. However, continued high interest costs on the large accumulated external debt will slow the adjustment in the current account deficit and the net international investment position.

IV. Policies Under the Program

A. Fiscal Policy

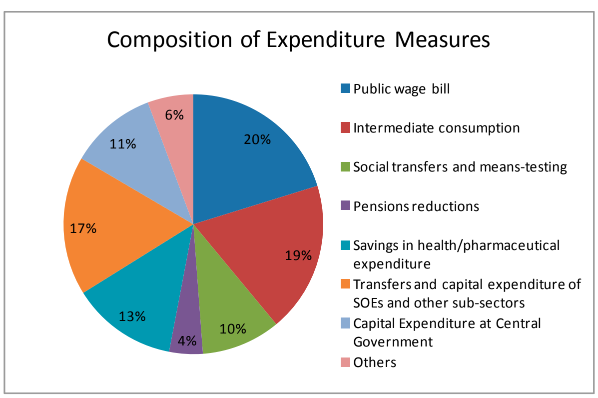
15. **Fiscal policy strikes a balance between regaining confidence and mitigating the impact on growth.** During the policy discussions, the authorities stressed their commitment to the EDP objectives, namely reaching a deficit of 3 percent of GDP and stabilizing debt by 2013. Staff argued that the original plan to over-perform and reach a deficit target of 2

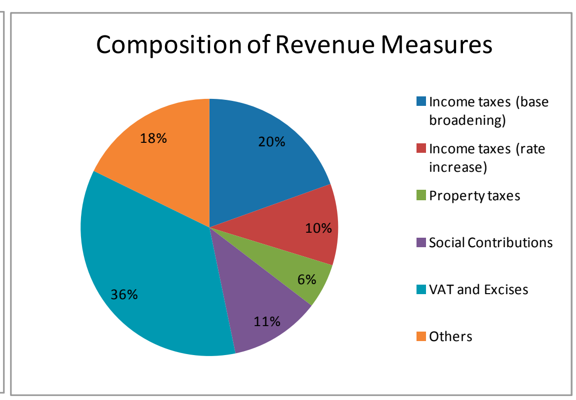
percent by 2013 was excessively ambitious and posed serious risks to growth. All parties agreed that under the circumstances it was important to protect growth by phasing-in the fiscal consolidation over the next three years with the support of fiscal and other structural reforms.

16. **At the same time, to ensure credibility the fiscal consolidation strategy is appropriately front-loaded.** The 2011 fiscal target requires discretionary fiscal measures in the budget amounting to 5.4 percent of GDP and additional spending compression (0.3 percent of GDP) relative to the 2011 budget. This front-loaded effort will be complemented with measures amounting to about 5 percent of GDP in 2012–13. At the same time, the program is carefully balanced between expenditure and revenue measures to minimize the negative impact of the fiscal consolidation on growth and the most vulnerable groups.

Fiscal Adjustment Measures, 2011–13(Percent of GDP)

Measures (in percent of GDP)	2011	2012	2013	Total
Revenue	2.0	0.9	0.5	3.4
Income Taxes	0.4	0.3	0.3	1.0
VAT	0.8	0.2	0.0	1.0
Social Contributions	0.3	0.1	0.0	0.4
Excise taxes	0.0	0.1	0.1	0.2
Property taxes	0.0	0.1	0.1	0.2
Other (incl. tolls, capital revenue)	0.5	0.1	0.0	0.6
Expenditure	3.7	2.1	1.4	7.2
Wage bill	0.9	0.3	0.2	1.4
Intermediate consumption	0.5	0.4	0.4	1.3
Pensions cut	0.0	0.3	0.0	0.3
Social Transfers	0.6	0.0	0.1	0.7
Savings in health/pharmaceutical expenditure	0.3	0.3	0.3	0.9
Savings/transfers to SOEs, Funds, and local/regional governments	0.6	0.5	0.2	1.2
Investment	0.3	0.3	0.2	0.8
Other	0.4	0.0	0.0	0.4
Total	5.7	3.0	1.9	10.6





Source: National Authorities; and IMF staff calculations.

17. **Total expenditures have reached unsustainable levels and are tilted towards unproductive spending.** The fiscal strategy will rein in current spending and stress improved assessment of capital expenditure decisions. Spending cuts will also cover defense, SOEs and local and regional government spending, where spending has not been monitored well and reforms have lagged. Specifically, the program incorporates the following measures (MEFP, ¶6)**:**

- Following the 5 percent average cut in public sector wages at the beginning of 2011, wages and pensions will be frozen through 2013, supported by a reduction through attrition in the size of the public sector.

- Significant savings will be made from reforms in the health sector through cuts in pharmaceutical spending, reduction in operational costs of hospitals, and increase in co-payments.

- Regarding capital expenditures, new large infrastructure projects are suspended until a thorough feasibility assessment is completed. In addition, line ministries will have to request pre-authorization before engaging in new capital expenditures and a public investment system will be implemented.

- On defense, the authorities will impose expenditures ceilings and enforce no new contracts; and reduce personnel and compensation by at least 10 percent during 2011-2014.

- Transfers to local and regional governments and other public bodies and entities will also be curtailed.

18. **The tax system is complex and distortive due to a myriad of benefits across all types of taxes.** It is also not sufficiently supportive of growth because of increasing reliance on direct taxation. With a view to supporting fiscal consolidation with a growth-friendly tax mix, the authorities aim at increasing the share of consumption taxes and reducing tax privileges (MEFP, ¶7):

- The higher VAT, PIT, and CIT rates in the 2011 budget are maintained during the program period and the list of goods and services subject to reduced VAT rates will be revised. The recurrent property tax (IMI) will be enhanced, excise taxes raised, and electricity taxation introduced.

- The existing tax benefits and incentives will be streamlined. On personal income tax, it will include caps on health, education, and housing allowances. On corporate income tax, it will (i) eliminate exemptions and reduced rates; (ii) limit the deduction of losses; and (iii) limit the carryover period to 3 years.

19. **In choosing fiscal measures, the authorities are protecting vulnerable groups.** The 5 percent cut in nominal public sector wages and the freezing of pensions in 2011 exempt those earning the lowest wages and pensions. The mean-testing program is being enhanced by applying unified and consistent selection criteria. In the health sector, an exemption threshold will be introduced to protect the most vulnerable from the proposed increase in “moderating fees” (for health care) increases and the reduction in exemptions.

B. Structural fiscal reform

20. **The authorities agreed on a comprehensive fiscal structural agenda to support the return to a sustainable medium-term fiscal position** (Annex 3). Increases in spending across the general government in recent years have resulted from limited fiscal transparency and weak monitoring and reporting mechanisms. Moreover, the proliferation of PPPs and SOEs and expansion of local and regional governments has increased fiscal risks (Annex 4) and confused the coverage of the general government’s activities. Furthermore, tax compliance is weak and there is a need to strengthen revenue administration. A comprehensive FAD TA agenda will focus on public financial management, revenue administration, SOEs, and PPPs.

21. **The authorities noted that the recently approved Budgetary Framework law will allow considerable improvements regarding the budget coverage, its implementation and monitoring**. They are committed to (i) publish a fiscal strategy for the general government; (ii) create an independent fiscal council; (iii) integrate SOE, PPP, and social security decisions with fiscal implications within the budget process; and (iv) monitor arrears and commitments, and strengthen commitment control procedures (MEFP, ¶9–13).

22. **The perimeter of the general government’s activities will be redefined by containing further expansion of SOEs, foundations, and associations.** To this end, the authorities will survey the existing entities; enforce a new set of public administration laws; and review the economic and financial profile of SOEs and the scope for their privatization. A comprehensive restructuring program for the central and local governments will be undertaken by reducing the number of administrative units, management positions, and employees (MEFP, ¶23–26).

23. **Staff stressed the importance of identifying and monitoring risks entailed by PPPs.** Under the program a thorough assessment of financial obligations, including contingent liabilities, will be conducted by a top tier international accounting firm. The authorities will also improve the legal and institutional framework to deal with PPPs (MEFP, ¶14–16).

24. **Bold reforms in revenue administration aim at improving tax compliance.** The program will support the implementation of the announced merger between the domestic and customs administrations. The audit system will be improved by increasing the number of

audit staff, modernizing the information systems, and increasing the power to collect third-party information. Finally, the appeals system will be strengthened (MEFP, ¶19–22).

C. Financial and Corporate Sector Policies

25. **Financial sector policies aim at ensuring financial stability and delinking the sector's access to markets from that of the sovereign.** Over the past year the fortunes of the banking sector have been closely tied to that of the sovereign. The program aims to encourage market-based solutions to strengthen banks' capital positions, including by attracting strategic investors with access to market funding to help further strengthen competitiveness in the banking sector. Safeguards are included in the program for capital support, with strict conditions, as well as to ensure adequate liquidity to avert a severe credit contraction. The program will also strengthen the supervision and monitoring framework.

26. **The immediate challenge is to manage the current tight liquidity conditions** (MEFP, ¶27)**.** Preserving adequate liquidity levels will be critical to avoid a credit crunch and adverse financial-real sector feedback loops. Despite the remaining unused eligible collateral in the banking system (approximately €15 billion), wholesale market net refinancing needs[2] are substantial (€25 billion over the next three months). While banks are taking measures to build up collateral further, difficulties in rolling over maturing liabilities may require additional measures to ensure sufficient system liquidity. The Bank of Portugal (BdP), in cooperation with the ECB, is prepared to take the appropriate measures to this end, and the authorities are raising the maximum amount of government guarantees for uncovered bank bonds to €35 billion (from the €20 billion previously available), which can be used by banks for ECB refinancing purposes subject to the approval of the Governing Council.

27. **Banks will increase capital to be in a stronger position to face weak growth prospects and the likely rise in losses on their balance sheets** (MEFP, ¶29–31). The BdP had already requested banks to raise their core Tier 1 capital level to 8 percent, but given the more challenging environment and to further enhance confidence in the solvency of the banking system and access to foreign resources, the requirements will be raised further to 9 percent by end-2011 and 10 percent at the latest by end-2012.[3] A Bank Solvency Support Facility—with resources of €12 billion that the authorities intend to provide in cash over the program period—has also been set up as a backstop mechanism to provide temporary capital injections for banks that might not be able to reach the higher capital requirements on time.[4]

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[2] Wholesale market net refinancing needs assumes no rollover of interbank liabilities or assets.

[3] The Core Tier 1 ratio of the five largest banking groups, representing 75 percent of assets of the banking sector, stood at 7.7 percent as of end-2010.

[4] Capital injections from the BSSF will be provided in cash rather than by issuing government bonds to strengthen further confidence in banks' solvency positions while also improving their liquidity.

However, to encourage market-based solutions, banks benefitting from equity injections will be subject to specific management rules and restrictions, as well as to a restructuring process. In light of its importance in the banking system and to preserve the sovereign's balance sheet, the state-owned banking group, Caixa Geral de Depósitos (CGD), will be expected to raise capital for its banking arm from internal resources, including through the already decided sale of the insurance arm of the group, as well as through the gradual disposal of all non-core subsidiaries, and, as needed, a reduction in the group's activities abroad.

28. **Monitoring of—and engagement with—the banking sector is being intensified to ensure an appropriate pace of deleveraging** (MEFP, ¶28, 31)**.** While the capital and liquidity support buffers should help cushion the impact of the crisis on banks' ability to extend credit, banks' deleveraging plans will also be monitored closely under the program to ensure consistency between banks' funding and lending policies, broad credit aggregates and the adjustment program. To this end, the BdP—in consultation with the EC, ECB, and Fund staff—is stepping up its solvency and deleveraging assessment framework, which will provide the basis for monitoring the deleveraging path of the main banks and request adjustments as needed.

29. **Financial sector stability is also being buttressed by reinforcing banking regulation and supervision and strengthening the early intervention and resolution framework** (MEFP, ¶32–35)**.** Disclosure on non-performing loans will be improved and other measures taken to strengthen supervisory practices and the early intervention and resolution framework (see Box 1 and MEFP, ¶34). The long standing Banco Português de Negocios (BPN) case will be brought to a close (MEFP, ¶33): following its split into a good bank-bad bank, with the undesirable assets isolated in three special purpose vehicles, and a failed sale last year, a new sale attempt on an accelerated schedule (by end-July) and without a minimum price, has been launched.

30. **Measures are being taken to help address rising risks in the corporate and household sectors.** The high level of indebtedness of the corporate and household sector represents an important risk to banks and the economy as a whole, in particular given the weak growth outlook and the ongoing deleveraging process. To help anticipate risks and formulate appropriate policy responses, monitoring of these sectors is being stepped-up considerably, and a task force is being constituted to prepare contingency plans for corporate and household sectors distress (MEFP, ¶37). To support these efforts, measures are being taken to facilitate effective corporate and household debt restructuring, including by amending the insolvency law and by strengthening out of court restructuring incentives (MEFP, ¶36).

Box 1. Principal Policies to address Private Sector Risks under the Program

The primary policies to address private sector risks under the program include:

For banks:

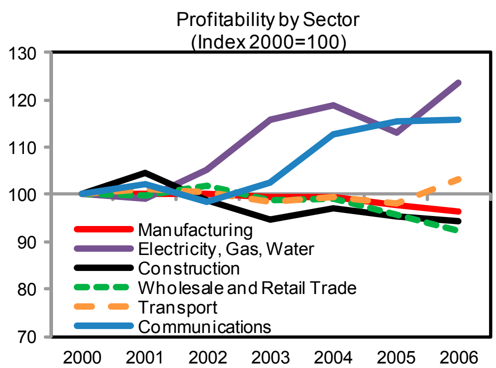
- Building up liquidity and capital buffers through market-based solutions, including from internal resources, through disposition of non-core assets, and by attracting strategic partners.
- Putting in place a Bank Solvency Support Facility (€12 billion), fully funded, with access conditions to support market-based solutions while limiting risks to the government.
- Ensuring adequate liquidity in the banking system by the BdP and the ECB, including by increasing the size of the government guarantee fund for bank bond issues to €35 billion which can be used by banks for ECB refinancing purposes subject to the approval of the Governing Council.
- Promoting an orderly and well balanced deleveraging of the banking sector by monitoring the deleveraging plans of the main banks, and ensuring consistency between funding and lending policies, broad credit aggregates and the adjustment program.
- Intensifying monitoring of the banking sector, including through the use of BdP's solvency and deleveraging assessment framework.
- Streamlining the state-owned CGD group to increase the capital base of its core banking arm as needed.
- Strengthening banking regulation and supervision through improved disclosure on non-performing loans, special on-site inspections and data verification, enhanced training of banking supervisors, and through recruitment of additional specialist banking supervisors.
- Improving the early intervention and resolution framework by imposing early reporting obligations, strengthening the remedial powers of BdP, requiring systemically important banks to prepare contingency resolution plans, and introducing an enhanced resolution regime for distressed credit institutions to promote financial stability and better protect depositors.
- Improving the deposit insurance framework by retaining the ability to solely fund the resolution of distressed credit institutions (subject to a cap) and providing for a depositor preference.
- Placing Banco Português de Negocios up for sale on an accelerated schedule and without a minimum price.

For the corporate sector and households:

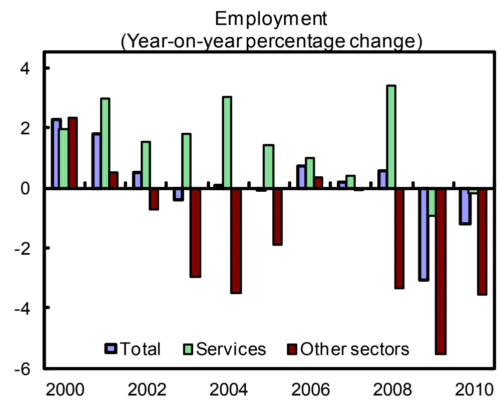
- Intensifying monitoring of risks through quarterly assessments, and preparing contingency plans for corporate and household sector distress.
- Reviewing the efficacy of existing corporate funding support measures.
- Refining the legal framework to facilitate orderly and efficient debt restructuring, including by amending the insolvency law to better support early rescue of viable firms and rehabilitation of financially responsible individuals and by strengthening out of court restructuring incentives.

D. Structural Policies

31. **The authorities have garnered broad political consensus for implementing far-reaching reforms to boost employment and growth and restore competitiveness**. Nominal wage growth above the euro area average and lagging productivity growth have priced out Portuguese workers, and employment in sectors more open to competition has declined. In protected sectors, profitability has risen and has led to reallocation of resources away from tradables. To address these and other deep-rooted factors at the heart of low competitiveness and growth (see paragraph 2), the program has been designed to promote adjustment in key structural areas. These include labor markets reforms to create jobs, increase productivity and promote competitiveness-enhancing wage adjustments, an upfront reduction in labor costs via a fiscal devaluation, and a far-reaching liberalization of the non-tradable sector.



Source: EU KLEMS database, and Fund staff calculations.



Labor market reforms

32. **Labor market reforms must address segmentation, the lengthening of unemployment duration, and increasingly limited firm-level flexibility in wage setting**. Segmented labor markets have caused protection of insiders, growing use of fixed term contracts, and low retention rates of fixed-term employees, despite potentially good skill matches. The unemployment insurance system is overly generous compared to both OECD and EU benchmarks, and evidence suggests that it creates disincentives for labor supply. High long-term and youth unemployment is also being driven by the low education and skill level of the labor force. The minimum wage has risen sharply recently and has reduced firm-level flexibility in setting wages. To address these impediments, key reforms under the program aim to:

- **Align labor contracts, with a view to reducing inefficient protection while broadening safety nets.** Policies under the program will revise the overly generous unemployment insurance system to change incentives and increase employment, while at the same time broadening social safety nets, by including new entrants and extending eligibility to the self-employed (MEFP, ¶38). Measures to be implemented over the next year will also reduce high severance payments, aligning them across fixed-term and open-ended contracts, and revise the overly restrictive interpretations of fair dismissal clauses in the labor code, reducing the bias toward using fixed-term contracts.

- **Promote labor cost developments consistent with enhancing firms' competitiveness.** Over the program period, any increase in the minimum wage will take place only if justified by economic conditions and agreed in the context of regular program reviews. In addition, commitments under the program will ensure clear criteria for the extension of collective wage bargaining agreements. These criteria will take into account the competitive position of firms. A number of measures to promote wage adjustments in line with productivity at the firm level are also envisaged (MEFP, ¶38).

- **Raise the quality of human capital and improve employability of the young and long-term unemployed.** The program will seek to improve current active labor market policies, and support continuing actions to tackle low educational attainment and early school leaving. This complements measures to enhance labor market flexibility, by ensuring that workers have the skill set necessary to move more easily into expanding opportunities.

Reducing reliance on labor taxes to promote an internal devaluation

33. **A potentially important policy move will be a plan to adopt a fiscally neutral reduction in labor costs, offset primarily by higher consumption taxes and expenditure cuts.** The strategy hinges on simulating the effect of currency depreciation: lower labor taxes increase the competitiveness of domestic production as firms pass on the decrease in labor costs to final producer prices, while higher consumption taxes reduce consumption. In addition the proposed reduction in labor costs is job creating. The impact of the reform, among other things, depends on the degree of competition in product markets, and the ability of labor markets to respond flexibly to the change in relative prices. The proposal, to be finalized ahead of the 2012 budget exercise, will be calibrated to take into account these considerations, as well as to mitigate the social impact of raising consumption taxes and ensure that changes to social security contributions do not place in jeopardy the sustainability of the pension system. Calibration will also consider the optimal mix of offsetting items (MEFP, ¶39).

Liberalization of the non-tradable sector

34. **To rebalance growth further toward the tradable sector, competition in the non-tradable sector must be promoted.** Low competition in key network industries, as well as other service sectors, has been the result of a competition framework that gives inadequate power to the competition authority, a high degree of state involvement in business activities, and over-regulation, even if not always binding, which ranks Portugal's business environment poorly against euro area benchmarks. Rent-seeking and excessive profits in

protected industries have created cost pressures which handicap the tradable sector, and have led to a less efficient resource allocation. To address these problems, the program will focus on:

- Market liberalization in electricity and gas, and a review of the efficiency and generosity of support schemes in the electricity sector that should reduce consumer prices (MEFP, ¶41).
- Facilitating entry in telecommunications and other services (MEFP, ¶41).
- Reducing state involvement in private sector activity and strengthening the independence of regulators (MEFP, ¶40). The Competition Law will be revised and, in the context of broader judicial reform, a new Court on Competition Matters will be established to allow more effective enforcement (MEFP, ¶41).

Privatization

35. **Privatization will raise efficiency while reducing state involvement and fiscal risks under the program.** The existing plan, elaborated through 2013, covers important players in transport, energy, communications, and insurance, as well as a number of smaller firms in high-tech industries. Pursuing a rapid disengagement of the public sector from transportation should be particularly effective in promoting growth: the potential for tourism development is high and would benefit from increasing competition and efficiency in the air sector. The program, thus, seeks acceleration as well as a broadening of the scope of privatization efforts. To that end, a detailed report on the operations and finances of all SOEs, to be finalized in early 2012, will serve as a guide to update the privatization plan (MEFP, ¶16–17).

Judicial Reform

36. **Improving the efficiency of judicial system is key to effective market functioning across sectors.** Slow judicial process, weak court management, and severe backlog of cases have adverse impacts on many sectors of the economy and have resulted in significant costs to stakeholders and society as a whole. Recognizing that it takes time to implement judicial reform, the initial set of measures will focus on speedy resolution of backlog cases and in particular tax and debt enforcement cases, restructuring of the court system to improve management efficiency, streamlining civil case processing in the courts; establishing sustainable and transparent budget for the judiciary, and promoting the use of alternative dispute resolution.

V. PROGRAM DESIGN

A. Access, Phasing, Conditionality

37. **The authorities have requested a three-year arrangement under the EFF for SDR 23,742 million (€26 billion), or 2, 305.7 percent of quota.** Portugal is facing a balance of payments need arising from a current account deficit and constrained access to external markets to roll over public sector external debt coming due. The external debt profile and a gradual adjustment in the current account deficit give rise to a projected total external financing gap of €78 billion. This will be covered in the ratio of 2 to 1 by European Union partners and the IMF. Taking into account the overall resources available to the authorities, including the EU-IMF financing, the authorities will have adequate funds to provide €12 billion to the Bank Solvency Support Facility, and to finance the resolution of BPN (expected to be partially recovered from subsequent asset sales). An extended arrangement accommodates the medium-term nature of Portugal's balance of payments problems, which cannot be resolved within the repurchase period provided under the credit tranche policies. European disbursements and repayment terms would be aligned to those under the EFF.

38. **Phasing of disbursements is necessarily front-loaded**. On approval of the extended arrangement, a disbursement of €6.1 billion will cover immediate financing needs. Resources for unwinding recent exceptional financing operations with the banking sector and other items of less immediate urgency have been delayed to the first review, when the new government will be in place. Disbursements in the first year of the program reflect large amortizations on medium and long-term external debt and the slow initial adjustment in the current account. Overall rollover rates on external debt for banks and households and corporates are assumed to fall to about 70 and 80 percent, respectively, in 2011, recovering over the following two years after a substantial fall in overall debt levels. For the sovereign, a gradual return to markets for medium and long-term debt is assumed, with access fully restored by the last year of the program. Rollover rates of 50 percent on maturing short-term debt are assumed for the first year, reflecting the current market stress and banks' need to deleverage, with full market access after that. To cover the risk that these markets may not reopen fully and other risks the program allows for the creation of a small financing buffer. Should market access be regained more promptly than assumed, the authorities have indicated their commitment in the LOI to refrain from drawing on the full EU/IMF financial support.

39. **Program conditionality is focused on monitoring of fiscal, structural, and financial sector performance**. Quantitative performance criteria include a floor on the consolidated General Government cash balance and ceilings on the stock of General Government debt, and a continuous ceiling on non-accumulation of new external payments arrears by the General Government. A continuous indicative target on the non-accumulation of domestic arrears will become effective from the first review, pending completion of a survey of General Government arrears (structural benchmark, end-August 2011).

40. **Prior actions and structural benchmarks have been developed in consultation with the EC/ECB to support the main goals of the program.** Fund conditionality has been tailored to support adjustment in macro-critical areas, which in Portugal's case include a number of important structural measures:

- **Prior actions** include an increase in the minimum risk-weighted capital adequacy requirement for banks to 10 percent, as well as critical measures improving fiscal control of state-owned enterprises, arrears and tax expenditures.

- Measures to improve **competitiveness** include aligning and reducing severance payments (end-July 2011), eliminating "golden shares"[5] (end-July 2011), amending the insolvency law (end-November 2011) and submitting a new competition law to Parliament (end-December 2011).

- Monitoring progress in **strengthening the financial sector** will be facilitated by an enhanced on-site inspection regime (end-June 2011), adding a new non-performing loan ratio in line with international practice (end-September 2011) and reforms to the intervention framework (end-November 2011).

- The inefficient **judicial process** has cross-cutting impacts across fiscal, financial and real sectors, and benchmarks on reviewing the Code of Civil Procedures and making arbitration for debt disputes operational are set for end- December 2011 and end-February 2012 respectively.

These measures are described in Table 2 of the MEFP.

B. Exceptional Access Criteria

41. **The proposed extended arrangement entails exceptional access.** Staff's assessment is that Portugal meets all four criteria for granting exceptional access, namely :

- **Criterion 1.** "*The member is experiencing or has the potential to experience exceptional balance of payments pressures on the current or capital account resulting in a need for Fund financing that cannot be met within the normal limits.*" Difficulties rolling over large public and private external debts are expected to generate persistent external financing needs over the next two years, as are ongoing current account deficits. The political crisis has exacerbated concerns about Portugal's large public sector borrowing

[5] A golden share is a nominal share which is able to outvote all other shares, and can give the government veto powers over any major corporate action, such as the sale of a major asset or subsidiary or of the company as a whole. The most recent use of such veto power was used to block Spanish Telefonica's bid to buy Portugal Telecom's stake in Brazil's Vivo. The bid had been accepted by PT's shareholders but blocked by government. The sale eventually went through, after EU courts ruled the veto in violation of EU law, by impeding the free movement of capital.

requirements, while much of this debt is held by non-residents. The private sector, in particular banks, face similar difficulties rolling over external debts, with financing needs currently met in part through liquidity assistance from the ECB. These financing requirements cannot be covered within the normal limits for Fund programs.

- **Criterion 2.** "*A rigorous and systematic analysis indicates that there is a high probability that the member's debt is sustainable in the medium term. However, in instances where there are significant uncertainties that make it difficult to state categorically that there is a high probability that the debt is sustainable over this period, exceptional access would be justified if there is a high risk of international systemic spillovers*." Staff calculations suggest that public debt will decline from a very high level after 2013 in the program baseline. Debt dynamics may worsen should growth, inflation, or real interest rate outturns be worse than expected, or contingent liabilities (e.g. from SOEs or PPPs) materialize, making it difficult to state categorically there is a high probability that debt is sustainable over the medium term. Fund support at the proposed level is justified given the high risk of international systemic spillover effects.

- **Criterion 3.** "*The member has prospects of gaining or regaining access to private capital markets within the timeframe when Fund resources are outstanding*." Implementation of the authorities' adjustment plans will increase credibility and reduce deficit financing needs, while the long-term growth payoff from structural reforms are expected to be visible by the end of the program. These two factors are expected to reduce sovereign default risks, enabling re-entry in private capital markets on reasonable terms within the timeframe when Fund resources are outstanding. Increased capital requirements for banks, underpinned by the resources available in the Bank Solvency Support Facility, and are designed to restore the banking systems' creditworthiness and access to wholesale funding markets.

- **Criterion 4.** "*The policy program of the member country provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment."* The adjustment plans represent a significant effort to address market pressures and to bolster fiscal sustainability. The main parties of the opposition have made public commitments to the program objectives and key measures, including adjustment. Broad consensus on complex structural reforms, such as labor market reforms, give confidence in policy continuity when the new government is in place. While institutional capacity to deliver the adjustment is judged adequate overall, Fund and EU technical assistance will be provided should specific areas require support. Staff's judgment is that the program has reasonably strong prospects for success.

C. Capacity to Repay the Fund and Risks to the Program

42. **Portugal's repayment capacity is expected to be sufficient**. The Fund's cumulative exposure to Portugal would be high. If resources are drawn according to schedule,

outstanding credit to the Fund would peak in 2014 at around 14½ percent of GDP. Debt service to the Fund at the peak in 2018, would amount to 5.4 percent of exports of goods and services and 2.4 percent of GDP.

43. **However, the program entails important risks**:

- The announced policy measures and the credibility provided by a Fund-supported program may fail to alleviate sovereign debt concerns, with an adverse impact on government financing prospects. In particular, refinancing risks from the closure or contraction of the Treasury bills market represent a near-term refinancing risk for the Government.

- Substantial fiscal consolidation and structural reform require social support and continued political consensus.

- Lower growth than expected would worsen the public debt dynamics substantially.

- Higher funding costs, rating downgrades, increasing non-performing loans, and portfolio losses could generate additional liquidity and solvency pressures on banks. Resort to public recapitalization could have macroeconomic, fiscal, and confidence effects.

- Even if domestic adjustment is implemented according to commitments under the program, there could be spillovers from deepening problems in the rest of the periphery. Despite the publicly-stated support for the program's overall objectives and key policies from the main opposition parties, the elections in June could slow program implementation.

44. **In accordance with Fund policy, staff has initiated the safeguards assessment of the BdP, and the assessment is expected to be complete by the time of the first review.** IMF funds will be deposited in the government accounts at the Bank of Portugal.

VI. Staff Appraisal

45. **Portugal has launched an ambitious and comprehensive program.** Its overarching focus is rightly on overcoming long-standing structural problems that have caused economic stagnation, lack of competitiveness, and high unemployment. At the same time, the program addresses large external and internal imbalances, through fiscal consolidation and by facilitating balance sheet adjustment in the banking system.

46. **The policy mix and the speed of adjustment are well calibrated.** Until supply-boosting reforms yield results, fiscal consolidation and financial deleveraging pose a particularly serious risk to growth and employment. In staff's view, the targeted fiscal path—notably the government's decision to ease the deficit target for 2011, but maintain the EDP target of 3 percent by 2013—appropriately balances the objective of minimizing the social

cost of adjustment with that of facilitating an early restoration of market confidence through ambitious and front-loaded fiscal adjustment. Large external support from the IMF and the EFSF are also key to avoiding socially-disruptive adjustment, as are several important measures in the program to mitigate the impact on the most vulnerable groups.

47. **The fiscal program is well-balanced and credible**: the adjustment is frontloaded, well specified for the full three-year period, mainly focused on expenditure cuts—in line with the need to reduce the public sectors demand on resources—and underpinned by comprehensive structural reforms in the public sector. Above all, the program has a much welcomed focus on regaining control over SOEs and PPPs, where large increases in public spending has taken place outside the control and scrutiny afforded by transparent budgetary processes. The analysis of contingent liabilities associated with PPPs, based on full access to contracts agreed with the state, is particularly important for assessing and managing fiscal risks going forward. The authorities should expect strong resistance from SOEs and PPPs to pose an early challenge to their determination to regain control over spending and to establish a clear perimeter for the public sector at all levels of government.

48. **Restoring banks' access to wholesale market financing is a priority.** While the high leverage points to underlying vulnerabilities, the primary problem facing the banking sector at this juncture is the gradual loss of funding as the government's financing problems have spilled over into the interbank market. A key objective of the program is therefore to restore banks' access to funding by strengthening their position through market-based means. The increase in capital adequacy requirements is a demanding but crucial first step in this regard. A capital backstop mechanism is available for banks that fail to meet this requirement, but conditions for using it must be such as to strongly encourage market based solutions. The state-owned bank CGD should not have access to this mechanism, but generate the necessary resources internally, by splitting off non-core assets. Meanwhile, the BdP should take decisive action to bring to closure the long-running BPN case.

49. **De-leveraging poses a potential risk.** In view of the high indebtedness of the corporate sector, it is essential to safeguard against adverse feed-back loops between the real and financial sectors and against the attendant risk of a damaging credit crunch. One such important safeguard is that the program provides considerable front-loaded financing from the EU/IMF for reducing the government's short-term liabilities to the banking system, which rose sharply as the government encountered mounting financing problems during the last year. Thus, the phasing of Fund support is important in delinking the banks from the sovereign and helping restore their market access. An equally crucial assumption for the credibility of the program is that the ECB maintains current channels for exceptional liquidity support until the banking system at large has regained normal access to funding, without prejudice to the ECB's focus on inflation control. While banks have scope for shedding non-core assets, shrinking their balance sheets by notably curtailing corporate sector credits would undermine the program's sustainability.

50. **Success hinges crucially on opening the economy to competition**. Plans to accelerate privatization, eliminate golden shares and other arrangements for government control of enterprises, and undertake regulatory reforms are a much welcomed first step. The notable reforms to make the labor market more flexible will also help boost productivity and competitiveness. Staff is particularly encouraged by the very bold plan to secure a deep and fiscally neutral cut in social security contributions. It is crucial that the package of offsetting fiscal measures, in addition to raising consumption taxes, rely to the extent possible on cutting public expenditures, thereby providing a direct link between efforts to reduce the public sector's claim on resources and competitiveness. Such a "fiscal devaluation" could potentially make a significant impact.

51. **Restoring competitiveness in a currency union will undoubtedly be challenging.** With no recourse to changing the exchange rate, the key question is whether the Government will succeed in reducing the external deficit through productivity boosting reforms that make the economy more competitive at current wage levels. If it fails, membership of the Euro Zone means that the economy will instead be forced to rebalance through a deep recession, including through a painful adjustment in nominal wages as unemployment surges. While it is unavoidable that Portugal will see a recession and a socially difficult rise in unemployment in 2011–12, staff believes that the recession should begin to bottom out during 2012 and give way to a gradual recovery in early 2013, provided that the ambitious reform program is implemented as planned. Without such reforms, the adjustment that lies ahead will be socially very difficult.

52. **The program is above all about creating opportunities and removing impediments to competition and employment**. Reforms of the non-tradable sector will rollback the barriers—formal and informal—that allow high profit margins and high prices, and the labor market reforms are essentially about giving a fair chance to outsiders to compete for jobs, not least the young. But the push-back from those that stand to lose privileges will undoubtedly be strong. In particular, the reforms of SOEs and PPPs and the opening-up of protected sectors are likely to soon encounter fierce resistance from vested interests, providing an early of test the authorities' determination to succeed. In this regard, the indication of support from the main opposition parties for the main objectives and key policies under the program hopefully suggest that a broader political resolve to tackle Portugal's long-standing problems might be emerging.

53. In view of Portugal's balance of payments need and the comprehensive package of adjustment measures already taken and proposed by the authorities, the staff supports the authorities' request for an Extended Arrangement in an amount equivalent to SDR 23.742 billion.

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

				Projections					
	2008	2009	2010	2011	2012	2013	2014	2015	2016
Real GDP	0.0	-2.5	1.3	-2.2	-1.8	1.2	2.5	2.2	2.0
Real domestic demand	0.8	-2.9	0.7	-5.8	-4.8	-0.4	1.4	1.0	0.6
Private consumption	1.3	-1.1	2.2	-4.3	-4.4	-0.8	1.2	0.8	0.3
Public consumption	0.4	3.7	1.8	-6.8	-4.8	-1.7	0.0	0.1	1.0
Gross fixed investment	-0.3	-11.2	-5.0	-9.9	-7.4	2.4	3.8	2.4	1.0
Private	-1.0	-13.3	-7.8	-6.5	-5.2	5.0	4.4	2.5	0.6
Government	4.3	3.1	10.9	-26.2	-21.0	-16.1	-1.7	2.0	4.7
Exports	-0.1	-11.6	8.8	6.2	6.0	6.4	6.4	6.6	6.6
Imports	2.3	-10.6	5.2	-5.3	-3.0	2.0	3.7	3.6	3.4
Contribution to Growth									
Total domestic demand	0.9	-3.2	0.7	-6.3	-5.0	-0.4	1.4	0.9	0.5
Private consumption	0.9	-0.7	1.5	-2.9	-2.9	-0.5	0.7	0.5	0.2
Public consumption	0.1	0.7	0.4	-1.4	-1.0	-0.3	0.0	0.0	0.2
Gross fixed investment	-0.1	-2.5	-1.0	-1.9	-1.3	0.4	0.6	0.4	0.2
Foreign balance	-1.0	0.7	0.6	4.1	3.2	1.6	1.1	1.3	1.5
Savings-investment balance (percent of GDP)									
Gross national savings	10.6	9.2	9.2	7.8	10.4	13.6	14.9	16.2	17.3
Private	11.9	16.2	15.7	11.1	12.8	14.9	15.6	16.5	17.2
Public	-1.3	-7.0	-6.6	-3.3	-2.4	-1.3	-0.7	-0.3	0.0
Gross domestic investment	22.5	19.9	19.0	18.0	17.1	17.3	17.5	17.6	17.5
Private	19.6	17.0	15.7	15.5	15.0	15.6	15.9	16.0	15.8
Public	2.9	2.9	3.3	2.5	2.1	1.7	1.6	1.6	1.7
Resource utilization									
Potential GDP	1.1	-0.2	-0.6	0.0	0.5	1.0	1.5	1.6	1.6
Output Gap (% of potential)	-0.2	-2.5	-0.6	-2.8	-5.0	-4.9	-4.0	-3.4	-3.0
Employment	0.5	-2.6	-1.5	-1.5	-1.1	0.4	1.1	1.2	0.8
Unemployment rate (%)	7.7	9.6	11.0	12.1	13.4	13.3	12.0	10.8	9.8
Prices									
GDP deflator	1.6	0.5	1.0	1.1	1.3	1.3	1.3	1.3	1.4
Consumer prices (harmonized index)	2.7	-0.9	1.4	3.5	2.1	1.4	1.5	1.5	1.6
Compensation per worker (whole economy)	2.8	4.6	2.6	-0.6	0.0	0.8	1.4	1.0	1.2
Labor productivity	-0.5	0.1	2.9	-0.7	-0.7	0.8	1.4	1.0	1.2
Unit labor costs (whole economy)	4.6	3.4	-1.6	0.1	0.7	0.0	0.0	0.0	0.0
Money and credit (end of period, percent change)									
Private sector credit	8.6	3.4	-0.2	-1.3	-0.5	1.0	1.5	2.7	3.5
Broad money	16.9	-3.3	-1.3	-1.1	-0.5	2.5	3.9	3.6	3.4
Interest rates (percent)									
6-month interbank rate	3.8	1.7	0.8	1.7	2.6	3.1	3.4	3.7	3.9
Government bond rate, 10-year	4.5	4.2	5.4	7.8	6.2	5.4	5.6	5.4	5.4
Fiscal indicators (percent of GDP)									
General government balance (percent of GDP)	-3.5	-10.1	-9.1	-5.9	-4.5	-3.0	-2.3	-1.9	-1.8
Revenues	41.1	39.7	41.5	41.8	42.4	42.3	42.4	42.4	42.3
Expenditures	44.6	49.8	50.7	47.7	46.8	45.3	44.8	44.3	44.1
Primary government balance (percent of GDP)	-0.5	-7.2	-6.1	-1.7	0.3	2.1	2.8	3.2	3.3
Structural balance	-3.8	-9.4	-9.6	-4.2	-1.4	0.0	0.0	-0.1	-0.2
General government debt	71.6	83.0	93.0	106.4	112.2	115.3	115.0	112.9	111.0
External sector (percent of GDP)									
Trade balance (goods)	-13.4	-10.6	-10.4	-8.5	-6.8	-5.8	-5.3	-4.6	-4.2
Current account balance	-12.6	-10.9	-9.9	-9.0	-6.7	-4.1	-3.4	-2.7	-2.2
Net international investment position	-96.1	-110.4	-107.5	-116.9	-123.3	-123.4	-121.4	-119.0	-116.4
Nominal effective rate: CPI based (2000=100)	109	109	107	107	106	106	105	105	104
REER based on CPI (2000=100)	113.6	113.1	110.6	111.5	111.8	111.3	111.0	110.4	110.0
(rate of growth)	0.8	-0.5	-2.2	0.8	0.3	-0.4	-0.3	-0.5	-0.4
Nominal GDP (billions of euro)	172.0	168.6	172.5	170.6	169.8	174.0	180.7	187.2	193.5

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

Table 2. Portugal: General Government Accounts

			Projections					
	2009	2010	2011	2012	2013	2014	2015	2016
				(millions of euros)				
Total revenues	66,967	71,664	71,258	71,906	73,609	76,716	79,283	81,861
Current receipts	65,390	67,150	69,093	69,752	71,400	74,423	76,908	79,405
Tax revenue	36,549	38,368	39,216	39,964	41,383	43,145	44,719	46,045
On goods and services	21,319	23,064	23,673	24,199	25,067	26,153	27,093	27,921
Direct taxes	15,231	15,304	15,543	15,766	16,316	16,992	17,626	18,123
Social security contributions	21,090	21,004	21,382	21,283	21,469	22,198	22,823	23,678
Other current revenues	7,750	7,778	8,496	8,505	8,548	9,080	9,365	9,683
Capital revenues	1,577	4,514	2,165	2,154	2,209	2,294	2,375	2,456
One-off transfer (PT)		2,800						
Total expenditures	84,006	87,425	81,300	79,500	78,808	80,954	82,919	85,272
Primary expenditures	79,134	82,230	74,173	71,362	70,001	71,652	73,378	75,431
Compensation of employees	21,295	21,105	19,590	19,080	18,608	18,527	18,605	19,022
Intermediate consumption	8,322	8,858	7,278	6,761	6,644	6,943	7,147	7,389
Subsidies	1,342	1,293	1,183	864	787	906	929	960
Social transfers	36,950	37,707	37,506	37,132	37,356	38,525	39,751	40,871
Other	4,342	4,259	3,775	3,288	3,014	3,108	3,224	3,333
Interest payments	4,872	5,195	7,127	8,137	8,807	9,302	9,541	9,841
Capital expenditures	6,883	9,007	4,840	4,236	3,593	3,643	3,722	3,854
Fixed capital formation	4,961	5,653	4,341	3,498	2,972	2,968	3,074	3,274
Net lending	1,921	3,354	499	738	620	674	648	581
Overall balance	**-17,039**	**-15,760**	**-10,042**	**-7,594**	**-5,199**	**-4,238**	**-3,636**	**-3,411**
				(percent of GDP)				
Total revenues	39.7	41.5	41.8	42.4	42.3	42.4	42.4	42.3
Current receipts	38.8	38.9	40.5	41.1	41.0	41.2	41.1	41.0
Tax revenue	21.7	22.2	23.0	23.5	23.8	23.9	23.9	23.8
On goods and services	12.6	13.4	13.9	14.3	14.4	14.5	14.5	14.4
Direct taxes	9.0	8.9	9.1	9.3	9.4	9.4	9.4	9.4
Social security contributions	12.5	12.2	12.5	12.5	12.3	12.3	12.2	12.2
Other current revenues	4.6	4.5	5.0	5.0	4.9	5.0	5.0	5.0
Capital revenues	0.9	2.6	1.3	1.3	1.3	1.3	1.3	1.3
One-off transfer (PT)		1.6						
Total expenditures	49.8	50.7	47.7	46.8	45.3	44.8	44.3	44.1
Primary expenditures	46.9	47.7	43.5	42.0	40.2	39.6	39.2	39.0
Compensation of employees	12.6	12.2	11.5	11.2	10.7	10.3	9.9	9.8
Intermediate consumption	4.9	5.1	4.3	4.0	3.8	3.8	3.8	3.8
Subsidies	0.8	0.7	0.7	0.5	0.5	0.5	0.5	0.5
Social transfers	21.9	21.9	22.0	21.9	21.5	21.3	21.2	21.1
Other	2.6	2.5	2.2	1.9	1.7	1.7	1.7	1.7
Interest payments	2.9	3.0	4.2	4.8	5.1	5.1	5.1	5.1
Capital expenditures	4.1	5.2	2.8	2.5	2.1	2.0	2.0	2.0
Fixed capital formation	2.9	3.3	2.5	2.1	1.7	1.6	1.6	1.7
Net lending	1.1	1.9	0.3	0.4	0.4	0.4	0.3	0.3
Overall balance	**-10.1**	**-9.1**	**-5.9**	**-4.5**	**-3.0**	**-2.3**	**-1.9**	**-1.8**
Memorandum items:								
Nominal GDP	**168,610**	**172,546**	**170,582**	**169,754**	**174,044**	**180,744**	**187,192**	**193,540**
Real GDP growth	**-2.5**	**1.3**	**-2.2**	**-1.8**	**1.2**	**2.5**	**2.2**	**2.0**
Public debt	139,945	160,470	181,546	190,510	200,744	207,781	211,417	214,829
Stuctural balance (percent of GDP)	-9.4	-9.6	-4.2	-1.4	0.0	0.0	-0.1	-0.2
Primary balance (percent of GDP)	-7.2	-6.1	-1.7	0.3	2.1	2.8	3.2	3.3
Public debt (percent of GDP)	83.0	93.0	106.4	112.2	115.3	115.0	112.9	111.0

Source: Ministry of Finance, and Fund staff projections

Table 3. Portugal: Public sector financing requirements and sources
(In billion of euros)

	2009	2010	2011	2012	2013	2014	2015	2016
Gross borrowing need	**38.8**	**42.3**	**56.5**	**36.0**	**29.9**	**30.0**	**24.6**	**29.8**
Overall balance	17.0	15.8	10.0	7.5	5.1	4.2	3.6	3.2
Amortization	21.7	26.5	29.6	24.0	18.7	23.0	21.0	26.6
M&LT	7.2	7.3	9.6	12.7	9.8	14.1	10.6	9.9
Residents	1.8	2.9	3.8	5.1	3.9	5.6	4.2	4.0
Non-residents	5.4	4.4	5.7	7.6	5.9	8.5	6.4	5.9
ST	14.5	19.2	20.1	11.2	8.9	8.9	8.9	8.9
Residents	0.8	2.2	9.1	5.1	2.7	2.7	2.7	2.7
Non-residents	13.7	17.0	11.0	6.1	6.1	6.1	6.1	6.1
EU and IMF	0.0	0.0	0.0	0.0	0.0	0.0	1.5	7.8
Other 1/	0.0	0.0	16.8	4.5	6.1	2.8	0.0	0.0
Gross financing sources	**38.8**	**42.3**	**18.7**	**10.9**	**19.9**	**24.8**	**24.6**	**29.8**
Privatization receipts	0.0	0.9	2.0	2.0	1.0	0.0	0.0	0.0
Market access	38.8	41.4	16.7	8.9	18.8	24.8	24.6	29.8
M&LT	19.6	21.3	5.5	0.0	10.0	16.0	15.8	20.9
Residents	7.8	11.6	1.6	0.0	4.0	5.7	5.7	8.7
Non-residents	11.8	9.7	3.8	0.0	5.9	10.2	10.1	12.2
ST	19.2	20.1	11.2	8.9	8.9	8.9	8.9	8.9
Residents	2.2	9.1	5.1	2.7	2.7	2.7	2.7	2.7
Non-residents	17.0	11.0	6.1	6.1	6.1	6.1	6.1	6.1
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing gap	**0.0**	**0.0**	**37.8**	**25.0**	**10.0**	**5.1**	**0.0**	**0.0**
European Union	…	…	25.2	16.7	6.7	3.4	…	…
IMF	…	…	12.6	8.3	3.3	1.7	…	…
Net placement (market access-amortization)	17.0	14.9	-12.9	-15.1	0.1	1.9	3.6	3.2
Residents	7.4	15.6	-6.2	-7.4	0.1	0.1	1.4	4.8
M&LT	6.0	8.7	-2.2	-5.1	0.1	0.1	1.4	4.8
ST (net increase)	1.4	6.9	-4.0	-2.4	0.0	0.0	0.0	0.0
Non-residents	9.7	-0.7	-6.7	-7.6	0.0	1.8	3.7	6.3
M&LT	6.4	5.3	-1.9	-7.6	0.0	1.8	3.7	6.3
ST (net increase)	3.3	-6.0	-4.8	0.0	0.0	0.0	0.0	0.0

Source: Portugese authorities and Fund staff estimates.

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

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

	2008	2009	2010	Projections 2011	2012	2013	2014	2015	2016
				(Billions of euro)					
Current account	**-21.7**	**-18.4**	**-17.1**	**-15.4**	**-11.3**	**-7.2**	**-6.2**	**-5.0**	**-4.2**
Trade balance	-23.0	-17.8	-17.9	-14.6	-11.5	-10.2	-9.6	-8.6	-8.1
Exports fob	39.2	32.0	36.9	41.0	43.8	47.0	50.6	54.7	59.3
Imports fob	62.2	49.8	54.8	55.6	55.3	57.2	60.2	63.3	67.5
Services, net	6.6	6.0	6.7	8.4	8.7	9.6	10.1	10.5	11.2
Exports	17.9	16.3	17.6	18.8	19.1	20.3	21.4	22.5	23.7
Imports	11.3	10.3	10.9	10.4	10.4	10.7	11.3	12.0	12.5
Of which:									
Tourism	4.5	4.2	4.7	5.4	5.6	6.1	6.6	6.9	7.2
Exports	7.4	6.9	7.6	8.1	8.3	8.9	9.5	9.9	10.5
Imports	2.9	2.7	3.0	2.7	2.7	2.7	2.9	3.0	3.3
Income, net	-7.8	-8.7	-8.0	-11.5	-11.0	-9.2	-9.4	-9.8	-10.3
Current transfers, net	2.5	2.1	2.2	2.2	2.4	2.5	2.7	2.8	3.0
Private remittances, net	2.6	2.1	2.2	2.4	2.5	2.6	2.7	2.8	2.9
Official transfers, net	-0.2	0.1	0.0	-0.2	-0.1	-0.1	-0.1	0.0	0.1
Capital account	**2.6**	**1.4**	**1.9**	**1.5**	**1.5**	**1.6**	**1.7**	**1.8**	**1.7**
Financial account	**19.1**	**15.7**	**15.6**	**-23.9**	**-15.3**	**-4.4**	**-0.6**	**3.3**	**2.5**
Direct investment	1.3	1.4	7.6	4.5	0.8	0.9	1.4	1.4	1.4
Portuguese investment abroad	-1.9	-0.6	6.5	3.4	-0.7	-1.1	-1.2	-1.2	-1.3
Foreign investment in Portugal	3.2	1.9	1.1	1.1	1.5	2.0	2.6	2.6	2.7
Portfolio investment, net	14.7	13.3	-9.6	-31.9	-20.5	-5.8	0.8	3.6	1.6
Financial derivatives	0.2	0.3	0.2	0.3	0.0	0.0	0.0	0.0	0.0
Other investment, net	3.0	0.8	18.3	3.5	4.5	0.5	-2.7	-1.7	-0.5
Reserve assets	-0.1	0.1	-1.0	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	-0.1	1.3	-0.5	0.0	0.0	0.0	0.0	0.0	0.0
Prospective financing	…	…	…	37.8	25.0	10.0	5.1	…	…
European Union (2/3 of total)	…	…	…	25.2	16.7	6.7	3.4	…	…
IMF (1/3 of total)	…	…	…	12.6	8.3	3.3	1.7	…	…
Memorandum items:									
Net international investment position 1/	-165.2	-186.2	-185.6	-199.5	-209.2	-214.8	-219.4	-222.7	-225.2
Direct investment, net	-26.6	-32.1	-34.4	-38.9	-39.7	-40.6	-42.0	-43.4	-44.8
Portfolio investment, net	-53.4	-70.0	-51.3	-57.2	-61.8	-66.0	-71.9	-75.5	-77.1
Financial derivatives	0.2	-0.4	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
Other investment, net	-93.9	-94.7	-114.4	-117.9	-122.4	-122.9	-120.1	-118.4	-118.0
Reserve assets	8.6	11.1	15.7	15.7	15.7	15.7	15.7	15.7	15.7
Nominal GDP	172.0	168.6	172.5	170.6	169.8	174.0	180.7	187.2	193.6
				(Percent of GDP)					
Current account	**-12.6**	**-10.9**	**-9.9**	**-9.0**	**-6.7**	**-4.1**	**-3.4**	**-2.7**	**-2.2**
Current account (including capital transfers)	-11.1	-10.1	-8.8	-8.1	-5.8	-3.2	-2.5	-1.8	-1.3
Of which: Balance of goods and services	-9.5	-7.0	-6.5	-3.6	-1.6	-0.3	0.3	1.0	1.6
Net international investment position 1/	-96.1	-110.4	-107.5	-116.9	-123.3	-123.4	-121.4	-119.0	-116.3
Direct investment, net	-15.4	-19.0	-19.9	-22.8	-23.4	-23.3	-23.2	-23.2	-23.1
Portfolio investment, net	-31.1	-41.5	-29.8	-33.5	-36.4	-37.9	-39.8	-40.3	-39.8
Financial derivatives	0.1	-0.3	-0.6	-0.7	-0.7	-0.6	-0.6	-0.6	-0.6
Other investment, net	-54.6	-56.2	-66.3	-69.1	-72.1	-70.6	-66.5	-63.3	-60.9
Reserve assets	5.0	6.6	9.1	9.2	9.3	9.0	8.7	8.4	8.1

Sources: Bank of Portugal; and IMF staff calculations.

1/ End-of-period data.

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

	2008	2009	2010	2011	2012	2013	2014	2015	2016
GROSS FINANCING REQUIREMENTS	**169.4**	**172.8**	**186.0**	**212.6**	**209.6**	**201.2**	**194.3**	**184.3**	**181.7**
Current account deficit	21.7	18.4	17.1	15.4	11.3	7.2	6.2	5.0	4.2
Medium- and long-term debt amortization	22.1	23.5	28.9	27.0	28.7	25.2	24.1	17.6	15.6
Public sector	7.3	5.4	4.4	5.7	7.6	5.9	8.5	6.4	5.9
Banks	11.4	14.5	20.5	17.2	17.2	12.7	10.1	7.5	5.6
Other private	3.4	3.7	4.0	4.1	3.8	6.6	5.5	3.8	4.0
Short-term debt amortization	125.6	130.9	140.0	170.1	169.5	168.9	164.0	160.1	154.1
Public sector	17.0	32.7	40.4	70.9	81.6	85.7	79.1	72.0	62.0
Central Bank	6.2	19.0	23.4	59.9	75.4	79.5	73.0	65.8	55.8
General government and SOEs	10.8	13.7	17.0	11.0	6.1	6.1	6.1	6.1	6.1
Banks	90.6	80.1	80.0	77.5	67.3	63.6	65.2	67.5	70.5
Other private	18.0	18.1	19.5	21.8	20.7	19.6	19.6	20.6	21.7
EU and IMF		0.0	0.0	0.0	0.0	0.0	0.0	1.5	7.8
SOURCES OF FINANCING	**169.4**	**172.8**	**186.0**	**174.8**	**184.5**	**191.2**	**189.2**	**184.3**	**181.7**
Capital account (net)	2.6	1.4	1.9	1.5	1.5	1.6	1.7	1.8	1.7
Foreign direct investment (net)	1.3	1.4	7.6	4.5	0.8	0.9	1.4	1.4	1.4
Inward	3.2	1.9	1.1	1.1	1.5	2.0	2.6	2.6	2.7
New borrowing and debt rollover	164.4	185.3	194.0	173.4	177.6	188.1	187.7	179.6	175.7
Medium and long-term borrowing	33.4	45.3	23.9	3.9	8.7	24.1	27.5	25.5	26.5
Public sector	14.1	11.8	9.7	3.8	0.0	5.9	10.2	10.1	12.2
Banks	15.4	26.2	5.6	0.0	6.4	11.6	11.5	10.8	9.5
Other private	3.9	7.3	8.5	0.0	2.3	6.6	5.8	4.5	4.8
Short-term borrowing	131.0	140.0	170.1	169.5	168.9	164.0	160.1	154.1	149.2
Public sector	32.7	40.4	70.9	81.6	85.7	79.1	72.0	62.0	52.2
Central Bank	19.0	23.4	59.9	75.4	79.5	73.0	65.8	55.8	46.1
General government and SOEs	13.7	17.0	11.0	6.1	6.1	6.1	6.1	6.1	6.1
Banks	80.2	80.0	77.5	67.3	63.6	65.2	67.5	70.5	74.2
Other private	18.1	19.5	21.8	20.7	19.6	19.6	20.6	21.7	22.7
Other	1.0	-15.2	-17.6	-4.7	4.7	0.7	-1.5	1.6	2.9
Of which: Net errors and omissions	-0.1	1.3	-0.5	0.0	0.0	0.0	0.0	0.0	0.0
FINANCING GAP	**0.0**	**0.0**	**0.0**	**37.8**	**25.0**	**10.0**	**5.1**	**0.0**	**0.0**
European Union (2/3 of total)	0.0	0.0	0.0	25.2	16.7	6.7	3.4	0.0	0.0
IMF (1/3 of total)	0.0	0.0	0.0	12.6	8.3	3.3	1.7	0.0	0.0
ROLLOVER RATES									
General government	153.7	150.4	96.7	59.7	44.6	100.0	112.2	129.6	151.7
Private	95.4	114.4	91.4	73.0	84.3	100.6	104.9	108.2	109.3
Banks	93.8	112.3	82.6	71.1	82.8	100.8	104.9	108.5	110.0
Non-financial corporates	102.8	123.5	128.9	80.2	89.5	100.0	105.0	107.3	107.4

Source: Bank of Portugal and staff estimates.

Table 6. Portugal: Selected Financial Indicators of the Banking System, 2005–10

(In percent)

	2005	2006	2007	2008	2009	2010Q1	2010Q2	2010Q3	2010Q4
Capital Adequacy									
Regulatory capital to risk-weighted assets	12.5	11.8	10.4	9.4	10.5	10.3	10.1	9.8	10.3
Regulatory Tier 1 capital to risk-weighted assets	8.3	8.7	7.0	6.6	7.9	7.8	8.0	7.9	8.3
Capital to assets 1/	6.2	6.6	6.5	5.8	6.5	6.5	6.2	6.3	6.7
Asset composition and quality									
Nonperforming loans net of provisions to capital 2/	2.9	2.5	4.1	7.6	7.9	8.9	10.4	11.8	10.5
Nonperforming loans to total gross loans 2/	1.5	1.3	1.4	1.8	2.8	3.0	3.2	3.5	3.3
Large exposures to capital 1/	63.4	75.3	79.8	83.3	83.6		109.6		126.2
Sectoral distribution of loans									
Residents	81.2	80.2	83.7	83.7	83.6	82.6	82.4	82.6	83.3
Deposit-takers	5.5	5.2	6.2	6.2	5.8	5.4	4.9	4.6	5.5
Central bank	1.6	1.6	1.3	1.3	1.2	1.0	0.9	0.8	0.5
Other financial corporations	3.4	3.4	3.6	3.6	3.7	3.6	3.9	3.9	3.9
General government	1.8	1.7	1.6	1.6	1.7	1.8	2.7	2.3	2.9
Nonfinancial corporations	29.4	28.7	31.6	31.6	31.5	31.2	30.8	31.2	30.7
Other domestic sectors	39.5	39.7	39.5	39.5	39.6	39.6	39.1	39.8	39.9
Nonresidents	18.8	19.8	16.3	16.3	16.4	17.4	17.6	17.4	16.7
Earnings and profitability									
Return on assets	1.0	1.2	1.1	0.4	0.4	0.6	0.5	0.5	0.5
Return on equity	15.9	18.3	16.6	5.6	7.3	8.8	8.4	7.7	7.5
Interest margin to gross income	51.8	52.0	54.0	59.5	53.8	52.9	52.1	52.6	52.2
Noninterest expenses to gross income	58.5	53.9	55.4	58.0	58.3	59.2	58.4	58.8	58.8
Liquidity									
Liquid assets to total assets 3/	14.8	13.5	11.2	12.8	13.2	13.3	14.7	17.6	18.0
Liquid assets to short-term liabilities 3/	95.1	91.2	85.6	67.8	84.5	72.8	73.5	88.4	85.3
Credits as percent of deposits 4/	…	…	147.1	145.7	147.9	149.2	152.7	144.2	143.7
Customer deposits to total (noninterbank) loans	66.4	62.8	59.5	59.0	59.2	58.4	56.9	60.1	60.4
Foreign-currency-denominated liabilities to total liabilities 5/	7.4	8.1	5.8	5.8	5.1	5.6	5.5	5.2	5.1

Sources: Bank of Portugal; and IMF staff estimates.

1/ On accounting basis; consolidated.

2/ On a consolidated basis.

3/ Three-month residual maturity.

4/ Net credit, including securitized and non derecognised credits, for domestic banks only.

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

Table 7. Portugal Monetary Survey, 2008–10
(In millions of euros, unless otherwise indicated; end of period)

	Dec-08	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
Aggregated Balance Sheet of Monetary Financial Institutions (MFIs)						
Assets	423,808	459,663	468,845	479,655	478,301	490,570
Cash	1,716	1,786	1,647	1,459	1,497	1,690
Claims on Bank of Portugal	7,119	10,557	8,510	6,751	4,480	6,611
Claims on other FIs	27,376	34,318	35,417	38,242	42,492	50,095
Claims (Loans) on non MFIs	281,371	297,020	297,277	307,693	307,852	313,198
General government	10,184	16,715	18,745	27,018	26,516	33,485
Private sector	271,187	280,305	278,532	280,675	281,336	279,713
Claims on non-residents	100,051	111,926	122,491	122,514	118,930	114,117
Other assets	6,175	4,056	3,503	2,998	3,054	4,859
Liabilities	423,808	459,663	468,845	479,655	478,301	490,570
Liabilities to Bank of Portugal (ECB access)	10,217	16,503	16,078	41,509	41,194	41,936
Liabilities to other FIs	38,600	46,711	52,429	52,337	56,425	59,420
Deposits of non MFIs	151,591	154,009	145,931	148,235	156,114	162,771
General government	7,045	6,436	6,414	7,918	11,505	7,282
Private sector	144,546	147,573	139,517	140,317	144,609	155,489
Securities other than capital	46,985	67,867	73,779	66,629	62,367	62,593
Liabilities to non-residents	145,364	139,774	146,122	138,023	129,653	129,403
Other	-4,856	-7,564	-8,167	-8,730	-9,206	-8,229
Capital and reserves	35,906	42,378	42,674	41,652	41,753	42,673
Money and Credit						
Net foreign assets	-40,590	-24,906	-21,754	-39,147	-37,127	-39,165
o/w Bank of Portugal	4,723	2,941	1,877	-23,638	-26,404	-23,879
o/w commercial banks	-45,313	-27,848	-23,631	-15,509	-10,723	-15,286
Net domestic assets	223,794	202,045	196,581	208,864	207,498	213,913
Public sector credit	6,881	13,906	16,188	23,538	19,455	29,885
Private sector credit	265,697	260,982	259,032	259,728	260,161	256,528
Other	-48,903	-72,962	-78,639	-74,947	-72,804	-73,761
Broad Money (M3)	183,204	177,139	174,827	169,717	170,371	174,748
Intermediate money (M2)	167,224	157,894	153,948	150,955	154,590	169,560
Narrow money (M1)	68,123	70,637	68,539	71,865	71,191	69,930
Public sector credit	10,184	16,715	18,745	27,018	26,516	33,485
Private sector credit	271,187	280,305	280,776	282,981	283,639	279,713
			(percent of GDP)			
Broad Money	106.5	105.4	103.3	99.5	99.2	101.0
Private sector credit	157.6	166.8	165.8	165.9	165.1	161.6
Public sector credit	5.9	9.9	11.1	15.8	15.4	19.3
			(percentage change)			
Broad Money	16.9	-3.3	-3.8	-6.3	-4.8	-1.3
Private sector credit	8.6	3.4	3.0	2.3	1.9	-0.2
Public sector credit	15.0	64.1	69.5	103.3	61.4	100.3
Memo items:						
Credit to deposits (in percent) 1/	163.0	161.9	163.6	165.5	161.1	153.5
Deposits (percent change)	16.0	6.1	1.9	1.8	5.1	10.6
Wholesale market funding (percent change) 2/	-0.3	7.2	8.1	0.8	-6.6	-8.2
Wholesale market funding (percent of assets) 2/	40.0	39.6	40.2	37.4	34.9	34.0
Capital (percent of assets)	7.2	7.4	7.2	6.7	6.7	6.9

Sources: Bank of Portugal and staff estimates.
1/ Private sector credit to deposits.
2/ Includes foreign interbank borrowing and securities issued.

Table 8. Portugal: Public Sector Debt Sustainability Framework, 2007–16
(In percent of GDP, unless otherwise indicated)

	Actual				Projections					
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Baseline: Public sector debt 1/	68.3	71.6	83.0	93.0	**106.4**	**112.2**	**115.3**	**115.0**	**112.9**	**111.0**
o/w foreign-currency denominated	0.2	1.2	1.2	1.5	1.7	1.7	1.7	1.7	1.7	1.6
Change in public sector debt	4.3	3.3	11.4	10.0	13.4	5.8	3.1	-0.4	-2.0	-1.9
Identified debt-creating flows (4+7+12)	-0.3	2.5	11.6	9.5	13.4	5.8	3.1	-0.4	-2.0	-1.9
Primary deficit	0.2	0.5	7.2	6.1	1.7	-0.3	-2.1	-2.8	-3.2	-3.3
Revenue and grants	41.1	41.1	39.7	41.5	41.8	42.4	42.3	42.4	42.4	42.3
Primary (noninterest) expenditure	41.4	41.6	46.9	47.7	43.5	42.0	40.2	39.6	39.2	39.0
Automatic debt dynamics 2/	-0.5	1.9	4.4	1.2	5.2	5.3	2.3	0.9	1.1	1.4
Contribution from interest rate/growth differential 3/	-0.5	2.0	4.3	1.1	5.2	5.3	2.3	0.9	1.1	1.4
Of which contribution from real interest rate	1.0	2.0	2.5	2.2	3.2	3.4	3.6	3.6	3.6	3.6
Of which contribution from real GDP growth	-1.4	0.0	1.8	-1.1	2.1	1.9	-1.3	-2.7	-2.4	-2.2
Contribution from exchange rate depreciation 4/	0.0	0.0	0.1	0.1	...	...	...	...	...	...
Other identified debt-creating flows	0.0	0.0	0.0	2.2	6.5	0.8	2.9	1.5	0.0	0.0
Privatization receipts (negative)	0.0	0.0	0.0	-0.5	-1.2	-1.2	-0.6	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	2.5	0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.2	7.6	2.0	3.5	1.5	0.0	0.0
Residual, including asset changes (2-3) 5/	4.6	0.9	-0.2	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Public sector debt-to-revenue ratio 1/	165.9	174.1	209.0	223.9	254.8	264.9	272.7	270.8	266.7	262.4
Gross financing need 6/	16.6	17.1	23.0	24.5	33.1	21.3	17.2	16.6	13.2	15.5
in billions of U.S. dollars	41.0	40.1	56.6	55.9	77.3	49.0	40.4	40.1	32.7	39.5
Scenario with key variables at their historical averages 7/					**106.4**	**109.4**	**114.4**	**118.2**	**120.5**	**122.9**
Scenario with no policy change (constant primary balance) in 2011-2016					**106.4**	**114.3**	**121.2**	**125.4**	**128.3**	**131.6**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline										
Real GDP growth (in percent)	2.4	0.0	-2.5	1.3	-2.2	-1.8	1.2	2.5	2.2	2.0
Average nominal interest rate on public debt (in percent) 8/	4.9	4.5	4.0	3.7	4.4	4.5	4.6	4.6	4.6	4.7
Average real interest rate (nominal rate minus change in GDP deflator, in percent	1.7	2.9	3.4	2.7	3.3	3.1	3.3	3.3	3.3	3.3
Nominal appreciation (increase in US dollar value of local currency, in percent)	9.2	7.4	-5.4	-4.7	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	3.2	1.6	0.5	1.0	1.1	1.3	1.3	1.3	1.3	1.4
Growth of real primary spending (deflated by GDP deflator, in percent)	10.9	0.6	9.9	2.9	-10.8	-5.1	-3.2	1.0	1.1	1.4
Primary deficit	0.2	0.5	7.2	6.1	1.7	-0.3	-2.1	-2.8	-3.2	-3.3

1/ General government gross debt.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate;
α = share of foreign-currency;denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as general government deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table 9. Portugal: External Debt Sustainability Framework, 2006–16
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Baseline: External debt	187.2	197.3	202.8	225.2	234.6	**245.5**	**249.3**	**245.5**	**239.0**	**230.9**	**222.3**
Change in external debt	10.9	10.1	5.5	22.4	9.4	10.9	3.8	-3.8	-6.5	-8.1	-8.6
Identified external debt-creating flows (4+8+9)	2.4	1.9	5.1	13.2	0.5	12.3	10.2	0.0	-4.2	-4.7	-4.6
Current account deficit, excluding interest payments	5.1	3.2	4.7	4.8	4.9	1.7	-0.4	-2.5	-3.3	-4.2	-5.0
Deficit in balance of goods and services	-71.4	-73.0	-75.9	-64.3	-69.6	-73.7	-75.7	-77.7	-79.4	-81.5	-84.2
Exports	31.5	32.8	33.2	28.7	31.6	35.1	37.1	38.7	39.9	41.2	42.9
Imports	-39.9	-40.3	-42.7	-35.7	-38.1	-38.7	-38.7	-39.0	-39.6	-40.2	-41.3
Net non-debt creating capital inflows (negative)	-1.1	1.8	-4.5	-1.8	-4.3	-1.9	-0.9	-1.3	-1.8	-2.3	-2.3
Automatic debt dynamics 1/	-1.5	-3.1	4.8	10.2	-0.1	12.5	11.5	3.7	0.9	1.8	2.7
Contribution from nominal interest rate	5.7	6.9	7.9	6.1	5.0	7.2	7.1	6.6	6.7	6.9	7.2
Contribution from real GDP growth	-2.4	-4.2	0.0	5.2	-2.9	5.3	4.4	-2.9	-5.8	-5.1	-4.5
Contribution from price and exchange rate changes 2/	-4.8	-5.8	-3.1	-1.1	-2.2	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 3/	8.5	8.2	0.5	9.2	8.9	-1.4	-6.4	-3.8	-2.3	-3.4	-4.0
External debt-to-exports ratio (in percent)	594.2	602.0	611.2	785.4	743.1	700.2	672.9	634.5	599.5	560.0	518.2
Gross external financing need (in billions of euros) 4/				172.8	186.0	212.5	209.6	201.2	194.3	182.8	173.9
in percent of GDP				102.5	107.8	124.6	123.4	115.6	107.5	97.6	89.8
Scenario with key variables at their historical averages 5/						**245.5**	**242.8**	**242.7**	**244.0**	**244.2**	**243.7**
Key Macroeconomic Assumptions Underlying Baseline											
Real GDP growth (in percent)	1.4	2.4	0.0	-2.5	1.3	-2.2	-1.8	1.2	2.5	2.2	2.0
GDP deflator in euros (change in percent)	2.8	3.2	1.6	0.5	1.0	1.1	1.3	1.3	1.3	1.3	1.4
Nominal external interest rate (in percent)	3.4	3.9	4.1	3.0	2.3	3.1	2.9	2.7	2.8	3.0	3.2
Growth of exports (euros, in percent)	16.4	9.9	2.8	-15.3	12.7	9.8	5.1	7.1	7.0	7.1	7.6
Growth of imports (euros, in percent)	10.7	6.7	7.8	-18.1	9.2	0.4	-0.5	3.4	5.3	5.3	6.2
Current account balance, excluding interest payments	-5.1	-3.2	-4.7	-4.8	-4.9	-1.7	0.4	2.5	3.3	4.2	5.0
Net non-debt creating capital inflows	1.1	-1.8	4.5	1.8	4.3	1.9	0.9	1.3	1.8	2.3	2.3

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 in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

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

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

Source: Fund staff projections.

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

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Disbursements	12,597	8,347	3,346	1,710	…	…	…	…	…
(in percent of quota)	1,117	740	297	152	…	…	…	…	…
(Projected debt service to the Fund, based on prospective drawings)									
Total	148	543	719	935	1,594	3,647	4,512	4,916	4,864
Interest and charges	148	543	719	935	1,082	1,032	895	725	531
Repayments	0	0	0	0	512	2,614	3,617	4,191	4,333
Total debt service, in percent of									
Exports of goods and services	0.2	0.9	1.1	1.3	2.1	4.4	5.1	5.2	4.9
GDP	0.1	0.3	0.4	0.5	0.9	1.9	2.2	2.3	2.2
(Projected level of credit outstanding based on prospective drawings)									
Outstanding stock	12,597	20,945	24,292	26,000	25,488	22,874	19,257	15,066	10,733
in percent of quota	1,117.1	1,857.4	2,154.2	2,305.7	2,260.3	2,028.5	1,707.7	1,336.1	951.8
in percent of GDP	7.4	12.3	14.0	14.4	13.6	11.8	9.5	7.2	4.9
Memorandum Items (in billions of euros)									
Exports of goods and services	60	63	67	72	77	83	89	94	99
GDP	171	170	174	181	187	194	202	210	219

Source: Fund staff projections.
1/ An exchange rate of 1.09512 Euros per SDR was used.

Annex 1. Debt Sustainability Analysis

The general government public debt has had a persistently upward trajectory over the past decade. From a debt level close to 50 percent of GDP in 2000, Portugal's debt reached 93 percent of GDP in 2010. This is explained by a combination of sluggish growth and expansionary fiscal policy, with permanent primary deficits. Even though public debt levels were consistent with the Maastricht criteria (below 60 percent of GDP) until 2004, Portugal did not take advantage of a period of favorable interest rates to reduce debt, and debt levels rose rapidly after 2008 in the context of the financial crisis. Driving the large deficit (10.1 percent of GDP) in 2009 were not temporary stimulus measures but permanent commitments that were not easily unwound after the crisis. As risk spreads on Portuguese debt rose sharply, the debt path, on current policies, became clearly unsustainable.

The debt is estimated to reach 106.4 percent of GDP in 2011 and to peak at 115.3 percent of GDP in 2013. During 2011 and 2012, negative growth— projected at 2.2 percent and 1.8 percent, respectively — will affect the debt dynamics. The primary deficit will be reduced from 6.1 percent of GDP in 2010 to 1.7 percent of GDP in 2011, but only from 2012 the country will start running primary surpluses. In addition, debt liabilities incurred to finance a bank solvency support fund will create an upward pressure in the other debt-creating flows. Despite the revenues arising from privatization projected at 1.1 percent of GDP in 2011, the bank solvency mechanism is large enough to create a net impact (i.e. excluding privatizations) of 6.5 percent of GDP in 2011 in other debt-creating flows. Even though this support is a backstop facility — intended to provide temporary capital injections for banks that might not be able to reach the higher capital requirements on time through marked-based solutions — the baseline fully incorporates this mechanism.

After stabilizing in 2013, debt will follow a downward path to reach 111 percent by 2016 – still at a high level and vulnerable to shocks. In particular, the stress tests under the DSA show that:

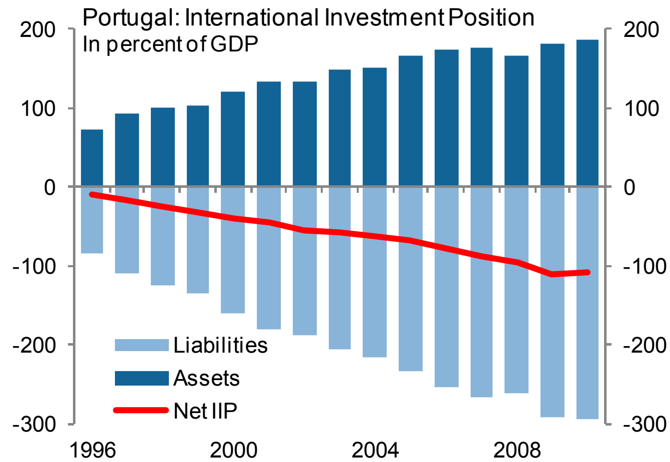
- The growth shock (growth at baseline minus one-half standard deviation in projection years) demonstrates the key vulnerability. Lower than projected growth would lead the debt to reach 120 percent of GDP by 2016 and not stabilize, even as stressed growth in this scenario is 1.3 percent in 2016 — still almost double the historical average of 0.7. This highlights that debt sustainability is highly dependent on the growth recovery starting in 2013 and, in the long-run, on the success of the structural agenda reforms to boost potential growth.

- The primary balance shock (primary balance at baseline minus one-half standard deviation in projection years) would lead the debt to stabilize in 2015 at 120 percent of GDP. Further increases in the primary balance will be needed after the end of the program.

- The contingent liabilities shock (by 10 percent of GDP) would still lead to stabilization in 2013 but—naturally—at a higher level (125.5 percent of GDP). Given the level of the fiscal risks that seems to exist in Portugal, and the absence so far of a systematic approach to identify and assess those risks, the authorities have agreed on start producing a fiscal risk statement with the 2012 budget. The greatest risks seen by staff are those related to SOEs and PPPs (see Annex 4), and structural measures are being put in place to reduce risks (see MEFP ¶ 14–6). Finally, as the economy contracts, there is also the risk of further reclassifications of SOEs and PPPs into the general government, as was the case in early 2011.

Annex 2. External Debt Sustainability Analysis

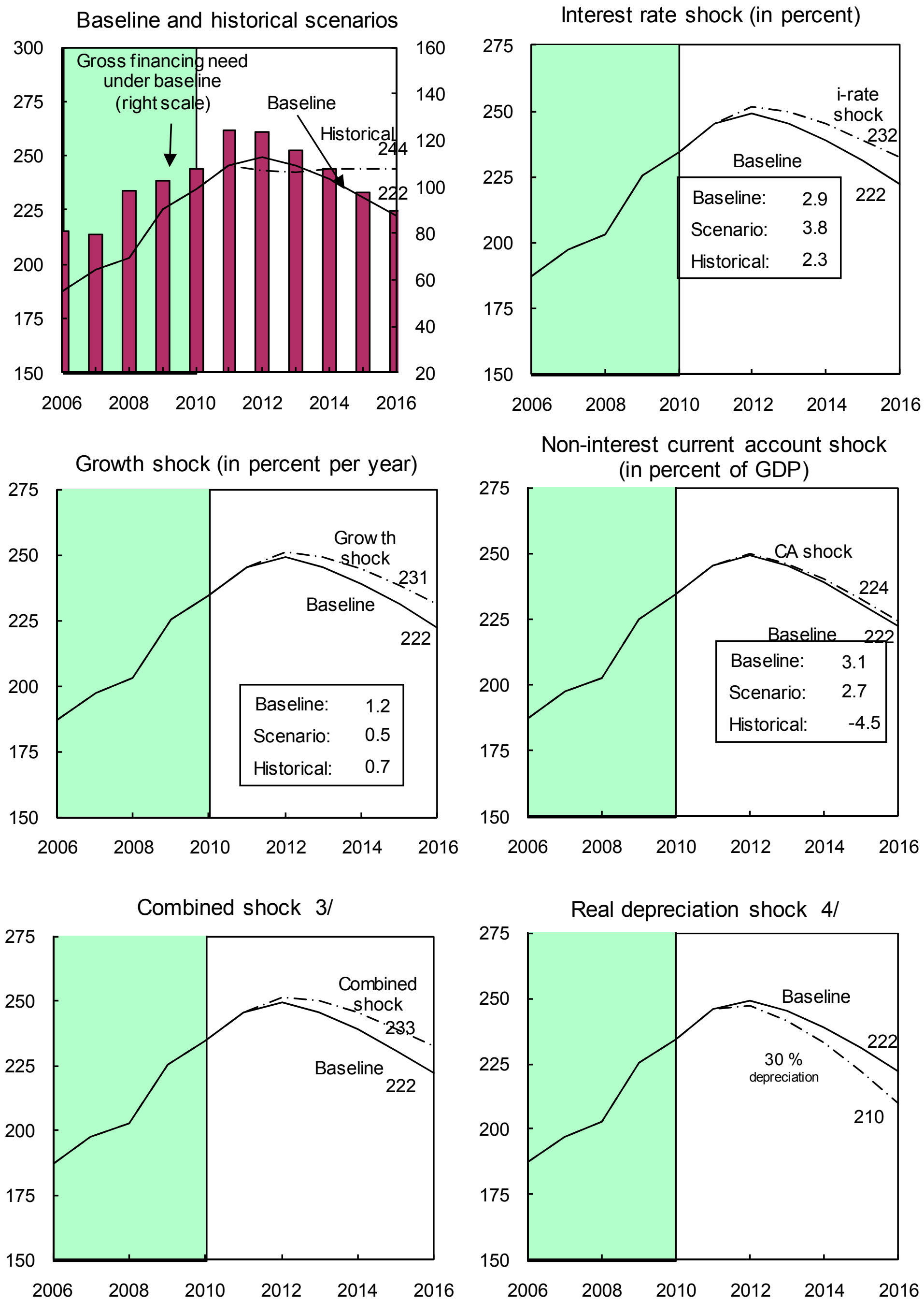
Portugal's external debts have risen rapidly in the last decade. While external assets have also been accumulated, liabilities have accumulated much faster, and the net international investment liability exceeded 100 percent of GDP at the end of 2010. Gross external debt, at €405 billion or 235 percent of GDP at end 2010, is extremely high.



Banks and the public sector are large external debtors Banks' net international investment liability peaked in 2007 at 55 percent of GDP. While this declined to 33 percent of GDP by end-2010, this is more than compensated by their indirect liability through liquidity support from the European System of Central Banks provided through the monetary authority. In terms of gross external debts, the banks' liabilities stood at 99 percent of GDP in 2010. The general government is also a heavily indebted to external creditors, with gross debts of €96 billion or 56 percent of GDP (up by 10 percentage points of GDP since 2007, before stabilizing in 2010 as foreign creditors retrenched). The Bank of Portugal's gross external debts have risen to 35 percent of GDP from below 5 percent in the same period, implying that the public sector as a whole has accounted for the entire increase in external debt during this period.

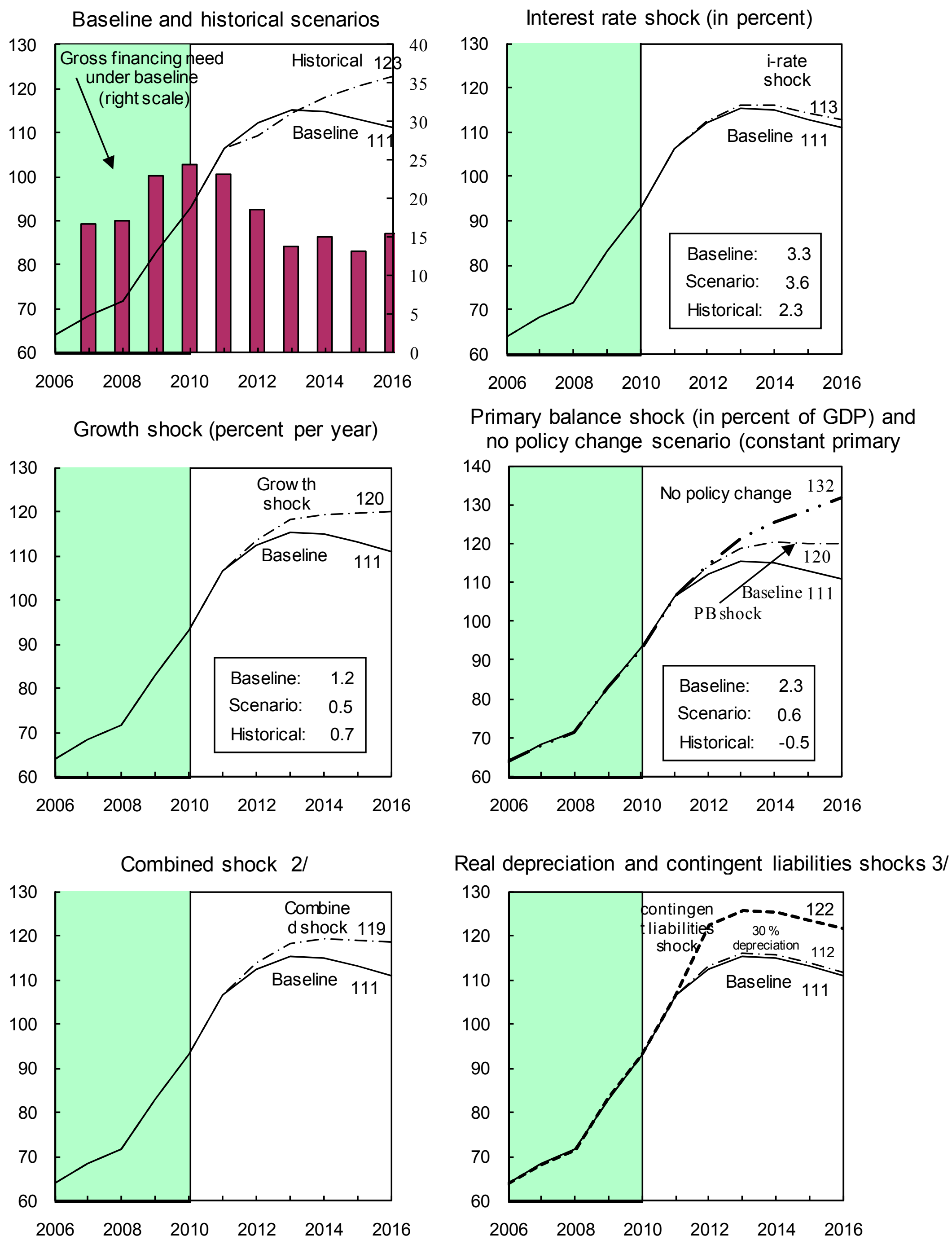
The analysis suggests expected declines in external debt are quite robust to shocks. In the baseline, external debt peaks in 2012 at 249 percent of GDP, and then declines as the current account and growth improve. This assumes the full amount under the program is drawn. In terms of GDP, private external debt peaked in 2009, while public external debt does so only in 2012. Growth and interest rate shocks would have similar, relatively modest impacts on the debt path: a shock equal to half a standard deviation in each variable would raise the debt ratio by 9–10 percentage points by the end of the period compared to the baseline. A half standard deviation shock to current account balances would have an impact of only 2 percentage points. The relatively modest impacts of the shocks reflect the low historical volatility of the variables.

Figure 1. Portugal: External Debt Sustainability: Bound Tests 1/ 2/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ 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 real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2010.

Figure 2. Portugal: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



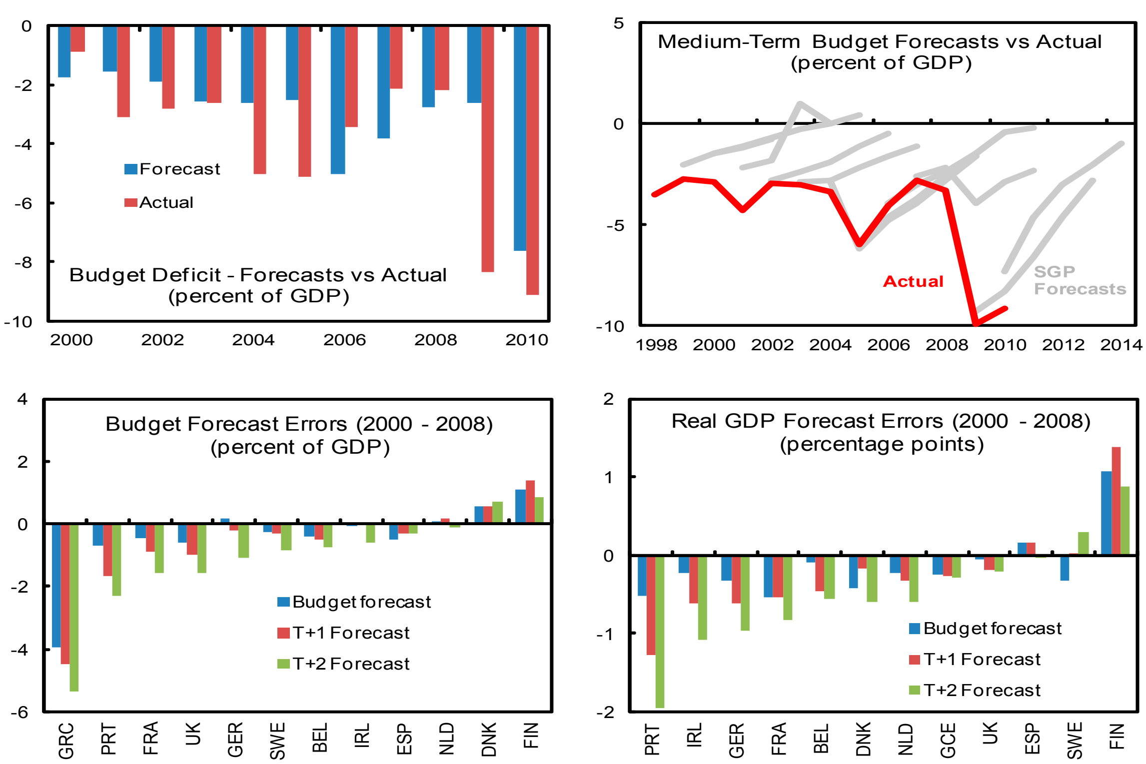
Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also show n.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, grow th rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, w ith real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Annex 3. Strengthening the Fiscal Framework

Portugal's record in delivering the annual budget is reasonable. Over the last decade, the actual budget deficit exceeded the budget forecast by an average of 0.9 per cent of GDP. Cumulatively, this translates into fiscal drift of 8 percent of 2010 GDP due to problems with budget execution, just under a quarter of the 35 percent of GDP increase in government debt over this period. While on the high side, this is not far out of line from that of Portugal's European peers (Charts 1and 3).

But the government has not been able to follow its medium-term plans to bring deficits under control. Chart 2 illustrates this problem, with the medium-term deficit projections from each of the annual SGP documents in grey compared to the actual outturn in red. This inability to follow through on the fiscal targets set in the budget year in the budget of the following year is the major cause of fiscal drift in Portugal, explaining the increase in government debt of around 16 per cent of GDP — approximately half of the overall increase.

Highly optimistic medium-term real GDP forecasts are a key factor behind these errors. These forecasts underpin most other budget projections, and errors here create a cascade of forecast errors throughout the budget. In this regard, Portugal has one of the worst records in Europe (Chart 4).



Source: IMF staff estimates.

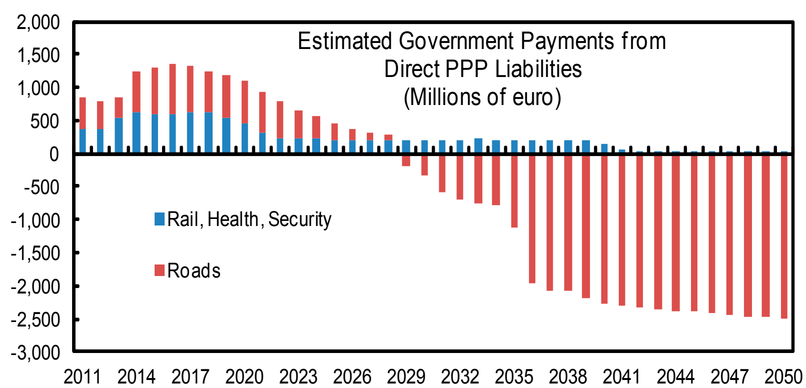
Without using the medium-term fiscal targets as the basis for the following years' budget, there has been no discipline to bring the deficit under control. To rectify this, the government will need to introduce a binding medium-term budget framework that is based on a clear, simple and easily understood fiscal strategy; stake political credibility on meeting this strategy; base it on realistic medium term forecasts; and reconcile and explain any deviation from that strategy, along with a clear plan for getting the budget back on track.

Annex 4. Fiscal Risks from SOEs and PPPs

There are significant fiscal risks associated with SOEs and PPPs, not all of which have yet been identified. Materialization of these contingent liabilities can pose a serious challenge for debt management and require close monitoring. Under the program, authorities have committed to not create any additional SOEs or PPPs contracts until a comprehensive assessment of fiscal risks is completed. A stronger legal and institutional framework will be put in place to address current weaknesses.

The SOE sector poses a major drain on public resources and raises concerns in the short term. The sector's financial position is fragile: at end-2009 total assets amounted € 70 billion (including € 20 billion in intangible assets) while total liabilities were € 64 billion. Out of a total debt at € 30 billion, 40 percent is guaranteed by the government, but the government may also end up financing other contingent liabilities. For example, Estradas de Portugal, one of the largest SOEs, is legally not allowed to have government guarantees, but is nevertheless being financed by the government because it is unable to meet its obligations and it cannot access the markets. In addition, some operations that are now treated as financing transactions (0.5 percent of GDP), may be reclassified as above-the-line transfers to SOEs, given the unhealthy financial position of some companies. Complete information on the number and risks arising from SOEs at the local and regional levels is not available.

Portugal's PPP program is one of the largest in the world but lacks adequate transparency and proper oversight. Some €30 billion has been invested in PPPs since the mid-1980s. Some of these PPPs contracts generate long-term rigid commitments that are projected to create increasing expenditure pressure until 2016 (see chart). The present value of expected payments for all such contracts, excluding forecast revenues from roads after 2028, is about 7 percent of GDP. There is no public information on contingent liabilities associated to PPPs. Moreover, there is a range of concerns regarding some of the contracts, which do not seem to have been supported by robust approval processes, informational requirements, and risk analysis. Even though the government considers that risks are almost entirely shifted to private contractors, the lack of information makes it difficult to assess the amount of direct and contingent liabilities related to these contracts. The Court of Auditors—in a report on PPPs related to roads— commented that the state did not have the resources, methodologies, or controls necessary to judge the appropriateness of the PPPs.



Source: IMF staff estimates.

APPENDIX I. PORTUGAL: LETTER OF INTENT

Lisbon, May 17, 2011

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. Strauss-Kahn:

1. Against the background of the structural challenges facing the Portuguese economy and contagion from the sovereign debt crisis in other euro area countries, financial conditions facing the Portuguese sovereign and banks have sharply worsened. To restore market confidence and to raise the potential of our economy to generate socially balanced growth and employment we are proposing a far-reaching reform programme, backed by substantial international financing to meet balance of payments needs.

2. Following up on already announced measures, we believe further comprehensive action is required on three fronts: (i) deep structural reforms to boost potential growth, create jobs, and improve competitiveness (including through a fiscal devaluation); (ii) a credible and balanced fiscal consolidation strategy, supported by structural fiscal measures and better fiscal control over PPPs and SOEs; and (iii) efforts to safeguard the financial sector against disorderly deleveraging through market-based mechanisms supported by back-up facilities. As our reform programme is implemented, priority will be given to protecting the most vulnerable groups.

3. To signal our strong commitment to implementing the ambitious reform programme, we request financing assistance from international partners. We estimate that the support needed for our external financing will be around €78 billion over the next three years. We therefore request that the Fund support our policy programme through an arrangement under the Extended Fund Facility in the amount of SDR 23,742 million (€26 billion) which could be drawn over a period of 36 months to cover the balance of payments needs. This arrangement, along with support of €52 billion from the European Financial Stability Mechanism and the European Financial Stability Facility will underpin confidence, support market access, and help ensure orderly adjustment and the restoration of sustainable growth. We will draw on these resources in parallel throughout the programme period, drawing on the EU/euro-area and IMF financing in a ratio of 2 to 1 following programme approval and after each review period (measured at the program exchange rate).

4. We are confident that the policies described in the attached Memorandum of Economic and Financial Policies (MEFP) are sufficient to achieve the objectives under the programme. Progress in the implementation of the policies under this programme will be

monitored through quarterly (and continuous) quantitative performance criteria (PCs) and indicative targets, prior actions, structural benchmarks, quarterly programme reviews, and consultation clauses. These are detailed in Tables 1 and 2. The attached Technical Memorandum of Understanding (TMU) contains definitions.

5. We stand ready to take additional measures that may be needed to meet the objectives of the economic programme and will maintain a close policy dialogue with the Fund, including to consult in advance of any necessary revisions to these policies. We are confident that resolute implementation of our economic programme will help our economy recover and bolster market sentiment. If fiscal consolidation proceeds faster than expected or if market conditions improve significantly during the programme period, we would refrain pari passu from drawing on the full EU/euro-area and IMF support.

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

Sincerely yours,

/s/	/s/
Fernando Teixeira dos Santos	Carlos da Silva Costa
Minister of State and Finance	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

May 17, 2011

A. Introduction and Macroeconomic Outlook

1. **The Portuguese economy faces considerable challenges**. Competitiveness indicators have suffered, economic growth has been anemic, and the current account deficit is at 10 percent of GDP. The global crisis exposed Portugal's weak fiscal and financial position with public debt at around 90 percent of GDP at end-2010 and private sector debt about 260 percent of GDP. Banks that financed this build-up in debt now have the highest loan-to-deposit ratio in Europe.

2. **To address these challenges we have embarked on a balanced and focused reform to correct external and internal imbalances and boost potential growth and employment.** Our strategy envisions bold and upfront structural reforms to improve competitiveness, an ambitious but credible pace of fiscal adjustment, and measures to ensure a stable and dynamic financial system. Large support from the international community will help reduce the social costs of adjustment. It will also allow us sufficient breathing space to establish a strong record of policy implementation before going back to markets.

3. **Growth is expected to recover only gradually over the next three years**. Output is expected to contract around 2 percent in 2011 and 2012 on account of needed fiscal consolidation, general confidence effects that led to the request for international financial support, and adjustments in the banking system. In addition, general market concerns for Euro area periphery countries are also likely to weigh on sentiment in the near term. Nevertheless, as markets regain confidence in the economy and structural reforms begin to deliver, activity is expected to start recovering in 2013 onwards.

B. Reducing Public Debt and Deficit

4. **Our fiscal targets are ambitious but realistic.** We will target a deficit of 5.9 percent of GDP in 2011, 4.5 percent of GDP in 2012 and—consistent with the Excessive Deficit Procedure deadline agreed with the EU—3 percent of GDP in 2013. This will stabilize public sector debt by 2013. This deficit path reflects an appropriate trade-off between the need to take decisive and frontloaded actions to restore market confidence while ensuring that the pace of adjustment does not take an excessive toll on growth and employment.

5. **Our program is fully specified and carefully balanced between expenditure and revenue measures.** The 2011 budget already entails a significant effort, with discretionary fiscal measures amounting to some 5.4 percent of GDP. The deficit target for 2011 takes into account that the recession is now expected to be deeper and that some SOEs have been reclassified and included in the general government. To reach our target for 2011, we will compress some spending (0.3 percent of GDP) relative to the 2011 budget, particularly in

subsidies to SOEs and health spending. Additionally, to reach the targets for 2012–13, we need to take measures of about 5 percent of GDP in 2012–13. These measures are fully specified in this MEFP at the outset. As to the policy mix, expenditure measures account for 3.5 percent of GDP and revenue measures for 1.4 percent of GDP. The priority given to expenditure measures is in line with the need to reduce the public sector's large claim on resources. The fiscal adjustment will be supported by well-specified structural reforms.

6. **Our program entails cuts in expenditures:**

- Following the 5 percent average cut in public sector wages this year, wages and pensions will be frozen through 2013, except, in the case of pensions, for those in the lowest categories. In addition, a special contribution levied on pensions above €1,500 will be introduced in 2012 but will exempt those in the lowest categories. Through a policy of only partly replacing separating staff, we will reduce the number of civil servants at the central government by 1 percent in both 2012 and 2013. The rationalization of the public administration at local and regional governments will provide further reduction in costs, including a reduction in employment by 2 percent annually.

- Better means-testing procedures will protect lower income families while making savings in social security non-contributory benefits. Rationalization of curricula and creation of school clusters, without damaging access, will cut costs in education. In addition, savings will be made through curtailing transfers to local and regional governments, other public bodies and entities, and SOEs.

- Our strategy depends also on improving decisions regarding capital expenditures. We will suspend the implementation of all new PPPs and large infrastructure projects until a thorough feasibility assessment is completed. No public funds or guarantees will be provided for the construction of the New Airport in Lisbon, and the high speed train project to Porto will remain suspended for the duration of the program. In addition, stronger controls will be put in place to rationalize new capital expenditures. Finally, line ministries will be required to request a pre-authorization of the Ministry of Finance (MoF) before engaging in new capital expenditure contracts.

- We will streamline spending on defense, SOEs, regional, and local governments. We will (i) submit a draft law by end-2011 revising the Military Funding Law to impose expenditures ceilings and enforce a zero-new-spending commitments rule; and (ii) reduce defense personnel and compensation by at least 10 percent during 2011–2014. In addition to measures detailed below (¶23) we will reduce SOE fringe benefits by at least 5 percent per year over 2011-2014 and will align wage compensation policies to those of the general government.

7. **On the revenue side, the focus is on increasing the share of consumption taxes and reducing tax privileges:**

- The higher VAT, PIT, and CIT rates in the 2011 budget will remain in effect through 2013. The list of goods and services subject to reduced VAT rates will be revised in 2011. The recurrent property tax (IMI) will be enhanced by a reassessment of the property values starting in the second half of 2011and by rate increases from 2012 which will help compensate for a reduction of property transfer tax (IMT). Excise taxes on vehicles and tobacco will be raised. Electricity taxation will be introduced from January 2012. The convergence of deduction treatment of wages and pensions for tax purposes will be concluded by end-2013.

- A comprehensive revision of tax exemptions will yield 0.5 percent of GDP. We will freeze all existing tax benefits and incentives, and roll back some of them. On personal income tax, we will set a global cap on health, education and housing allowances, differentiated according to tax bracket; and phase out the allowance on mortgage expenses and rents through legislation to be approved by end-2011. On corporate income tax, we will by end-2011 (i) eliminate exemptions—including those subject to the sunset clause of the Tax Benefit Code—and all reduced rates; (ii) limit the deduction of losses; and (iii) limit the carryover period to 3 years. The temporary exemption of the annual property tax will be considerably reduced by end-2011.

8. **In choosing fiscal measures, we have taken care to protect vulnerable groups.** The 5 percent cut in nominal public sector wages and the freezing of pensions in 2011 exempt those earning the lowest wages and pensions. The special contribution on pensions will be levied only above a monthly threshold of €1,500. The means-testing program is being enhanced by applying unified and consistent selection criteria throughout the transfers system. In the health sector, an exemption threshold will be introduced to protect the more vulnerable from the proposed "moderating fees" (for health care) increases and the reduction in exemptions. The exemption threshold based on the value of the property will be kept.

C. Streamlining the Public Sector

Public Financial Management (PFM)

9. **The strategic focus of the budget will be sharpened**. A fiscal strategy for the general government will be published by end-August 2011, and thereafter in April annually, specifying 4-year medium-term economic and fiscal forecasts. This will include supporting analysis and underlying assumptions and 4-year costings of new policy decisions (structural benchmark). Starting with the budget for 2012, budgets will be prepared within the context of the fiscal strategy and will report information to allow for an assessment of performance against this strategy. An independent fiscal council will be established by end-September 2011 to assess the government's performance against the fiscal strategy.

10. **The budget process will be further integrated.** SOE, PPP, and social security decisions with fiscal implications will be integrated with the budget process to reduce fragmentation. Capital expenditure decisions will be taken in a medium-term context, with enhanced monitoring and control, through the implementation of a public investment information system, as announced in the 2011 budget. Top-down budgeting with indicative expenditure ceilings and a medium-term budget framework for the central government budget will be introduced in the 2012 Budget and will be put into full effect with the 2013 budget. A new budget framework law incorporating some of these reforms has been approved by Parliament and is awaiting Presidential assent. A proposal to revise the local and regional financial laws will be submitted to parliament by end-2011 in order to fully adapt them to the principles and rules of the new budgetary framework law. We stand ready to refine further the budget framework based on inputs from EC and IMF staff.

11. **Expenditure control will be strictly enforced and arrears will be monitored and reported regularly**. Standard definitions of arrears and commitments will be approved by May 2011(prior action). Any changes to the budget execution procedures necessary to align with these definitions will be implemented by end-2011, aided by technical assistance from the EC and IMF. Until then, existing commitment control procedures will be enforced to prevent the creation of new arrears. We will conduct and publish by end-August 2011 (structural benchmark) a comprehensive survey of arrears as at end-June 2011 covering all general government entities, as well as SOEs classified outside the general government sector. Following the survey, arrears of general government, will be monitored and published monthly.

12. **Fiscal reporting will be strengthened.** Consolidated general government cash-based reports will be developed and initially reported to the EC and IMF, before moving to external publication by end-December 2011. We will adopt a standard double entry-based chart of accounts and accounting policies consistent with International Public Sector Accounting Standards by end-2012. We will prepare a comprehensive inventory of the existing tax expenditures (including all types of exemptions, deductions, and reduced rates), by type of tax, along with their costing estimates (prior action). Starting with the 2012 budget, we will enhance our annual tax expenditure reports following international standards so that they (a) cover central, regional, and local governments; (b) use a more comprehensive concept of tax expenditures; and (c) include the methodology used for estimating such expenditures.

13. **We will start publishing a comprehensive report on fiscal risks as part of the annual budget.** This will commence with the 2012 Budget and will be consistent with international best practices. The report will take into account risks, including those related to forecast expenditure and revenue, contingent liabilities, the debt composition, the banking system, all PPPs, all SOEs, and natural disasters.

Public-Private Partnerships (PPPs)

14. **We will undertake a comprehensive review of PPPs and concessions to reduce the government's financial exposure.** The PPPs have exposed the government to significant financial obligations, and exposed weaknesses in its capacity to effectively manage these arrangements. The review will comprise two parts:

- We will request technical assistance from the EC and the IMF to undertake an assessment by end-August 2011 of at least the 20 most significant PPP and concession contracts, including the major *Estradas de Portugal* PPPs. The technical assistance report will identify the key areas of concern and prepare the terms of reference for a more detailed study described below.

- Based on this assessment, we will recruit a top tier international accounting firm by end-December 2011 (structural benchmark) to complete a more detailed study of PPPs and concessions by end-March 2012. It will assess the scope to renegotiate any PPP or concession contracts to reduce financial obligations without expropriating investors. The review will identify and, where practicable, quantify major contingent liabilities and any amounts that may be payable by the government. All PPP and concession contracts will be made available for these reviews.

15. **We will substantially enhance the annual report on PPPs to strengthen reporting and approval mechanisms.** Starting with the July 2012 report, the annual reports will detail all future cash flows and include a discussion of the government's obligations on an ongoing basis. The legal and institutional framework for assessing and entering into PPP or concession agreements as well as monitoring its execution will also be reviewed and strengthened under the supervision of the MoF and in consultation with EC and IMF staff by end-2012. We will not enter into any new PPPs or concessions at the central or local government levels until at least the completion of these reviews and legal and institutional reforms.

State-Owned Enterprises (SOEs)

16. **The MoF's central role in the financial governance of SOEs will be enhanced to cut operating costs and streamline the sector.** We will prepare a comprehensive report on ten SOEs posing the largest potential fiscal risks to the state (prior action). We will expand the coverage of this report by end-July 2011 to include all large central government SOEs to (i) complete concrete plans to reduce their overall operating costs by at least 15 percent over 2009 levels; (ii) review tariff structures to reduce subsidization; and (iii) apply tighter debt ceilings for 2012 onwards. In consultation with EC and IMF staff, we will review the level of service provision of SOEs by end-September 2011 as an input into the budget. A report will be prepared by end-February 2012 (structural benchmark) that reviews the operations and

finances of SOEs at all levels of government. It will also include a systematic assessment of SOEs' future financial prospects, the potential exposure of the government, and scope for orderly privatization. We will not create any additional SOEs at the central or local government levels at least until the completion of these reviews and will prepare a plan by end-2011 to strengthen governance of SOEs.

Privatization

17. **We plan to accelerate our privatization program.** The existing plan, elaborated through 2013, covers transport (Aeroportos de Portugal, TAP, and freight branch of CP), energy (GALP, EDP, and REN), communications (Correios de Portugal), and insurance (Caixa Seguros), as well as a number of smaller firms. The plan targets front-loaded proceeds of about €5 billion through the end of the program, with only partial divestment envisaged for all large firms. However, we are committed to go even further, by pursuing a rapid full divestment of public sector shares in EDP and REN, and are hopeful that market conditions will permit sale of these two companies, as well as of TAP, by the end of the 2011. We will identify, by the time of the second review, two additional large enterprises for privatization by end-2012. An updated privatization plan will be prepared by end-March 2012.

Health Sector

18. **A comprehensive reform will improve efficiency and effectiveness in the health care system.** Amongst other reforms, moderating fees will be increased by September 2011, indexed to inflation by end-2011, and exemptions will be substantially reduced by September 2011. In order to protect the more vulnerable, means-testing mechanisms will be put in place.

Revenue Administration

19. **The revenue administration will be modernised.** The domestic tax administration, customs administration, and the information technology service will be unified. We will complete a study by end-September 2011 to assess the feasibility of the new structure taking over the collection function of the social security administration. The structure, to be designed in consultation with EC and IMF staff, will be organized around core business functions and complemented by a taxpayer segmentation approach, mainly through the adoption of a Large Taxpayer Unit. The design of the new structure will be completed by end-2011 and fully implemented by end-2012. The structure will streamline local branches, closing down at least 20 percent of local offices in both 2011 and 2012.

20. **A revenue administration strategic plan for 2012–14 will be prepared by end-October 2011**. This will include concrete actions to combat tax fraud and evasion. We will also prepare a report by end-2011 assessing the current state of our tax information systems, and propose the next steps to strengthen the information technology function. We will submit to Parliament by end- 2011 a law to reinforce the auditing and enforcement powers of the central revenue administration to exercise control over the whole territory of Portugal, including currently exempt tax regimes. The law will also give to the central tax

administration the exclusive power to issue interpretative rulings on taxes with national scope, in order to ensure its uniform application.

21. **The operational capacity of the revenue administration will be strengthened.** The audit workforce will be increased to 30 percent of total employees of the tax administration by the end of 2012, mostly through reallocation of staff in the public sector and within the tax administration, and adopting a clear risk management approach for taxpayer selection. We will enhance third-party information to support audit.

22. **We will facilitate an orderly and efficient resolution of tax cases.** Tax tribunals will be specialized in large cases and will be assisted by independent tax specialists similar to the pool used for tax arbitration by end-January 2012. A temporary task force of judges will be established to clear cases worth above €1 million by end-2012 (prior action). The new tax arbitration law will be implemented by end-July 2011. We will include the application of above-market interest charges on the outstanding debt over the entire court proceeding, and impose a special statutory interest on non-compliance with a tax court decision. We will conduct a review of audit performance by end-September 2011 incorporating qualitative indicators in the current quantitative model. An integrated information system between the revenue administration and the tax tribunals will be adopted by end-2011.

Public Administration and its Perimeter

23. **The structure of public administration will be streamlined.** A second phase of the public administration restructuring program (PRACE 2007) will be implemented for central government by end-2011. A similar program for local governments will be launched by April 2012. The objective will be to improve efficiency, and reduce the size of public administration across all levels. We will reduce the number of central government employees by at least 1 percent a year over the duration of the program, with at least 2 percent reduction at the local level, through a policy of only partly replacing separating staff, while at the same time increasing mobility across the administration. As part of these reforms, we will reduce management positions and administrative units by at least 15 percent (on average, over end-2010 levels) by end-2011 for central government and end-June 2012 for local governments, and reduce the number of local branches of line ministries.

24. **The creation of new public and quasi-public entities will be controlled more strictly and the existing number entities will be streamlined.** In conjunction with the SOE review, a comprehensive survey of public and quasi-public entities, including associations, foundations and other bodies, across all levels of government will be published by end-2011. Based on this survey, the administration responsible for public entities will decide to close or maintain them. A new set of public administration laws regulating the creation of SOEs, foundations, associations, and similar bodies at the central and local levels will be adopted by July 2012. We will move immediately to make any legal changes required to enhance

monitoring, reduce operating costs and temporarily stop the creation of any new public or quasi-public bodies (including SOEs) at the local level.

25. **We will work with the regional government to bring about similar changes at their level of government**. These efforts will cover preventing creation of SOEs, PPPs, concessions, and any other quasi public entities. We will work to reduce management positions and administrative units by at least 15 percent and put in place a new set of public administration framework laws. We will also work with regional governments to reduce the number of their employees by at least 2 percent a year over the duration of the program.

26. **Local government administration will be reorganized.** There are currently around 308 municipalities and 4,259 parishes. By July 2012, the government will develop a consolidation plan to reorganize and significantly reduce the number of such entities. We will implement these plans based on agreement with the EC and the IMF. 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.

D. Protecting the Financial System amidst Deleveraging

27. **While the Portuguese banking system has weathered the crisis well so far, bank liquidity remains under pressure.** 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. Banks will be encouraged to take actions to strengthen their collateral buffers. Subject to approval under EC competition rules, the authorities are committed to facilitating the issuance of government guaranteed bank bonds in an amount of up to €35 billion, including the existing package of support measures.

28. **We see a balanced and orderly deleveraging of the banking sector as critical to eliminating its funding imbalances on a permanent basis**. The process should take place in an orderly manner within the Eurosystem framework and consistent with the IMF/EU adjustment program, taking into account the need to reduce reliance on Eurosystem funding and to continue to support the more productive sectors of the domestic economy, not least SMEs. The BdP and the ECB, in consultation with EC and IMF staff, will include clear periodic target leverage ratios and will ask banks to devise by end-June 2011 institution-specific medium-term funding plans to achieve a stable market-based funding position. To smooth the deleveraging process, we will encourage private investors to maintain their exposure. Quarterly reviews will be conducted in consultation with EC and IMF staff, and will examine the feasibility of individual banks' plans and their implications for leverage ratios, as well as the impact on credit aggregates and the economy as a whole, and the BdP will then request adjustments in the plans as needed.

29. **To bolster the resilience of the banking sector, we are asking banks to further strengthen their capital buffer, while augmenting the bank solvency support mechanism**.

The BdP had already required banks to raise their core Tier 1 capital level to 8 percent and significant progress has been achieved in reaching this level. However, the environment has become more challenging lately, and to further enhance confidence in the solvency of the banking system, the BdP will now direct all banking groups subject to supervision in Portugal to reach a core Tier 1 capital of 9 percent by end-2011 and 10 percent at the latest by end-2012 (prior action) and maintain it thereafter. If needed, using its Pillar 2 powers, the BdP will also require some banks, based on their specific risk profile, to reach these higher capital levels on an accelerated schedule, taking into account the indications of the solvency assessment framework described in paragraph 31. Banks will be required to present plans to the BdP by end-June 2011 on how they intend to reach the new capital requirements through market solutions. However, in the event that they cannot reach the targets on time, ensuring higher capital standards may temporarily require public provision of equity for the private banks. We are thus augmenting the bank solvency support facility in line with EU state aid rules. Taking into account the overall resources available to us, including the EU-IMF financing, we will have adequate funds to provide €12 billion to the facility. This will be done in a way that preserves the control of the management of the banks by their non-state owners during a first phase and allow them the option of buying back the government’s stake. The banks benefitting from equity injections will be subjected to specific management rules and restrictions, and to a restructuring process in line with EU competition and state aid requirements, that will provide the incentive to give priority to market-based solutions.

30. **We will streamline the state-owned CGD group to increase the capital base of its core banking arm as needed**. With 23 percent of the system’s assets, this bank plays a central role in the financial system and we realize that its balance sheet should be optimized. The CGD bank is expected to raise its capital to the new required levels from internal group resources and improve the group’s governance. This will include a more ambitious schedule towards the already announced sale of the insurance arm of the group, a program for the gradual disposal of all non-core subsidiaries, and, if needed, a reduction of activities abroad.

31. **The BdP is further intensifying its monitoring of the banking sector**. It is stepping-up its solvency and deleveraging assessment framework for the system as a whole and for each of the eight largest banks, and will seek an evaluation of the enhanced assessment framework by end-September 2011 (structural benchmark) by a joint team of experts from the EC, the ECB and the IMF. By end-June 2011, the BdP will also design a program of special on-site inspections to validate the data on assets that banks provide as inputs to the solvency assessment (structural benchmark). This program will be part of a capacity building technical cooperation project put in place with the support of the EC, the ECB, and the IMF that will bring together Portuguese supervisors, cooperating central banks and/or supervisory agencies, external auditors and other experts as needed. The BdP will provide quarterly updates of banks’ potential capital needs going forward and check that their deleveraging process remains on track and properly balanced. Whenever the assessment framework will indicate that a bank’s core Tier 1 ratio might fall under 6 percent under a

stress scenario over the course of the program, the BdP, using its Pillar 2 powers, will ask it to take measures to strengthen its capital base.

32. **The BdP has kept a watchful eye on the banking sector and will continue to strengthen banking regulation and supervision**. The efficacy of the supervisory function is being permanently improved. This has included the reorganization of the function into three more focused departments last year and the setting-up of an interdepartmental committee for the purpose of financial stability monitoring and macro-prudential supervision. An internal bank evaluation system is currently being developed and is being fine-tuned. Disclosure on non-performing loans will be improved by adding a new ratio aligned with international practices to the current ratio that covers only overdue loan payments by end-September 2011 (structural benchmark). Still more focus will be put on on-site inspections and verification of data accuracy with technical assistance from the IMF, in the context of the data verification exercise for the new solvency assessment framework. New resources will be allocated for the recruitment of additional specialist banking supervisors. Close coordination will be maintained with home and host country supervisors, within the EU framework for cross-border banking supervision and with relevant non-EU host supervisors of branches and subsidiaries of Portuguese banks.

33. **We are stepping-up our efforts to bring closure to the case of Banco Português de Negocios (BPN)**. Following the unsuccessful privatization of the bank in 2010, and taking into account the recent deterioration of economic conditions, we are now launching a process to sell the bank on an accelerated schedule and without a minimum price. To this end, we will submit a new plan to the EC for approval under competition rules. Our target is to find a buyer by end-July 2011 at the latest. To facilitate the sale, the 3 existing special purpose vehicles holding its non-performing and non-core assets have been separated from BPN, and more assets could be transferred into these vehicles as part of the negotiations with prospective buyers. BPN is also undertaking additional cost-cutting measures to increase its attractiveness to investors. Once a solution has been found, CGD's state-guaranteed claims on BPN and all related special purpose vehicles will be taken over by the state according to a timetable to be defined at that time.

34. **We will strengthen the early intervention and resolution framework.** This will allow timely and effective intervention and resolution in line with EU developments and international sound practices. Legislation concerning credit institutions will be amended, in consultation with EC, ECB, and IMF staff, by end-November 2011 (structural benchmark) to, inter alia, impose early reporting obligations based on clear triggers and penalties; empower the BdP with remedial measures to promote implementation of a recovery plan; and require credit institutions with systemic risks to prepare contingency resolution plans subject to regular review. The amendments will also introduce a resolution regime for distressed credit institutions as a going concern under official control to promote financial stability and protect depositors. There will be clear triggers for its initiation, and restructuring tools for the resolution authorities shall include (i) recapitalization without shareholder pre-

emptive rights in accordance with the relevant EU framework; (ii) transfer of assets and liabilities to other credit institutions; and (iii) a bridge bank.

35. **We will strengthen the legislation on the Deposit Guarantee Fund (FGD) and on the Guarantee Fund for Mutual Agricultural Credit Institutions (FGCAM)**. This will be done in consultation with EC, ECB and IMF staff, by end-2011 (structural benchmark). These funds' functions will be re-examined to strengthen protection of guaranteed depositors. These funds should retain the ability to fund the resolution of distressed credit institutions and in particular the transfer of guaranteed deposits to another credit institution but not to recapitalize them. Such financial assistance shall be capped at the amount of guaranteed deposits that would have to be paid out in liquidation. This should be permissible only if it does not prejudice the ability of these funds to perform their primary function. Further, the Insolvency Law will be amended by end-November 2011 to provide that guaranteed depositors and/or the funds (directly or through subrogation) will be granted a priority ranking over unsecured creditors in the credit institution's insolvent estate.

36. **The legal framework will be refined to facilitate orderly and efficient corporate and household debt restructurings.** The Insolvency Law will be amended to better support effective rescue of viable firms (end-November 2011 structural benchmark), with technical assistance from the IMF, to, inter alia, introduce fast track court approval procedures for restructuring plans. General principles on voluntary out of court restructuring in line with international best practices will be issued by end-September 2011. We will also take the necessary actions to authorize the tax and social security administrations to use a wider range of restructuring tools based on clear criteria and review the tax law to identify impediments to debt restructuring. The amendments to the Insolvency Law will also include improvements of personal insolvency procedures to better support rehabilitation of financially responsible individuals. Finally, we will launch a campaign to raise awareness of the restructuring tools available for early rescue of viable firms through, e.g., training and new information means.

37. **The government will intensify the monitoring of the corporate and household sectors, and prepare contingency plans for a large debt overhang in these sectors**. Starting quarterly, reports on corporate and household sectors will be prepared, to include an assessment of their funding pressures and debt refinancing activity. An assessment of the guarantees programs currently place and an evaluation of market-based financing alternatives will also be performed. Finally, a task force will be constituted to prepare contingency plans to efficiently deal with the challenges posed by corporate and household sectors indebtedness. These enhanced monitoring actions will put be in place by end-September 2011 in consultation with EC, IMF, and ECB staff.

E. Enhancing Competitiveness through Structural Reforms

Labor markets

38. **Reforms will focus on creating new jobs, not least for the young.** We must address the fundamental problems that impede the efficient transition of workers across occupations, firms and sectors and create socially unfair privileges. To this end, in consultation with our social partners, we will adopt the following measures:

- **Reform employment protection legislation to foster flexibility and improve equity**. We will align severance payments for open-ended and fixed-term hires, submit legislation by end-July 2011 (structural benchmark) reducing severance payments for all new contracts to 10 days per year of tenure, with an additional 10 days financed out of employers' financed fund, and present a proposal to revise severance payment entitlements for current employees in line with the reform for new hires by end-2011, without reducing accrued-to-date entitlements. As a further step, by end-March 2012, we will prepare a proposal to align the level of severance payments to the EU average, while at the same time amending the dismissal fund in a way that allows the portability of worker's entitlement to severance pay. We will prepare by end-December 2011 a proposal aimed at introducing adjustments to the cases for fair individual dismissals.

- **Revise the unemployment insurance system to change incentives, increase employment, and strengthen social safety nets**. We will reduce the maximum duration of unemployment insurance benefits to no more than 18 months, and cap unemployment benefits at 2.5 times the social support index and introduce a declining profile of benefits after six months of unemployment (a reduction of at least 10 percent in benefits), without reducing accrued-to-date entitlements. To extend social safety nets, we will reduce the necessary contributory period to access unemployment insurance from 15 to 12 months, and present a proposal to extend eligibility for clearly-defined categories of self-employed. Training opportunities will be strengthened, especially for the low-skilled.

- **Ensure that labor costs support job creation and competitiveness**. Over the program period, any increase in the minimum wage will take place only if justified by economic conditions and agreed in the context of regular program reviews.

- **Define clear criteria for the extension of collective agreements**, including the representativeness of the negotiating organizations and the implications of the extension for the competitive position of non-affiliated firms. To promote wage adjustments in line with productivity at the firm level we will (i) allow works councils to negotiate mobility conditions and working time arrangements; (ii) reduce the threshold below which works councils or other workers organizations cannot conclude firm-level agreements to 250 employees per firm; and (iii) include in sectoral collective agreements conditions under which works councils can independently conclude firm-level agreements.

Fiscal devaluation

39. **A critical goal of our program is to boost competitiveness.** This will involve a major reduction in employer's social security contributions**.** This measure will be fully calibrated by the time of the first review (end-July 2011, structural benchmark). The offsetting measures needed to ensure fiscal neutrality may include changing the structure and rates of VAT, additional permanent expenditure cuts, and raising other taxes that would not have an adverse effect on competitiveness. In calibrating this measure, we will take measures to: (i) mitigate the social impact of higher consumption taxes; (ii) ensure that changes to social security contributions are compensated by allocating equivalent revenues in order not to jeopardize the sustainability of the pension system; and (iii) ensure that tax changes are passed through to lower prices. While the proposal might be implemented in two steps, the bold first step will be implemented in the context of the 2012 budget. A structural benchmark for October 2011 will be set at the time of the first review.

Competition Framework

40. **To rebalance growth toward the tradable sector, we need to foster competition in the non-tradable sector**. State involvement in private sector activities will be reduced, and the independence of sectoral regulators reinforced. We will eliminate "golden shares" and all other special rights established by law or in the statutes of publicly quoted companies that give special rights to the state (structural benchmark, end-July 2011).

41. **We will take bold steps to address excessive profits and reduce the scope for rent-seeking behavior**.

- In electricity, we will review the efficiency of support schemes for co-generation and renewables, assessing their rationale, levels, and other relevant design elements, including options for reducing the implicit production subsidy (structural benchmark, end-December 2011). We will reassess legacy support measures associated with the production of electricity under the ordinary regime, and, where possible, revise downwards the guaranteed compensation mechanism (CMEC) paid to producers and the remaining long-term power-purchase agreements (PPAs).

- In telecommunications, we will facilitate the entry in the market of new players awarding the right to use new radio frequencies for broadband wireless access and lowering mobile termination rates, alleviate restrictions on mobility of consumers and ensure that the provision on universal service designation and the incumbent's concession contract are non-discriminatory.

- We will review and reduce the number of regulated professions (by end-September 2011 for professions not regulated by Parliament and by end-March 2012 for all others); eliminate the restriction on the use of advertising in regulated professions (end-September 2011); improve the recognition framework on professional qualifications, ease the requirements related to the establishment of foreign service providers in Portugal; and reduce the number of requirements to which cross-border service providers are subject (end-December 2011).

- We will (i) submit to Parliament a law revising the Competition Law, clearly separating rules on competition enforcement procedures and penal procedures, and (ii) establish a new Court on Competition Matters and introduce greater specialization of judicial functions (structural benchmark).

42. **We commit to a number of additional measures to enhance the flexibility and productive capacity of the economy.** In particular, we will undertake a comprehensive reform of the housing market which aims at facilitating labor mobility and reducing incentives for private sector over-borrowing. We also commit to tackle low educational attainment and improve the quality of secondary and vocational education, and continue reducing the administrative burden for firms in all sectors and facilitate access to export markets by end-March 2012. The joint EC-ECB Memorandum of Understanding further specifies these and other structural policies recommended in the MEFP.

Judicial Reforms

43. **Immediate priority will be given to improve the efficiency of the judicial process.** The current tedious judicial process coupled with a severe backlog of cases impede effective market functioning across a number of sectors. We are committed to implement the announced Judicial Reform Map without delay and take additional steps to make the judicial system efficient and effective.

44. **We aim to resolve the backlog of cases in the courts within 24 months**. An audit of the backlog cases including debt enforcement, insolvency, and tax and labor cases will be completed by end-June 2011. Based on this audit, additional measures will be developed by end-September 2011 to expedite the resolution of the backlog, including (i) establishing separate Chambers or Teams involving all agencies solely for resolving the backlog; (ii) restructuring court record-keeping to take cases off the books; (iii) merging similar small debt enforcement cases; (iv) *strengthening and enforcing existing regulations allowing dormant cases to be removed from the court register*; (v) imposing additional costs and penalties against non-cooperative debtors in enforcement cases; and (vi) assigning special court managers to allow judges to focus on the cases.

45. **The court system will be restructured to improve management efficiency.** Thirty-nine court units, with added management support for each unit, will be established by end-

2012. This restructuring will be entirely financed through expenditure savings and gains of efficiency and is part of the rationalization effort, in order to improve efficiency in the management of infrastructure and public services. We will develop a roadmap for this reform, identifying key quarterly milestones by end-September 2011. A new internal management system will be implemented for two county courts (including Lisbon) by end-2011. The new Courts on Competition Matters and Intellectual Property Rights will become operational by end-January 2012; and we will assess the need for separate Chambers within the Commercial Courts with specialized judges for insolvency cases by end-2011. A new personnel management plan will be developed to support judicial specialization and mobility of court officials by end-2011.

46. **We will further improve the efficiency of civil case processing in the courts.** The new experimental civil procedure regime which has been applied to seven courts will be extended to four courts by end-September 2011. A report will be prepared by end-2011 on whether such regime should be applied to all courts. Finally, we will review the Code of Civil Procedure and prepare a proposal by end-2011 (structural benchmark) addressing the key areas for refinement, including (i) consolidating legislation for all enforcement cases before the court, (ii) giving judges the power to expedite cases, (iii) reducing administrative burdens on judges, and (iv) enforcing statutory deadlines for court processes and in particular injunction procedures and debt enforcement and insolvency cases.

47. **A more sustainable and transparent budget for the judiciary is crucial to the success of the judicial reform.** We will standardize the court fees and introduce special court fees for certain cases and procedures by end-September 2011. The Ministry of Justice will develop and publish an annual plan on the allocation of resources based on court by court performance data. A workload/staffing assessment will be completed for the six pilot courts under the Judicial Reform Map and the specialized courts by end-March 2012. In addition, quarterly reports on recovery rates, duration and costs of corporate insolvency and tax cases will be published starting from the third quarter of 2011.

48. **Alternative dispute resolution (ADR) needs to be strengthened to better facilitate out-of-court settlement.** We will adopt the Law on Arbitration by end-September 2011. We will take all necessary legal, administrative, and other steps to make arbitration for debt enforcement cases fully operational by end-February 2012 to facilitate resolution of backlog cases and out-of-court settlement (structural benchmark). The Justices for Peace regime will be optimized by increasing its capacity to handle small claim cases by end-March 2012. To bolster the ADR regime, we will adopt measures to give priority to the ADR enforcement cases in the courts by end-2011.

F. Program Matters

49. **In the context of the arrangement, the BdP will undergo a safeguards assessment in accordance with the IMF safeguards policy**. In this regard, and to facilitate a timely

completion of the assessment, the authorities have provided the information requested for the assessment to commence, and have also authorized the external auditors to provide information to and hold discussions with IMF staff. A memorandum of understanding between the government and the BdP will establish a clear framework on the modalities for the repayment of IMF financing and the servicing of interest payments and other charges. As part of these arrangements, Fund disbursements will be deposited into the government's account at the BdP pending their use.

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

	Performance Criteria (unless indicated otherwise)			Indicative Targets			
	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
1. Floor on the consolidated General Government cash balance (cumulative) 1/	-5.4	-6.7	-10.3	-1.7	-3.8	-5.9	-7.6
2. Ceiling on accumulation of domestic arrears by the General Government (continuous indicative target) 2/	…	0	0	0	0	0	0
3. Ceiling on the overall stock of General Government debt	175.9	175.9	175.9	189.4	189.4	189.4	189.4
4. Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by the general government 3/	0	0	0	0	0	0	0

1/ Corresponds to an overall deficit of the General Government of €10,042 million on ESA 95 basis. Cumulative from January 1, 2011 for 2011, and cumulative from January 1, 2012 for 2012.
2/ Applies on a continuous basis from September 15, 2011 onwards. Insufficient information for application in June.
3/ Applies on a continuous basis from June 15, 2011 onwards.

Table 2. Portugal: Structural Conditionality

	Measure	Status / Timing
Prior Actions		
1	Direct all banking groups subject to supervision in Portugal to reach a core Tier 1 capital of 9 percent by end-2011 and 10 percent by end-2012 and maintain it thereafter, with banks required to present by end-June 2011 plans on how they intend to comply with these requirements.	Met
2	Prepare a comprehensive report on 10 SOEs posing the largest potential fiscal risks to the state. The report would cover (i) concrete plans, per enterprise, for reducing its operational costs, consistent with an average cut of at least 15 percent in the sector over 2009 levels; (ii) a planned revision of the tariffs.	Met
3	Prepare a comprehensive inventory of the existing tax expenditures (including all types of exemptions, deductions, and reduced rates), by type of tax, along with their costing estimates.	Met
4	Approve a standard definition of arrears and commitments	Met
5	Establish a temporary task force of judges to clear tax cases worth above €1 million	Met
Structural Benchmarks		
A. Strengthen financial stability and enhance banking sector monitoring:		
6	Design a program of special on-site inspections to validate the data on assets that banks provide as inputs to the solvency assessment.	End-Jun. 2011
7	Seek evaluation of the enhanced solvency and deleveraging assessment framework by a joint team of experts from the EC, the ECB and the IMF.	End-Sep. 2011
8	Improve disclosure on non-performing loans by adding a new ratio aligned with international practices to the current ratio that covers only overdue loan payments.	End-Sep. 2011
9	Amend legislation concerning credit institutions in consultation with the EC, the ECB and the IMF to strengthen the early intervention framework and introduce a regime for restructuring of banks as a going concern under official control.	End-Nov. 2011
10	Amend the Insolvency Law to better facilitate effective rescue of viable firms and support rehabilitation of financially responsible individuals.	End-Nov. 2011
11	Amend the relevant legislation to strengthen deposit insurance framework by authorizing bank resolution financing and introducing depositor preference.	End-Dec. 2011
B. Enhance competitiveness:		
12	Eliminate “golden shares” and all other special rights established by law or in the statutes of publicly quoted companies that give special rights to the state.	End-Jul. 2011
13	Submit to Parliament a law, already agreed with social partners, to align and reduce severance payments on all new contracts (fixed term and open-ended).	End-Jul. 2011
14	Finalize calibration of fiscal reform to reduce unit labor costs via deficit-neutral reduction in labor taxes.	End-Jul. 2011
15	Submit to Parliament legislation revising the Competition Law, making it as autonomous as possible from the Administrative Law and the Penal Procedural Law and more harmonized with the European Union competition legal framework.	End-Dec. 2011
16	Review the efficiency of support schemes for co-generation and renewables and propose possible options for reducing the implicit subsidy.	End-Dec. 2011
17	Review the Code of Civil Procedure and prepare a proposal addressing the key areas for refinement.	End-Dec. 2011
18	Take all necessary legal, administrative, and other steps to make arbitration for debt enforcement cases fully operational.	End-Feb. 2012
C. Strengthen public financial management and reduce fiscal risks:		
19	Publish a fiscal strategy document for the general government which will specify 4-year medium-term economic and fiscal forecasts, supporting analysis and underlying assumptions, and 4-year costings of new policy decisions.	End-Aug. 2011
20	Conduct and publish the results of a survey of arrears of general government entities and SOEs for all categories of expenditure as at end-June 2011.	End-Aug. 2011
21	Based on assessment from EU/IMF technical assistance on the budgetary implications of main PPP programs, recruit a top tier international accounting firm to complete a more detailed study of PPPs and identify areas for deeper analysis by an international consulting firm.	End-Dec. 2011
22	Prepare a report on SOEs based on forecast financial statements assessing their financial prospects, potential government exposure, and scope for orderly privatization.	End-Feb. 2012

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

May 17, 2011

1. This Technical Memorandum of Understanding (TMU) sets out the understandings regarding the definitions of the indicators subject to quantitative targets (performance criteria and indicative targets), specified in the tables annexed to the Memorandum of Economic and Financial Policies. It also describes the methods to be used in assessing the Program performance and the information requirements to ensure adequate monitoring of the targets. We will consult with the EC, the ECB, and the IMF before modifying measures contained in this letter or adopting new measures that would deviate from the goals of the Program, and provide the EC, the ECB, and the IMF with the necessary information for Program monitoring.

2. For Program purposes, all foreign currency-related assets, liabilities, and flows will be evaluated at "Program exchange rates" as defined below, with the exception of the items affecting government fiscal balances, which will be measured at spot exchange rate (i.e., the rate for immediate delivery) prevailing on the date of the transaction. The Program exchange rates are those that prevailed on May 5, 2011. In particular, the exchange rates for the purposes of the Program are set €1 = 1.483 U.S. dollar, €1 = 116.8390 Japanese yen, €1.09512 = 1 SDR.

3. For reporting purposes, the transmission of the data covered by this TMU will begin having as a reference the month of June 2011, being the Ministry of Finance (MoF), by the Direcção-Geral do Orçamento (DGO), and the Banco de Portugal (BdP), responsible for the transmission.

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 MTU, 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 includes**:**

- The Central Government. This includes:
  - The entities covered under the State Budget, as defined in the current Budget Framework Law, Law No. 91/2001 of August 20 , amended by Law 48/2004 of August 24, 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), including Caixa Geral de Aposentações (CGA) and National Health Service (NHS)

entities, and other entities belonging to the budgetary Central Government classified by the National Statistical Authority (INE) as part of the Central Government.

- Other entities 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 Authority (INE) as part of the Central Government.

- State-owned enterprises (SOE) which are, under the ESA95 and ESA95 Manual on Government Deficit and Debt rules, classified by the INE as part of the Central Government (ISOE).

- Regional and Local Governments (*Administrações Regionais and Locais*), including 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.

- Social Security Funds comprising all funds that are established in the general social security system.

• This definition of General Government also includes any new funds, or other special budgetary and extra budgetary programs or entities that may be created during the Program period to carry out operations of a fiscal nature and which are, under the ESA95 and ESA95 Manual on Government Deficit and Debt rules, classified by the INE in the correspondent subsector. The MoF will inform the EC, ECB, and IMF of the creation of any such new funds, programs, entities or operations at the time of its creation or statistical re-classification or, in the case of Regional and Local Governments, at the time the Government acknowledges its creation.

• The General Government, as measured for purposes of Program monitoring in 2011, shall not include entities nor operations that are re-classified into General Government during the remainder of 2011.

5. **Supporting material:**

- 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.

- Data on the cash balances of the other parts of General Government as defined in paragraph 4 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 called guarantees and PPP-related revenues and expenditures.

- Data on domestic and foreign debt redemptions, new domestic and foreign debt issuance, change in the domestic and foreign cash balances of the Central Government at the BdP and other financial institutions, and all other sources of financing including capital transactions, and arrears of the General Government will be provided to the EC, the ECB, and the IMF by the DGO in the MoF within seven weeks after the closing of each month.

- BdP will provide to the EC, the ECB, and the IMF detailed monthly data on the financing of the General Government, as defined in ESA95, within seven weeks after the closing of each month.

Quantitative Performance Criteria, Indicative Ceilings, and Continuous Performance Criteria: Definitions and Reporting Standards

G. 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. The net acquisition of financial assets for policy purposes, including loans and equity participation will be recorded as cash expenditures, except for transactions related to the banking sector support and restructuring strategy under the Program.

- **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 non-recurrent 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; EU expenses, and called guarantees (excluding those related to the banking sector support and restructuring strategy) where the Central Government makes payments on behalf of entities that are not part of the General Government.

- **The cash balance of the Regional and Local Governments, Social Security Funds and 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 MoF will make this specification available by end-May 2011. The reporting by Local Government will be phased as set out in paragraph 8 below.

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

Other provisions

7. For the purpose of the program, the expenditure of the central government that is monitored excludes payments related to bank support, when carried out under the program's banking sector and restructuring strategy. Transactions that are excluded from the balance include loans to financial institutions and investments in equity of financial institutions (requited recapitalization); unrequited recapitalization; and purchases of troubled assets. 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. Production of the consolidated General Government budget execution report for internal, EC, ECB, and IMF monitoring will begin in July 2011. The reports will be published externally from end-December 2011. The larger municipalities (defined as those with a population of 100,000 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, 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 quarterly 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**.

- Data on cash balances of the State Government, SEO 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 MoF will submit by end-July and end-January, 2012 a full reconciliation of the cumulative monthly cash deficit up to, respectively, end-March and end-September with the corresponding cumulative accrual deficits determined by the INE in accordance with ESA 95 rules. 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.

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

10. **Definition**. For the purpose of the Program, domestic arrears are defined as invoices 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 in the supplier contract, arrears are defined as invoices that have remained unpaid for 90 days or more after the date of the invoice. Data on arrears will be provided within six weeks after the end of each month. The continuous target of non-accumulation of domestic arrears requires that the total arrears at the end of any month are not greater than the corresponding total at the beginning of the month. Furthermore, in line with quantitative targets to be established at the time of the first review, the existing stock of arrears will be settled or otherwise reduced. This also includes arrears that are being accumulated by the NHS and SOE, which are, otherwise, to a degree excluded from the General Government under ESA95 and ESA95 Manual on Government Deficit and Debt rules classification.

11. Commitment is defined as an explicit or implicit agreement 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.

12. **Supporting material.** Starting in September 2011, the MoF will provide consistent data on monthly expenditure arrears of the General Government, as defined above. Data will be provided within seven weeks after the end of each month and will include total arrears classified by the different constituent sectors of the General Government sub-sector as defined in paragraph 4.

I. 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 ceiling on the stock of General Government debt will exclude debt arising from payments for bank restructuring, when carried out under the Program's banking sector support and restructuring strategy. This includes loans to financial institutions and investments in equity of financial institutions (requited recapitalization); unrequited recapitalization; and purchase of troubled assets. However, any financial operation by the central government to support banks, including the issuance of guarantees or provision of liquidity will be immediately reported to the EC, ECB and IMF.

14. **Adjusters**. For 2011, the ceiling of the overall stock of General Government debt will be adjusted upward (downward) by the amount of any upward (downward) revision to the stock at end-December 2010 general government debt of EUR160.47 billion.

15. **Supporting material**. Quarterly data on the total stock of General Government debt as defined in paragraph 13 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.

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

16. **Definition**. For the purposes of the Program, an external debt payments arrear will be defined as a payment on debt to non-residents 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**. The stock of external debt payment arrears of the General Government will be provided by the MoF with a lag of not more than seven days after the test date.

K. Bank Solvency Support Facility

18. EUR 1 billion will be provided in cash and be made available in a separate dedicated account to be set up at the Bank of Portugal by end-June 2011. The remainder of the EUR 12 billion foreseen for the bank support fund will be deposited into the dedicated account consistent with the need for bank capital determined by Program reviews.

L. 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.

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

APPENDIX II. PORTUGAL: LETTER OF INTENT

Lisbon, May 13, 2011

Mr Jean-Claude Juncker
President
Eurogroup

Mr György Matolcsy
President
Council of the European Union (ECOFIN)

Mr Olli Rehn
Commissioner
European Commission

Mr Jean-Claude Trichet
President
European Central Bank

Dear Sir

1. Against the background of the structural challenges facing the Portuguese economy and contagion from the sovereign debt crisis in other euro area countries, financial conditions facing the Portuguese sovereign and banks have sharply worsened. To restore market confidence and to raise the potential of our economy to generate socially balanced growth and employment we are proposing a far-reaching reform programme, backed by substantial international financing to meet balance of payments needs.

2. Following up on already announced measures, we believe further comprehensive action is required on three fronts: (i) deep structural reforms to boost potential growth, create jobs, and improve competitiveness (including through fiscal devaluation); (ii) a credible and balanced fiscal consolidation strategy, supported by structural fiscal measures and better fiscal control over PPPs and SOEs; and (iii) efforts to safeguard the financial sector against disorderly deleveraging through market-based mechanisms supported by back-up facilities. As our reform programme is implemented, priority will be given to protecting the most vulnerable groups.

3. To signal our strong commitment to implementing the ambitious reform programme, we request financing assistance from international partners. We estimate that the support needed for our external financing will be around €78 billion over the next three years. We

therefore request support from the European Financial Stability Mechanism and the European Financial Stability Facility which could be drawn over a period of 36 months. The overall total of this support will be €52 billion. We are also sending a parallel request for financial assistance to the IMF for a total amount of €26 billion (SDR 23.7 billion). This arrangement will underpin confidence, support market access and help ensure orderly adjustment and the restoration of sustainable growth. We will draw on these resources in parallel throughout the program period, drawing on the EU/euro-area and IMF financing in a ratio of 2 to 1 following programme approval and for each review period (measured at the programme exchange rate).

4. We are confident that the policies described in the attached Memorandum of Economic and Financial Policies (MEFP) are sufficient to achieve the objectives under the programme. An annexed Memorandum of Understanding (MoU) specifies detailed economic policy measures that will be used as benchmarks for assessing policy performance in the context of the quarterly reviews, in coordination with the IMF and the European Commission, under the financial assistance programme. The reviews will assess progress in the programme's implementation and permit understandings on any additional measures that may be needed to achieve its objectives.

5. In particular, progress in the implementation of the policies under this programme will be monitored through quarterly (and continuous) quantitative performance criteria (PCs) and indicative targets, prior actions, structural benchmarks, quarterly programme reviews, and any consultation clauses (these are detailed in Tables 1 and 2; the attached Technical Memorandum of Understanding (TMU) contains definitions), and through the detailed and specific economic policy criteria in the MoU.

6. The conditionality under the programme provides substantial comfort that the programme will be delivered and that the support will be repaid. We will ensure that the financial assistance in the context of the EFSM and EFSF to be provided to Portugal will be subject to the loan terms and conditions that will protect the EU, the euro-area and EU Member States' financial and legal interests in a non discriminatory way as compared to the assistance provided by the euro-area and the EU to other Member States.

7. The Portuguese Government and Banco de Portugal believe that the policies set forth in the attached MoU are adequate to achieve the objectives of our economic programme. We, nonetheless, stand ready to take additional measures that may be needed to meet the objectives set. We will maintain a close policy dialogue and will consult with the European Commission, the ECB and the IMF prior to the adoption of any such measures and in advance of any necessary revisions to the policies included in the MEFP and the MoU. All available information requested by the European Commission, the ECB and the IMF to assess implementation of the programme will be provided.

8. We are confident that resolute implementation of our economic programme will help our economy recover and bolster market sentiment. If fiscal consolidation proceeds faster than expected or if market conditions improve significantly during the programme period, we would refrain pari passu from drawing on the financing assistance.

9. This letter is copied to Mr. Strauss-Kahn.

Sincerely yours,

/s/	/s/
Fernando Teixeira dos Santos	Carlos da Silva Costa
Minister of State and Finance	Governor of Banco de Portugal

Attachment: 1. Memorandum of Economic and Financial Policy Conditionality (MEFPC);

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

May 17, 2011

With regard to Council Regulation (EU) n° 407/2010 of 11 May 2010 establishing a European Financial Stabilisation Mechanism (EFSM), and in particular Article 3(5) thereof, this Memorandum of Understanding details the general economic policy conditions as embedded in Council Implementing Decision […] of […] on granting Union financial assistance to Portugal.[1]

The Council Implementing Decision specifies that the first disbursement of financial assistance from the EFSM shall be released subject to the entry into force of this Memorandum of Understanding on specific economic policy conditionality (MoU) and of the Loan Agreement. Before the signature of this MoU, Portugal has completed the prior actions set out in the Memorandum of Economic and Financial Policies (MEFP) and which are also included in this MoU.

The Decision also makes the release of further instalments conditional on a positive conclusion of the reviews of conditionality that will take place throughout the three-year duration of the programme. These reviews will assess progress made with respect to the policy criteria in the Council Implementing Decision and specified in the MEFP and in this MoU, as well as Council Recommendations in the context of the Excessive Deficit Procedure. The first quarterly review will be carried out in the third quarter of 2011 and will assess compliance with the conditions to be met by end-July. The following reviews taking place in any given quarter will assess compliance with the conditions to be met by the end of the previous quarter.

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

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

1. Fiscal policy

Objectives

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

Fiscal policy in 2011

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

1.2. Over the remainder of the year, the government will rigorously implement the Budget Law for 2011 and the additional fiscal consolidation measures introduced before May 2011. Progress will be assessed against the (cumulative) quarterly deficit ceilings in the Memorandum of Economic and Financial Policies (MEFP), including the Technical Memorandum of Understanding (TMU). **[Q3 and Q4-2011]**

Fiscal policy in 2012

1.3. On the basis of a proposal developed by the time of the first review **[end-July 2011]**,[2] the 2012 Budget will include a budget neutral recalibration of the tax system with a view to lower labour costs and boost competitiveness **[October 2011]**.

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

1.5. Throughout the year, the government will rigorously implement the Budget Law for 2012. Progress will be assessed against the (cumulative) quarterly deficit ceilings in the Memorandum of Economic and Financial Policies (MEFP), including the Technical Memorandum of Understanding (TMU). **[Q1, Q2, Q3 and Q4-2012]**

1.6. The following measures will be carried out with the 2012 Budget Law **[Q4-2011]**, unless otherwise specified:

Expenditure

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

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

i. reduce the number of services while maintaining quality of provision;

ii. create a single tax office and promoting services' sharing between different parts of the general government;

iii. reorganise local governments and the provision of central administration services at local level;

iv. regularly assess the value for money of the various public services that are part of the government sector as defined for national accounts purposes;

v. promote mobility of staff in central, regional and local administrations;

vi. reduce transfers from the State to public bodies and other entities;

vii. revise compensation schemes and fringe benefits in public bodies and entities that independently set their own remuneration schemes;

viii. reduce subsidies to private producers of goods and services.

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

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

i. Limit staff admissions in public administration to achieve annual decreases in 2012-2014 of 1% per year in the staff of central administration and 2% in local and regional administration. **[Q3-2011]**

ii. Freeze wages in the government sector in nominal terms in 2012 and 2013 and constrain promotions.

iii. Reduce the overall budgetary cost of health benefits schemes for government employees schemes (ADSE, ADM and SAD) lowering the employer's contribution and adjusting the scope of health benefits, with savings of EUR 100 million in 2012.

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

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

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

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

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

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

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

i. sustaining an average permanent reduction in operating costs by at least 15%;

ii. tightening compensation schemes and fringe benefits;

iii. rationalisation of investment plans for the medium term;

iv. increase their revenues from market activities.

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

Revenue

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

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

i. abolishing all reduced corporate income tax rates;

ii. limiting the deductions of losses in previous years according to taxable matter and reducing the carry-forward period to three years;

iii. reducing tax allowances and revoking subjective tax exemptions;

iv. curbing tax benefits, namely those subject to the sunset clause of the Tax Benefit Code, and strengthening company car taxation rules;

v. proposing amendments to the regional finance law to limit the reduction of corporate income tax in autonomous regions to a maximum of 20% vis-à-vis the rates applicable in the mainland.

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

i. capping the maximum deductible tax allowances according to tax bracket with lower caps applied to higher incomes and a zero cap for the highest income brackets;

ii. applying separate caps on individual categories by (a) introducing a cap on health expenses; (b) eliminating the deductibility of mortgage principal and phasing out the deductibility of rents and of mortgage interest payments for owner-occupied housing; eliminate interest income deductibility for new mortgages (c) reducing the items eligible for tax deductions and revising the taxation of income in kind;

iii. proposing amendments to the regional finance law to limit the reduction of personal income tax in autonomous regions to a maximum of 20% vis-à-vis the rates applicable in the mainland.

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

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

1.23. Raise VAT revenues to achieve a yield of at least EUR 410 million for a full year by:

i. reducing VAT exemptions;

ii. moving categories of goods and services from the reduced and intermediate VAT tax rates to higher ones;

iii. proposing amendments to the regional finance law to limit the reduction of VAT in the autonomous regions to a maximum of 20% vis-à-vis the rates applicable in the mainland.

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

i. raising car sales tax and cutting car tax exemptions;

ii. raising taxes on tobacco products;

iii. indexing excise taxes to core inflation;

iv. introducing electricity excise taxes in compliance with EU Directive 2003/96.

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

Fiscal policy in 2013

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

1.27. Throughout the year, the government will rigorously implement the Budget Law for 2013. Progress will be assessed against the (cumulative) quarterly deficit ceilings in the Memorandum of Economic and Financial Policies (MEFP), including the Technical Memorandum of Understanding (TMU). **[Q1, Q2, Q3 and Q4-2013]**

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

Expenditure

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

i. central administration functioning: EUR 500 million. Detailed plans will be presented and assessed before Q3-2012;

ii. education and school network rationalization: EUR 175 million;

iii. wage bill: annual decreases of 1% per year in headcounts of central administration and 2% in local and regional administrations;

iv. health benefits schemes for government employees: EUR 100 million.

v. health sector: EUR 375 million;

vi. transfers to local and regional authorities: EUR 175 million;

vii. costs in other public bodies and entities, and in SOEs: EUR 175 million;

viii. capital expenditure: EUR 350 million;

ix. maintain the suspension of pension indexation rules except for the lowest pensions in 2013.

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

Revenue

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

i. corporate tax bases and reduce tax benefits and tax deductions: EUR 150 million;

ii. personal income tax benefits and tax deductions: EUR 175 million;

iii. taxation of all types of cash social transfers and convergence of personal income tax deductions for pensions and labour income: EUR 150 million;

iv. excise taxes: EUR 150 million.

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

Fiscal policy in 2014

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

1.34. Throughout the year, the Government will rigorously implement the Budget Law for 2014. Progress will be assessed against the (cumulative) quarterly deficit ceilings in the Memorandum of Economic and Financial Policies (MEFP), including the Technical Memorandum of Understanding (TMU). **[Q1 and Q2-2014]**

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

2. Financial sector regulation and supervision

Objectives

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

Maintaining liquidity in the banking sector

2.1. Subject to approval under EU competition rules, the authorities are committed to facilitate the issuance of government guaranteed bank bonds for an amount of up to EUR 35 billion, including the existing package of support measures.

Deleveraging in the banking sector

2.2. Banco de Portugal (BdP) and the ECB, in consultation with the European Commission (EC) and the IMF, will include clear periodic target leverage ratios and will ask banks to devise by **end-June 2011** institution-specific medium-term funding plans to achieve a stable market-based funding position. To smooth the deleveraging process, the authorities will encourage private investors to maintain their exposure. Quarterly reviews will be conducted in consultation with the EC and the IMF, and will examine the feasibility of individual banks' plans and their implications for leverage ratios, as well as the impact on credit aggregates and the economy as a whole, and the BdP will then request adjustments in the plans as needed.

Capital buffers

2.3. BdP will direct all banking groups supervised by BdP to reach a core Tier 1 capital ratio of 9 percent by **end-2011** and 10 percent at the latest by **end-2012** and maintain it thereafter.[3] If needed, using its Pillar 2 powers, the BdP will also require some banks, based on their specific risk profile, to reach these higher capital levels on an accelerated schedule, taking into account the indications of the solvency assessment framework described below. Banks will be required to present plans to BdP by **end-June 2011** on how they intend to reach the new capital requirements through market solutions.

2.4. In the event that banks cannot reach the new capital requirements on time, ensuring higher capital standards might temporarily require public provision of equity for the private banks. To that effect, the authorities will augment the bank solvency support facility, in line with EU state aid rules, with resources of up to EUR 12 billion provided under the programme. The facility will be designed in a way that preserves the control of the management of the banks by their non-state owners during an initial phase and allows them the option of buying back the government's stake. The banks benefitting from equity

[3] Prior action in the Memorandum of Economic and Financial Policies.

injections will be subjected to specific management rules and restrictions, and to a restructuring process in line with EU competition and state aid requirements, that will provide the incentive to give priority to market-based solutions.

Caixa Geral de Depósitos (CGD)

2.5. The state-owned CGD group will be streamlined to increase the capital base of its core banking arm as needed. The CGD bank is expected to raise its capital to the new required level from internal group resources, and improve the group's governance. This will include a more ambitious schedule toward the already announced sale of the insurance arm of the group, a program for the gradual disposal of all non-core subsidiaries, and, if needed a reduction of activities abroad.

Monitoring of bank solvency and liquidity

2.6. The BdP is stepping up its solvency and deleveraging assessment framework for the system as a whole and for each of the eight largest banks, and will seek an evaluation of the enhanced assessment framework by **end-September 2011** by a joint team of experts from the EC, the ECB and the IMF.[4]

2.7. By **end-June 2011**, the BdP will also design a program of special on-site inspections to validate the data on assets that banks provide as inputs to the solvency assessment. This program will be part of a capacity building technical cooperation project put in place with the support of the EC, the ECB, and the IMF that will bring together Portuguese supervisors, cooperating central banks and/or supervisory agencies, external auditors and other experts as needed.[5]

2.8. The BdP will provide quarterly updates of banks' potential capital needs going forward and check that their deleveraging process remains on track and properly balanced. Whenever the assessment framework will indicate that a bank's core Tier 1 ratio might fall under 6 percent under a stress scenario over the course of the program, the BdP, using its Pillar 2 powers, will ask it to take measures to strengthen its capital base.

Banking regulation and supervision

2.9. BdP will ensure by **end-September 2011** that the disclosure of non-performing loans will be improved by adding a new ratio aligned with international practices to the current ratio that covers only overdue loan payments.[6] BdP will intensify on-site inspections and verification of data accuracy with technical assistance from the IMF, in the context of the data verification exercise for the new solvency assessment framework. BdP will allocate new resources to the recruitment of additional specialist banking supervisors. Close coordination will be maintained between home and host country supervisors within the EU framework for

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

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

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

cross-border banking supervision and with relevant non-EU host supervisors of branches and subsidiaries of Portuguese banks.

Banco Português de Negócios

2.10. The authorities are launching a process to sell Banco Português de Negócios (BPN) on an accelerated schedule and without a minimum price. To this end, a new plan is submitted to the EC for approval under competition rules. The target is to find a buyer **by end-July 2011** at the latest.

2.11. To facilitate the sale, the three existing special purpose vehicles holding its non-performing and non-core assets have been separated from BPN, and more assets could be transferred into these vehicles as part of the negotiations with prospective buyers. BPN is also launching another program of more ambitious cost cutting measures with a view to increase its attractiveness to investors

2.12. Once a solution has been found, CGD's state guaranteed claims on BPN and all related special purpose vehicles will be taken over by the state according to a timetable to be defined at that time.

Bank resolution framework

2.13. The authorities will amend legislation concerning credit institutions in consultation with the EC, the ECB and the IMF by **end-November 2011** to, inter alia, impose early reporting obligations based on clear triggers and penalties. BdP will be authorised to take remedial measures to promote implementation of a recovery plan. Credit institutions with systemic risks will be required to prepare contingency resolution plans) subject to regular review.[7]

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

The Deposit Guarantee Fund

2.15. The authorities will strengthen the legislation on the Deposit Guarantee Fund (FGD) and on the Guarantee Fund for Mutual Agricultural Credit Institutions (FGCAM), in consultation with EC, the ECB and the IMF, **by end-2011.**[8] These funds' functions will be re-examined to strengthen protection of guaranteed depositors. These funds should however retain the ability to fund the resolution of distressed credit institutions and in particular the transfer of guaranteed deposits to another credit institution but not to recapitalise them. Such

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

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

financial assistance shall be capped at the amount of guaranteed deposits that would have to be paid out in liquidation. This should be permissible only if it does not prejudice their ability to perform their primary function.

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

Corporate and household debt restructuring framework

2.17. To better facilitate effective rescue of viable firms, the Insolvency Law will be amended by **end-November 2011** with technical assistance from the IMF, to, inter alia, introduce fast track court approval procedures for restructuring plans. [9]

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

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

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

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

Monitoring of corporate and household indebtedness

2.22. The authorities will prepare quarterly reports on corporate and household sectors including an assessment of their funding pressures and debt refinancing activities. The authorities will assess guarantee programmes currently in place and evaluate market-based financing alternatives. A task force will be constituted to prepare contingency plans to efficiently deal with the challenges posed by high corporate and household sectors indebtedness. These enhanced monitoring actions will put be in place by **end-September 2011** in consultation with the EC, the IMF and the ECB.

3. Fiscal-structural measures

Objectives

Improve the efficiency of the public administration by eliminating redundancies, simplifying procedures and reorganising services; regulate the creation and functioning of all public

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

entities (e.g. enterprises, foundations, associations); streamline the budgetary process through the newly approved legal framework, including by adapting accordingly the local and regional financial legal frameworks; strengthen risk management, accountability, reporting and monitoring.

Public Financial Management framework

To strengthen the public financial management framework the Government will take the following measures:

Reporting

3.1. Approve a standard definition of arrears and commitments.[10] **[Q2-2011]**

3.2. Conduct and publish a comprehensive survey of arrears by **end-August 2011** covering all categories of expenditure payables as at the end of June 2011. All general government entities and SOEs classified outside the general government will be covered by this survey.[11]

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

3.4. The existing annual report on tax expenditures will be improved, starting with the 2012 budget, in line with international best practices. The report will cover central, regional and local administrations. Technical assistance may be provided if necessary. **[Q3-2011]** A comprehensive inventory of the existing tax expenditures, by type of tax, along with their policy costs estimates will be prepared by **Q2-2011**.[12]

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

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

ii. public quarterly balance targets for the general government as defined in national accounts.

3.6. Implement any changes to the budget execution rules and procedures necessary to align with the standard definition of arrears and commitments. Meanwhile, existing commitment control procedures will be enforced for all types of expenditure across the general government. Technical assistance may be provided if necessary. **[Q4-2011]**

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[10] Prior action in the Memorandum of Economic and Financial Policies.

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

[12] Prior action in the Memorandum of Economic and Financial Policies.

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

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

3.9. Publish information on: number of general government staff on a quarterly basis (no later than 30 days after the end of the quarter); Stock and flows over the relevant period per Ministry or employment entity (i.e. new hiring, retirement flows, and exit to other government service, private sector or unemployment); average wage, allowances and bonuses. **[Q1-2012]**

Monitoring

3.10. Approve a standard definition of contingent liabilities. **[Q2-2011]**

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

Budgetary framework

3.12. Publish a fiscal strategy document for the general government by **end-August 2011** and annually thereafter in April for the Stability Programme. The document will specify 4-year medium-term economic and fiscal forecasts and 4-year costs of new policy decisions. Budgets will include a reconciliation of revisions to the 4 year fiscal forecasts attributable to policy decisions and parameter revisions e.g. policy decisions, changes in the macroeconomic environment.[13]

3.13. Ensure full implementation of the Budgetary Framework Law adopting the necessary legal changes, including to the regional and local finance laws: **[Q3-2011]**

i. The general government perimeter will cover the State, Other public bodies and entities, Social Security, SOEs and PPPs reclassified within the general government and local and regional administrations.

ii. Define in detail the proposed characteristics of the medium-term budgetary framework, including medium-term fiscal strategy, decision-making and prioritisation process, carry over rules, commitment controls; and appropriate contingency reserves and related access rules. **[Q3-2011]**

3.14. A proposal to revise the local and regional finance laws will be submitted to Parliament in order to fully adapt the local and regional financing framework to the principles and rules

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

adopted by the recently revised Budgetary Framework Law, namely in what concerns (i) the inclusion of all relevant public entities in the perimeter of local and regional government; (ii) the multi-annual framework with expenditure, budget balance and indebtedness rules, and programme budgeting; and (iii) the interaction with the function of the Fiscal Council. **[Q4-2011]**

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

3.16. Adopt the Statutes of the Fiscal Council, based on the working group report of 6 April 2011. The Council will be operational in time for the 2012 budget. **[Q3-2011]**

Public Private Partnerships

The Government will:

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

3.18. Perform with the technical assistance from EC and the IMF, an initial assessment of at least the 20 most significant PPP contracts, including the major *Estradas de Portugal* PPPs, covering a wide range of sectors. **[end-August 2011]**

3.19. The Government will recruit a top tier international accounting firm to undertake a more detailed study of PPPs in consultation with INE and the Ministry of Finance.[14] The review will identify and, where practicable, quantify major contingent liabilities and any related amounts that may be payable by the Government. It will assess the probability of any payments by Government in relation to the contingent liabilities and quantify such amounts. The study, to be completed by **end-March 2012,** will assess the feasibility to renegotiate any PPP or concession contract to reduce the Government financial obligations. All PPPs and concession contracts will be available for these reviews. **[Q4-2011]**

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

3.21. Enhance the annual PPP and concessions report prepared by the Ministry of Finance in July with a comprehensive assessment of the fiscal risks stemming from PPPs and concessions. The report will provide information and analysis at sectoral level. The annual review of PPPs and concessions will be accompanied by an analysis of credit flows channelled to PPPs through banks (loans and securities other than shares) by industry and an impact assessment on credit allocation and crowding out effects. This particular element will be done in liaison with the Bank of Portugal. **[Q2-2012]**

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

State-owned enterprises[15]

3.22. Report on concrete plans to reduce the overall operating costs of central government 10 State-owned enterprises (SOEs) posing the largest potential fiscal risks to the State by at least 15% over the 2009 levels and on a planned review of the tariff structure.[16]

3.23. Prepare a comprehensive assessment of the tariff structure of State-owned enterprises (SOEs) to reduce the degree of subsidisation. For the central government SOEs, the assessment will be done by **end-July 2011**, for local and regional government SOEs by **end-September 2011**. Review the level of service provisions of all SOEs. **[Q3-2011]**

3.24. Review ongoing plans to reduce operational costs by the end of 2011 by at least 15% on average compared with 2009, proposing company specific cuts that are consistent with a realistic economic and financial assessment. For the central government SOEs, the review will be carried out by **end-July 2011**, for local and regional government SOEs by **end-September 2011**.

3.25. Apply tighter debt ceilings to SOEs from 2012 onwards. For the central government SOEs, the plans will be announced by **end-July 2011**, for local and regional government SOEs by **end-September 2011**.

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

3.27. Prepare a report reviewing the operations and finances of SOEs at central, regional and local government levels. The report will assess these companies' business financial prospects, the potential exposure of the government and scope for orderly privatisation. The Government will adopt the necessary legal changes to fulfill this requirement. Technical assistance will be provided.[17] **[Q1-2012]**

3.28. No additional SOEs at central government level will be created until this review is completed. Given the financial impact of these decisions, the Government will submit to Parliament a draft law so that this limitation will also be applicable to local authorities. The Government will promote the initiatives needed so that the same objective is achieved by the regions. **[Q1-2012]**

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

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

16 Prior action in the Memorandum of Economic and Financial Policies.

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

promote the initiatives needed so that the same objective is achieved by the regions. **[Q1-2012]**

3.30. The annual SOEs report prepared by the MoF **in July 2011** will include a comprehensive fiscal risk report detailing and analyzing all liabilities (explicit and implicit) of SOEs.

Privatisation

3.31. The Government will accelerate its privatisation programme. The existing plan, elaborated through 2013, covers transport (Aeroportos de Portugal, TAP, and freight branch of CP), energy (GALP, EDP, and REN), communications (Correios de Portugal), and insurance (Caixa Seguros), as well as a number of smaller firms. The plan targets front-loaded proceeds of about €5.5 billion through the end of the program, with only partial divestment envisaged for all large firms. The Government commits to go even further, by pursuing a rapid full divestment of public sector shares in EDP and REN, and is hopeful that market conditions will permit sale of these two companies, as well as of TAP, by the **end of 2011**. The Government will identify, by the time of the **second review**, two additional large enterprises for privatisation by end-2012. An updated privatisation plan will be prepared by **March 2012.**

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

Revenue administration

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

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

i. Establishing special chambers within the tax tribunals, specialised to handle large cases and assisted by a specialised technical staff pool; **[Q1-2012]**

ii. Reducing the number of municipal offices by at least 20% per year in 2012 and 2013; **[Q4-2012 and Q4-2013]**

iii. Increase in the resources devoted to auditing in the tax administration to at least 30% of the total staff, mostly through reallocations of staff within the tax administration and other parts of the public administration. The threshold should be attained by **Q4-2012**.

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

i. Reviewing the assessment of audit performance based on both qualitative and quantitative indicators; **[Q3-2011]**

ii. Applying interest charges on the outstanding debt over the whole appeal period using an interest rate above market levels. Impose a special statutory interest on non-compliance with a tax court decision; **[Q3-2011]**

iii. Implement the new tax arbitration law by **Q3-2011;**

iv. Establishing an integrated IT system between the revenue administration and the tax courts; **[Q4-2011]**

v. Setting up a temporary task force of judges by **Q2-2011**[18] to clear cases worth above EUR 1 million by **Q4-2012**.

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

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

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

Public administration

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

Central, regional and local administration

3.39. Reduce management positions and administrative units by at least 15% in the central administration. **[Q4-2011]**

3.40. In view of improving the efficiency of the central administration and rationalising the use of resources, implement a second phase of the public administration restructuring programme (PRACE 2007). **[Q4-2011]**

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

3.42. In conjunction with the review of SOEs (see above), prepare a detailed cost/benefit analysis of all public and quasi-public entities, including foundations, associations and other bodies, across all levels of government. **[Q4-2011]** Based on the results of this analysis, the

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18 Prior action in the Memorandum of Economic and Financial Policies.

administration (central, regional or local) responsible for the public entity will decide to close or to maintain it in respect of the law (see below). **[Q2-2012**]

3.43. Regulate by law the creation and the functioning of foundations, associations, and similar bodies by the central and local administration. This law, which will also facilitate the closure of existing entities when warranted, will be prepared in coordination with a similar framework to be defined for SOEs. The law will define the monitoring and reporting mechanisms and evaluation performance. In addition, the Government will promote the initiatives needed **[Q4-2011]** so that the same objective is achieved by the regions.

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

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

Shared services

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

i. Fully implement the strategy of shared services in the area of financial (GeRFIP) and human resources (GeRHup). **[Q2-2012]**

ii. Rationalise the use of IT resources within the central administration by implementing shared services and reducing the number of IT entities in individual Ministries or other public entities. **[Q4-2012]**

3.47. 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

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

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

Health care system

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

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

Financing

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

i. a substantial revision of existing exemption categories, including stricter means-testing in cooperation with Minister of labour and social affairs; **[by September-2011]**

ii. increase of moderating fees in certain services while ensuring that primary care moderating fees are lower than those for outpatient specialist care visits and lower than emergency visits; **[by September-2011]**

iii. legislate automatic indexation to inflation of NHS moderating fees. **[Q4-2011]**

3.51. Cut substantially (by two thirds overall) tax allowances for healthcare, including private insurance. **[Q3-2011]**

3.52. To achieve a self sustainable model for health-benefits schemes for civil servants, the overall budgetary cost of existing schemes – ADSE, ADM (Armed Forces) and SAD (Police Services) - will be reduced by 30% in 2012 and a further 20% in 2013, at all levels of general government. Further reductions at a similar pace will follow in the subsequent years towards having them self-financed by 2016. The budgetary costs of these schemes will be reduced by lowering the employer's contribution and adjusting the scope of health benefits. **[Q4-2011]**

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

Pricing and reimbursement of pharmaceuticals
3.54. Set the maximum price of the first generic introduced in the market to 60% of the branded product with similar active substance. **[Q3-2011]**

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

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

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

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

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

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

Pharmacies sector

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

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

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

Centralised purchasing and procurement

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

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

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

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

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

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

Primary care services

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

i. increasing the number of USF (*Unidades de Saúde Familiares*) units contracting with regional authorities (ARSs) using a mix of salary and performance-related payments as currently the case. Make sure that the new system leads to reduction in costs and more effective provision; **[Q3-2011]**

ii. set-up a mechanism to guarantee the presence of family doctors in needed areas to induce a more even distribution of family doctors across the country. **[Q4-2011]**

Hospital services

3.71. Set out a binding and ambitious timetable to clear all arrears (accounts payable to domestic suppliers past due date by 90 days) and introduce standardised commitment control procedures for all entities to prevent the re-emergence of arrears. **[Q3-2011]**

3.72. Provide detailed description of measures aimed at achieving a reduction of EUR 200 million in the operational costs of hospitals in 2012 (EUR 100 million in 2012 in addition to savings of over EUR 100 million already in 2011), including reduction in the number of management staff, as a result of concentration and rationalisation in state hospitals and health centres. **[Q3-2011]**

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

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

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

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

3.77. Continue with the reorganisation and rationalisation of the hospital network through specialisation and concentration of hospital and emergency services and joint management (building on the Decree-Law 30/2011) joint operation of hospitals. These improvements will deliver additional cuts in operating costs by at least 5 per cent in 2013. A detailed action plan is published by 30 November 2012 and its implementation is finalised by the first quarter 2013. **[Q2-2012]**

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

3.79. Annually update the inventory of all practising doctors by specialty, age, region, health centre and hospital, public and private sector so as to be able to identify practising, professional and licensed physicians and current and future staff needs by the above categories. **[Q3-2011]**

3.80. Prepare regular annual reports, the first to be published by the end of March 2012, presenting plans for the allocation of human resources in the period up to 2014. The Report specifies plans to reallocate qualified and support staff within the NHS. **[Q3-2011]**

3.81. Introduce rules to increase mobility of healthcare staff (including doctors) within and across health regions. Adopt for all staff (including doctors) flexible time arrangements, with a view of reducing by at least 10% spending on overtime compensation in 2012 and another 10% in 2013. Implement a stricter control of working hours and activities of staff in the hospital. **[Q1-2012]**

Cross services

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

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

4. Labour market and education

Labour market

Objectives

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

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

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

Unemployment benefits

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

i. reducing the maximum duration of unemployment insurance benefits to no more than 18 months. The reform will not concern those currently unemployed and will not reduce accrued-to-date rights of employees;

ii. capping unemployment benefits at 2.5 times the social support index (IAS) and introducing a declining profile of benefits over the unemployment spell after six months of unemployment (a reduction of at least 10% in the benefit amount). The reform will concern those becoming unemployed after the reform;

iii. reducing the necessary contributory period to access unemployment insurance from 15 to 12 months;

iv. presenting a proposal for extending eligibility to unemployment insurance to clearly-defined categories of self-employed workers providing their services to a single firm on a regular basis. The proposal will take into account the risks of possible abuses and will contain an assessment of the fiscal impact of extending benefits under several scenarios concerning eligibility criteria (namely the involuntary character of unemployment) and requirements for increased social security contributions for firms making use of these arrangements.

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

Employment protection legislation

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

4.4. Severance payments.

i. The Government will submit **by end-July 2011** legislation to Parliament to implement a reform in the severance payments for new hires in line with the March 2011 Tripartite Agreement.[19] Severance payments of open-ended

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

contracts will be aligned with those of fixed-term contracts. The reform will re-design the system for severance payment entitlements as follows:

- o total severance payments for new open-ended contracts will be reduced from 30 to 10 days per year of tenure (with 10 additional days to be paid by an employers' financed fund) with a cap of 12 months and elimination of the 3 months of pay irrespective of tenure;
- o total severance payments for fixed-term contracts will be reduced from 36 to 10 days per year of tenure for contracts shorter than 6 months and from 24 to 10 days for longer contracts (with 10 additional days to be paid by an employers' financed fund);
- o implementation of the fund agreed in the March Tripartite Agreement to partly finance the cost of dismissals for new hires.

ii. By **Q4-2011**, the Government will present a proposal to align severance payment entitlements for current employees in line with the reform for new hires, (taking into account the revised link between entitlement and seniority and the cap to total entitlements) without reducing accrued-to-date entitlements. This plan will lead to draft legislation to be submitted to Parliament by [**Q1-2012**].

iii. By **Q1-2012**, the Government will prepare a proposal aiming at:

- o aligning the level of severance payments to that prevailing on average in the EU;
- o allowing the severance pay entitlements financed from the fund agreed in the Tripartite agreement to be transferable to different employers by means of the creation of notional individual accounts.

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

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

i. Individual dismissals linked to unsuitability of the worker should become possible even without the introduction of new technologies or other changes to the workplace (art. 373-380, 385 Labour Code). Inter alia, a new reason can be added regarding situations where the worker has agreed with the employer specific delivery objectives and does not fulfil them, for reasons deriving exclusively from the workers' responsibility;

ii. Individual dismissals linked to the extinction of work positions should not necessarily follow a pre-defined seniority order if more than one worker is assigned to identical functions (art. 368 Labour Code). The predefined seniority order is not necessary provided that the employer establishes a relevant and non- discriminatory alternative criteria (in line with what already happens in the case of collective dismissals);

iii. Individual dismissals for the above reasons should not be subject to the obligation to attempt a transfer for a possible suitable position (art. 368, 375 Labour Code). As a rule, whenever there are work positions available that match the qualifications of the worker, dismissals should be avoided.

Working time arrangements

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

i. The Government will prepare an assessment regarding the use made of increased flexibility elements by the social partners associated with the 2009 Labour Code revision and prepare an action plan to promote the use of flexible working time arrangements, including on modalities for permitting the adoption of "bank of hours" working arrangement by mutual agreement of employers and employees negotiated at plant level**. [Q4-2011]**

ii. Draft legislation will be submitted to Parliament by **Q1-2012** on the following aspects:

- implementation of the commitments agreed in the March Tripartite Agreement regarding working time arrangements and short-time working schemes in cases of industrial crisis, by easing the requirements employers have to fulfill to introduce and renew these measures;
- revision of the minimum additional pay for overtime established in the Labour Code: (i) reduction to maximum 50% (from current 50% for the first overtime hour worked, 75% for additional hours, 100% for overtime during holydays); (ii) elimination of the compensatory time off equal to 25% of overtime hours worked. These norms can be revised, upwards or downwards, by collective agreement.

Wage setting and competitiveness

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

i. commit that, over the programme period, any increase in the minimum wage will take place only if justified by economic and labour market developments and agreed in the framework of the programme review;

ii. define clear criteria to be followed for the extension of collective agreements and commit to them. The representativeness of the negotiating organisations and the implications of the extension for the competitive position of non-affiliated firms will have to be among these criteria. The representativeness of negotiating organisations will be assessed on the basis of both quantitative and qualitative indicators. To that purpose, the Government will charge the national statistical authority to do a survey to collect data on the representativeness of social partners on both sides of industry. Draft legislation defining criteria for extension and modalities for their implementation will be prepared by **Q2-2012;**

iii. prepare an independent review by **Q2-2012** on**:**

- o how the tripartite concertation on wages can be reinvigorated with the view to define norms for overall wage developments that take into account the evolution of the competitive position of the economy and a system for monitoring compliance with such norms**;**
- o the desirability of shortening the survival (sobrevigência) of contracts that are expired but not renewed (art 501 of the Labour Code).
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4.8. The Government will promote wage adjustments in line with productivity at the firm level. To that purpose, it will**:**

i. implement the commitments in the Tripartite Agreement of March 2011 concerning the "organised decentralisation", notably concerning: (i) the possibility for works councils to negotiate functional and geographical mobility conditions and working time arrangements; (ii) the creation of a Labour Relations Centre supporting social dialogue with improved information and providing technical assistance to parties involved in negotiations; (iii) the lowering of the firm size threshold above which works councils can conclude firm-level agreements to 250 employees. Action for the implementation of these measures will have to be taken **by Q4-2011;**

ii. promote the inclusion in sectoral collective agreements of conditions under which works councils can conclude firm-level agreements without the delegation of unions. An action plan will have to be produced **by Q4-2011**.

iii. **By Q1-2012,** present a proposal to reduce the firm size threshold for works councils to conclude agreements below 250 employees, with a view to adoption **by Q2-2012**.

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

Active labour market policies

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

i. a report on the effectiveness of current activation policies and other ALMPs in tackling long-term unemployment, improving the employability of the young and disadvantaged categories, and easing labour market mismatch;

ii. an action plan for possible improvements and further action on activation policies and other ALMPs, including the role of Public Employment Services.

Education and training

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

i. Set up an analysis, monitoring, assessment and reporting system in order to accurately evaluate the results and impacts of education and training policies, notably plans already implemented (notably concerning cost saving measures, vocational education and training and policies to improve school results and contain early school leaving). **[Q4-2011]**

ii. Present an action plan to improve the quality of secondary education services including via: (i) the generalization of trust agreements between the Government and public schools, establishing wide autonomy, a simple formula-based funding framework comprising performance evolution criteria, and accountability; (ii) a simple result-oriented financing framework for professional and private schools in association agreements based on fixed per-class funding plus incentives linked to performance criteria; (iv) a reinforced supervisory role of the General Inspectorate**. [Q1-2012]**

iii. Present an action plan aimed at (i) ensuring the quality, attractiveness and labour market relevance of vocational education and training through partnerships with companies or other stakeholders; (ii) enhancing career guidance mechanisms for prospective students in vocational educational training. **[Q1-2012]**

5. Goods and services markets

Energy markets

Objectives

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

Liberalisation of electricity and gas markets

5.1. Regulated electricity tariffs will be phased out **by January 1, 2013** at the latest. Present a roadmap for the phasing out following a stepwise approach by **end-July 2011**. The provisions will specify:

i. The timeline and criteria to liberalise the remaining regulated segments, such as pre-determined conditions relating to the degree of effective competition in the relevant market;

ii. The methods to ensure that during the phasing-out period market prices and regulated tariffs will not diverge significantly and to avoid cross-subsidisation between consumers segments;

iii. The definition of vulnerable consumers and the mechanism to protect them.

5.2. Transpose the Third EU Energy Package by the **end of June 2011**. This will ensure the National Regulator Authority's independence and all powers foreseen in the package.

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

5.4. Regulated gas tariffs are to be phased out by **January 1, 2013** at the latest.

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

Additional costs associated with electricity production under the ordinary regime

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

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

5.7. Review the efficiency of support schemes for co-generation and propose possible options for adjusting downward the feed-in tariff used in co-generation (reduce the implicit subsidy).[20] **[Q4-2011]**

5.8. Review in a report the efficiency of support schemes for renewables, covering their rationale, their levels, and other relevant design elements.[21] **[Q4-2011]**

5.9. For existing contracts in renewables, assess in a report the possibility of agreeing a renegotiation of the contracts in view of a lower feed-in tariff.[22] **[Q4-2011]**

5.10. For new contracts in renewables, revise downward the feed-in tariffs and ensure that the tariffs do not over-compensate producers for their costs and they continue to provide an incentive to reduce costs further, through digressive tariffs. For more mature technologies

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

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

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

develop alternative mechanisms (such as feed-in premiums). Reports on action taken will be provided annually in **Q3-2011, Q3-2012** and **Q3-2013**.

5.11. Decisions on future investments in renewables, in particular in less mature technologies, will be based on a rigorous analysis in terms of its costs and consequences for energy prices. International benchmarks will be used for the analysis and an independent evaluation will be carried out. Reports on action taken will be provided annually in **Q3-2011, Q3-2012** and **Q3-2013**.

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

Energy policy instruments and taxation

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

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

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

Telecommunications and postal services

Objectives

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

Telecommunications:

The Government will:

5.16. Ensure more effective competition in the sector by implementing the new Directive on EU electronic communications regulatory framework (“Better Regulation Directive”), which will (among others) enhance independence of the National Regulator Authority. **[Q2-2011]**

5.17. Facilitate market-entry by auctioning ‘new’ radio frequencies (i.e. auction of spectrum) for broadband wireless access **[Q3-2011]** and lowering mobile termination rates **[Q3-2011]**.

5.18. Ensure that the provision on universal service designation and the incumbent’s concession contract are non-discriminatory: re-negotiate the concession contract with the undertaking currently providing the universal service and launch a new tender for designation of universal service providers. **[Q3-2011]**

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

Postal services

The Government will:

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

5.21. Eliminate VAT exemption for products within the universal service **[Q3-2011]**

Transport

Objectives

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

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

Strategic Plan for Transport:

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

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

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

Railways sector

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

i. Strengthen the rail regulator independence and competences including by strengthening its administrative capacity in terms of decision and execution powers and staffing;

ii. Ensure full independence of the state-owned railway operator CP from the State;

iii. Balance the infrastructure manager's revenues and expenditures on the basis of a multi-annual contract with the infrastructure manager of a duration of at least three years and concrete commitments on State finance and performance;

iv. Carry-out a rationalisation of the network and effective incentives for the infrastructure manager to reduce its costs, whereby the regulatory body will be given a monitoring role;

v. Revise the existing Public Service Obligations (PSOs) on rail passenger transport, including the legal basis and administrative capacity for stepwise introduction of competitive tendering for PSOs;

vi. Revise the infrastructure charging scheme to introduce a performance scheme, permitting operators to introduce yield management of tickets, in particular to raise ticket prices;

vii. Privatise the freight branch of the state-owned rail operator and some suburban lines.

Ports *[Q4-2011]*

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

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

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

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

Other services sector

Objectives

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

Sector-specific legislation of Services

5.28. Adopt the remaining necessary amendments to the sector specific legislation to fully implement the Services Directive, easing the requirements related to establishment and reducing the number of requirements to which cross-border providers are subject. Amendments will be presented to the Parliament **[Q3-2011]** and adopted by **[Q4-2011].**

5.29. In case unjustified restrictions remain following the notification to the Commission of the recently adopted sector-specific amendments in the areas of construction and real estate, review and modify them accordingly. This includes making less burdensome the requirements applying to cross-border providers, both for construction and real estate activities, and reviewing obstacles to the establishment of service providers such as restrictions on subcontracting (for construction) and on excessive liquidity obligations and physical establishment (for real estate). **[Q4-2011]**

Professional qualifications

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

Regulated professions

5.31. Eliminate restrictions to the use of commercial communication (advertising) in regulated professions, as required by the Services Directive [**Q3-2011].**

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

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

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

Administrative burden

5.35. Continue the simplification reform effort by:

i. making the Points of Single Contact (PSC) more user-friendly and responsive to SMEs needs, extending on-line procedures to all sectors covered by the Services Directive **[Q4-2011]** and adapt the content and information available at the PSC to the new legislation to be adopted **[Q1-2012]**;

ii. making fully operational the "Zero authorisation" project that abolish authorisations/licensing and substitute them with a declaration to the PSC for the wholesale and retail sector and restaurants and bars **[Q4-2011]**. The project shall include all levels of administration, including all municipalities **[Q2-2012]**;

iii. extending PSC to services not covered by the Services Directive **[Q1-2013]**;

iv. extending the Zero authorisation project to other sectors of the economy **[Q1-2013].**

6. Housing market

Objectives

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

Rental market

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

Administrative procedures for renovation

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

Property taxation

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

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

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

7. Framework conditions

Judicial system

Objectives

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

The Government will:

Court backlog

7.1. Intensify implementation of proposed measures under the Judicial Reform Map. Conduct an audit of the backlog cases in order to better target measures **[end-June 2011]**. Eliminate court backlogs by **Q2-2013.**

7.2. Based on the audit, better target existing measures and assess the need for additional measures to expedite the resolution of the backlog **[Q2-2011]**. Additional measures to be considered include, among others: (i) establishing separate Chambers or Teams (solely) directed towards resolving the backlog, (ii) restructuring court record-keeping so that cases can be taken off the books; (iii) merging similar small debt enforcement cases; (iv) strengthening and enforcing existing regulations allowing dormant cases to be removed from the court register; (v) imposing additional costs and penalties against non-cooperative debtors in enforcement cases; (vi) introducing a staggered court fee structure for extended litigation prompted by litigating parties without manifest cause; and (vii) assigning special court managers to manage the court agenda/hearings allowing judges to focus on the cases.

Management of courts

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

7.4. Adopt new court management methods for two county courts, including Lisbon. **[Q4-2011]**

7.5. Develop a personnel management plan that permits judicial specialisation and mobility of court officials. **[Q4-2011]**

Alternative dispute resolution for out-of-court settlement

7.6. The Government will present a Law on Arbitration by **end-September 2011** and make arbitration for debt enforcement cases fully operational by **end-February 2012** to facilitate resolution of backlog cases and out of court settlement.[23]

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

7.8. Adopt measures to give priority to alternative dispute resolution enforcement cases in the courts. **[Q4-2011]**

Civil cases in the courts

7.9. Extent the new experimental civil procedure regime to 4 courts. **[Q3-2011]**

7.10. Assess in a report whether the experimental civil procedure regime will be applied to all courts. **[Q4-2011]**

7.11. Make specialised courts on Competition and on Intellectual Property Rights fully operational. **[Q1-2012]**

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

7.13. The Government will review the Code of Civil Procedure and prepare a proposal **by end-2011** addressing the key areas for refinement, including (i) consolidating legislation for all enforcement cases before the court, (ii) giving judges the power to expedite cases, (iii) reducing administrative burdens on judges, and (iv) enforcing statutory deadlines for court processes and in particular injunction procedures and debt enforcement and insolvency cases.[24]

7.14. Adopt specific measures for an orderly and efficient resolution of outstanding tax cases including (also covered under revenue administration):

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

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

i. taking necessary steps to implement the Tax Arbitration Law (to enable an effective out of court resolution of tax claims); **[Q3-2011]**

ii. assessing measures to expedite the resolution of tax cases such as: i) creating a special procedure for high value cases; ii) establishing criteria for prioritizing; iii) extending statutory interests for the entire the court proceeding; iv) imposing a special statutory interest payment on late compliance with a tax court decision. **[Q4-2011]**

Budget and allocation of resources

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

7.16. Develop an annual workplan on the allocation of resources based on court by court performance data, which will be published annually on the internet.

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

7.18. Publish quarterly reports on recovery rates, duration and costs of corporate insolvency and tax cases, publishing the first report by **Q3-2011.**

Competition, public procurement and business environment

Objectives

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

Competition and sectoral regulators

7.19. The Government will eliminate "golden shares" and all other special rights established by law or in the statutes of publicly quoted companies that give special rights to the state (**end-July 2011**).[25]

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

i. Establish a specialised court in the context of the reforms of the judicial system **[Q1-2012]**.

ii. Propose a revision of the competition law, making it as autonomous as possible from the Administrative Law and the Penal Procedural Law and more

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

harmonized with the European Union competition legal framework, in particular:[26] **[Q4-2011]**

- simplify the law, separating clearly the rules on competition enforcement procedures from the rules on penal procedures with a view to ensure effective enforcement of competition law;
- rationalize the conditions that determine the opening of investigations, allowing the competition authority to make an assessment of the relevance of the claims;
- establish the necessary procedures for a greater alignment between Portuguese law on merger control and the EU Merger Regulation, namely with regard to the criteria to make compulsory the ex ante notification of a concentration operation.;
- ensure more clarity and legal certainty in the application of Procedural Administrative law in merger control.
- evaluate the appeal process and adjust it where necessary to increase fairness and efficiency in terms of due process and timeliness of proceedings.

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

7.21. Ensure that the national regulator authorities (NRA) have the necessary independence and resources to exercise their responsibilities. **[Q1-2012]** In order to achieve this:

i. provide an independent report (by internationally recognised specialists) on the responsibilities, resources and characteristics determining the level of independence of the main NRAs. The report will benchmark nomination practices, responsibilities, independence and resources of each NRA with respect to best international practice. It will also cover scope of operation of sectoral regulators, their powers of intervention, as well as the mechanisms of coordination with the Competition Authority. **[Q4-2011]**

ii. based on the report, present a proposal to implement the best international practices identified to reinforce the independence of regulators where necessary, and in full compliance with EU law. **[Q4-2011]**

Public procurement

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

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

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

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

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

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

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

7.27. Ensure ex-ante auditing/checks on public procurement by the appropriate national bodies (most notably the Portuguese Court of Auditors) as a tool to prevent and counteract the practice of illegal award of additional works/services and increase transparency. **[Q3-2011]**

7.28. Upgrade the national Public Procurement Portal (Base) based on Resolution nº 17/2010 of the National Parliament in order to improve transparency of award procedures **[Q4-2011]**

7.29. Modify Art. 42 (7) (8) (9) of the Public Procurement Code, which sets out a requirement for investment in R&D projects on all public contracts worth more than EUR 25 million, to ensure full compliance with the Public Procurement directives, in particular by: i) eliminating the condition for the R&D project to be carried out in national territory; ii) requiring the R&D investments to be directly relevant for the performance of the contract; and iii) ensuring that all amounts to be spent on R&D projects are linked and justified by the subject-matter of the contract. **[Q4-2011]**

Business environment

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

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

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

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

INTERNATIONAL MONETARY FUND

EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
Washington, DC 20431 USA

IMF Executive Board Approves an €26 Billion Extended Arrangement for Portugal

The Executive Board of the International Monetary Fund (IMF) today approved a three-year SDR 23.742 billion (about €26 billion) arrangement under the Extended Fund Facility for Portugal in support of the authorities' economic adjustment and growth program. This front-loaded program makes SDR 5.6 billion (about €6.1 billion) immediately available to Portugal from the IMF. In 2011, total IMF financing will amount to about €12.6 billion and will be partnered with about €25.2 billion committed by the European Union.

The extended arrangement for Portugal, which is part of a cooperative package of financing with the European Union amounting to €78 billion over three years, entails exceptional access to IMF resources, amounting to 2,306 percent of Portugal's IMF quota, and was approved under the IMF's fast-track Emergency Financing Mechanism procedures.

The financing package is designed to allow Portugal some breathing space from borrowing in the markets while it demonstrates implementation of the policy steps needed to get the economy back on track.

"The Portuguese authorities have put forward a program that is economically well-balanced and has growth and job creation at its center," Acting Managing Director John Lipsky said. "It addresses the fundamental problem in Portugal – low growth – with a policy mix based on restoring competitiveness through structural reforms, ensuring a balanced fiscal consolidation path, and stabilizing the financial sector."

"The authorities should be commended for this ambitious program that will involve sacrifices but that can lead to a stronger, more dynamic economy able to generate growth, jobs, and opportunity. The indication of support from the main political parties for the principal objectives and key policies indicates a cross-party resolve to tackle Portugal's long-standing problems." Mr. Lipsky added.

"The substantial financial support will help minimize the social costs of the adjustment. The program also includes a strong social safety net, by exempting lower categories of public wages and pensions from reduction, and by ensuring protection to the most vulnerable.

"The IMF, together with our European partners, is committed to support this national effort. Today's action by the IMF to support Portugal will contribute to the broad international effort underway to help bring stability to the Euro Area and secure recovery in the global economy," Mr. Lipsky said.

Following the Executive Board's action, Mr. Lipsky, as Acting Chair of the Board, said:

"The Portuguese economy faces a severe crisis as a result of a buildup of external and internal imbalances and deep-rooted structural problems that have engendered economic stagnation, lack of competitiveness and high unemployment. The authorities' program aims at tackling these issues through an ambitious and comprehensive structural reform agenda, well balanced fiscal consolidation, and measures that will facilitate an orderly adjustment in private sector balance sheets.

"The fiscal consolidation plan under the program is ambitious but credible. The targeted fiscal path toward meeting the Excessive Deficit Procedure goal of 3 percent of GDP by 2013 strikes an appropriate balance between limiting the impact of fiscal adjustment on economic activity and restoring debt sustainability, while the most vulnerable segments of society remain protected. The plan will be supported by important fiscal reforms to streamline the functioning of the public sector and reduce fiscal risks.

"The financial sector component of the authorities' program aims to promote market-based solutions to boost banks' capital and restore confidence and access to wholesale market funding. To this end, the Bank of Portugal has already requested that banks raise their Core Tier 1 capital level to 9 percent by end-2011 and 10 percent by end-2012. Safeguards for capital and liquidity support are also provided under the program, helping ensure an orderly deleveraging of the economy and continued stability for Portugal's financial system.

"Growth-enhancing policies are central to the program. A far-reaching structural reform program has been put into place to increase competition, reduce labor costs, and boost employment and productivity. Strong implementation of these reforms will be key to set the economy on a recovery path and improve market sentiment."

ANNEX

Recent Economic Developments

Long-standing structural problems—including low productivity, weak competitiveness, and high debt—have severely undermined growth and given rise to large external and fiscal imbalances. While the government has made some efforts over the past year to bring the fiscal deficit under control and tackle structural impediments, the impact has not been sufficiently strong.

Fiscal improvement in 2010 was marginal, with corrective action delayed, in part reflecting a weak fiscal framework. As a result, the overall fiscal deficit declined only to 9.1 percent of GDP in 2010 from 10.1 percent in 2009. Moreover, the ambitious budget target of 4.6 percent of GDP for 2011 also fell out of reach.

Contagion and fiscal risks stoked funding pressures for the sovereign and banks. Government funding costs increased to post-euro record highs and distress in the sovereign debt market spilled over into the bank wholesale market. This caused a tightening in banks' liquidity position as they lost access to wholesale funding markets, on which they were heavily reliant. In response to the increased funding strains and rising losses on banks' loan portfolios, banks tightened lending policies and credit growth has slowed considerably.

Against this background, concerns over Portugal's growth prospects and the sustainability of its external debt have intensified in recent months, culminating in a request for external financial assistance.

Program Summary

The program focuses on: structural reforms to boost growth and employment; an ambitious but balanced fiscal stabilization path, supported by structural fiscal reform; and safeguards to ensure financial stability and prevent a protracted credit contraction.

The main elements of the program are as follows:

Growth-enhancing reforms. A bold structural reform agenda focused on increasing competition, reducing labor costs, and boosting employment and productivity. The reform package will be key to improving the economy's growth prospects and to restoring debt sustainability.

Restoring confidence and fiscal sustainability. An ambitious and credible fiscal consolidation plan that strikes a balance between ensuring debt sustainability and limiting the adverse impact of adjustment on growth. The fiscal objectives will be supported by important structural fiscal reforms to streamline the functioning of the public sector and reduce fiscal risks.

Safeguarding financial stability. An increase in the capital positions of banks through market-based solutions will be supported, as needed, by a fully funded capital backstop facility. Safeguards to support adequate banking system liquidity and for strengthening the supervisory and regulatory framework are also embedded in the program. Together these measures should help achieve an orderly deleveraging of private sector balance sheets and preserve financial sector stability.

Large external financing assistance under the program will help the transition and re-establish much-needed policy credibility. Major political parties have publicly supported the main elements of the program.

Statement by Arrigo Sadun, Executive Director for Portugal and

José Cardoso, Advisor to Executive Director

May 18, 2011

We thank staff for the insightful and thorough analysis of the Portuguese economy. The frank and constructive dialogue engaged with staff was highly appreciated by the Portuguese authorities. The analysis and dialog has led to an ambitious adjustment program — set out in MEFP — that aims to address the long standing structural bottlenecks of the Portuguese economy.

1) Need for the Program

Portugal's long-standing problems of low productivity, loss of competitiveness, subdued economic growth, and high levels of private debt were compounded by the global economic and financial crisis. Additionally, the consolidation effort made prior to the global crisis was interrupted by the need to introduce, in the European context, economic and employment stimulus measures, which significantly deteriorated the fiscal position. The subsequent fiscal consolidation effort, again in the European context, had then to be accelerated due to the beginning of the European sovereign debt crisis. These events exposed the country to its long standing growth weakness and external imbalances.

In April 2011, the situation degraded significantly. The country became unable to refinance its debt at rates compatible with long-term fiscal sustainability. In parallel, the banking sector — which is heavily dependent on external financing, and lately also increasingly reliant on the Eurosystem funding — was almost shut out of international market funding.

To restore market confidence; to raise the potential of the Portuguese economy to generate socially balanced growth and employment; and to safeguard financial stability in Portugal, the euro area, and the EU; the Portuguese authorities agreed with the IMF, European Commission, and ECB, a far-reaching adjustment program focused on structural reforms, and backed by substantial external financing to meet balance of payments needs.

2) Timing of the Program

The authorities were implementing a series of policy actions to tackle the public finances difficulties. In March 2011, under the annual update of the SGP, the authorities announced strong actions with additional measures for 2011, and more-detailed measures for 2012 and 2013. The SGP annual update was welcomed by the European institutions and partners as a strong commitment toward comprehensive measures to undergo an appropriate fiscal adjustment. Also, a Tripartite Agreement with the social partners was signed in March to ensure broad consensus around key structural reforms to promote competitiveness and employment.

However, economic and financial developments in Portugal came to a critical juncture. Amidst increasing market skepticism on peripheral countries, Portugal witnessed in late March/beginning of April 2011 a sudden deterioration in financial market sentiment, which made it increasingly challenging for Portugal to meet its financing needs. The SGP annual update — whose guidelines were welcomed by the European Commission and the ECB — was not approved in parliament. This led to political instability, and to the consequent resignation of the government and dismissal of the parliament. Additionally, the fiscal account figures from 2007 onwards have been revised reflecting methodological/perimeter changes, part of them in a broader European context of application of statistical rules. Arguing all these facts, rating agencies significantly downgraded Portuguese sovereign debt and major Portuguese banks, and spreads widened significantly.

In view of these setbacks, caused by exceptional circumstances, the Portuguese authorities officially requested financial assistance in April 2011.

3) Main Features of the Program

Building on measures already announced by the government, further comprehensive actions will be taken in three fronts: (i) deep structural reforms to boost potential growth, create jobs, and improve competitiveness; (ii) a credible and balanced fiscal consolidation strategy, supported by structural fiscal measures and better fiscal control over Public-Private Partnerships (PPPs) and State-Owned Enterprises (SOEs); and (iii) efforts to safeguard the financial sector against disorderly deleveraging through market-based mechanisms supported by back-up facilities.

Hence, the adjustment program set out in the MEFP aims at:

- reinforcing the authorities' adjustment plan by detailing the fiscal consolidation measures announced in the SGP annual update, coupled with additional measures, with a clear emphasis on the expenditure side;

- reinforcing structural reforms for the long-run growth promotion, and the economy's adjustment toward the tradable sector, building on previous years' achievements;

- strengthening the financial sector, ensuring the capacity of the banking system to continue financing the economy;

- achieving an appropriate trade-off between, on the one hand, the need to implement decisive and frontloaded measures to restore market confidence and market access at more sustainable terms, and, on the other hand, mitigate the cost of the economic adjustment process and structural reforms on growth and employment; and

- safeguarding the protection of the most vulnerable groups of the population, and reducing the social costs of the economic changes that are needed for Portugal.

4) Public Finances

2013 was the deadline set in November 2009 by the Council of the EU, in the framework of the excessive deficit procedure, for Portugal to correct the excessive deficit. This deadline has always remained unchanged, and is the deadline set in the adjustment program.

This deadline should not be confused with the more ambitious targets that had been set internally by the Portuguese authorities in May 2010. These targets accelerated the process of fiscal consolidation — including the advance by one year (2012) of the excessive deficit correction — and debt stabilization, by frontloading already decided measures and introducing new measures. These targets were set in the context of a European effort against a bleak backdrop in the financial markets, impacting the costs of financing and increasing countries' risks.

Under the circumstances that the country started facing recently, the deadline set in the program to correct the excessive deficit strikes an appropriate balance between the mentioned necessary adjustment, and the growth and employment promotion. The MEFP presents these objectives and the way to achieve them. The Portuguese authorities are strongly committed and engaged with these objectives, under the appropriately-frontloaded multiyear fiscal adjustment program set out in the MEFP.

The correction of fiscal imbalances assumes a conservative macro scenario of a real GDP contraction around 2 percent in 2011 and again around 2 percent in 2012, with a recovery in economic activity in 2013 onwards based on exports. It hinges on a credible and balanced fiscal consolidation strategy, supported by structural fiscal measures and better fiscal control over PPPs and SOEs, aiming to put the gross public debt-to-GDP ratio on a firm downward path in the medium term, and to correct the excessive deficit procedure by 2013 (5.9 percent in 2011, 4.5 percent in 2012, and 3.0 percent in 2013). For 2011, there will be a rigorous implementation of the 2011 State Budget and the measures announced in the SGP annual update; and for 2012 and 2013 these measures will be reinforced by additional measures set out in the MEFP with a clear emphasis on the expenditure side.

For 2011, in order to further ensure the achievement of fiscal targets, there will be a strengthening of the current fiscal consolidation measures. Notwithstanding very positive developments on the export side, there are clear downside risks to the macroeconomic prospects regarding domestic demand in 2011. Current market volatility justifies precaution and, accordingly, the reinforcement of measures aiming to secure the achievement of the fiscal targets. This reinforcement includes five main areas of action, namely additional savings in the health care sector; additional reduction of costs of SOEs and related subsidies; further reductions in expenditure of other Public Entities and Bodies, and in transfers from the State to other sectors of public administration; additional tightening of social expenditure; and further reduction in capital expenditure. These measures will be taken on top of the freezing of pensions, and the reduction of public sector monthly wages above €1500 (with progressive incidence from 3.5 percent to 10 percent), resulting in an expected 5 percent reduction in the total wage bill.

For 2012 and 2013, bold measures representing 5.1 percent of GDP will be taken to increase revenue and, with more emphasis, reduce expenditure. The reduction of expenditure will represent 3.4 percent of GDP during 2012-2013, and will include: freezing wages in the public sector and pensions until 2013 (except for the lowest pensions); establishing promotions constraints; reducing civil servants (1 percent per year in central government and 2 percent per year in local governments); creating a special contribution for pensions above €1500; tightening cost control on health, education, and defense; reducing budgetary costs of health benefit schemes for government employees; rationalizing the Public Administration; reducing expenditures on social benefits with a non-contributory nature; reducing costs in SOEs and Other Public Entities and Bodies; reducing transfers to local and regional governments; and reducing capital expenditures.

The increase in revenues will represent 1.7 percent of GDP during 2012-2013, and will hinge on a broad scope of applications involving central, regional, and local administration. The measures will encompass: a standstill rule of all tax expenditures; a revision and limitation of tax benefits and deductions in terms of personal income and corporate income taxation; limits to tax reductions in the regions; a revision of the personal income tax (PIT) for income in kind; a conclusion of the convergence in the PIT regime of pensions and labor income; rationalization of the VAT tax structure; a review of excise taxes and indexation to inflation; combat to informality and tax evasion; a reassessment of the property values; a reduction of temporary exemptions of the annual property tax (IMI); and a gradual rebalancing of taxation on real estate by reinforcing IMI relative to the property transfer tax (IMT).

As to the privatizations agenda, it includes an ambitious and accelerated program of privatizations involving transport, energy, communications, and insurance sectors. By March 2012, an updated privatization plan will be prepared, and the Portuguese authorities are available to go even further than the current program if market conditions permit, avoiding ineffective fire sales that would deplete the State's assets without achieving the underlying objectives.

5) Financial Sector

The Portuguese banking system has been highly resilient in a particularly challenging environment. Portuguese banks have succeeded in ensuring a smooth financing of the private sector, and in maintaining globally adequate solvency levels and overall profitable positions. This was due inter alia to their relatively conservative business model, coupled with several mitigating factors, notably the absence of a housing bubble and a high exposure to counterparties and segments with relatively low probabilities of default. However, given its prominent role in the financing of the Portuguese economy, the banking sector is highly leveraged and thus particularly dependent on financing from international markets. In the context of a succession of sovereign downgrades — following the sovereign debt crisis in other euro area countries — the financing conditions of banks deteriorated sharply, being accommodated through high levels of Eurosystem financing. Going forward, the banking sector faces considerable challenges. In fact, the Portuguese economy will experience a protracted adjustment of its structural imbalances, including not only an ambitious fiscal consolidation path, but also a deleveraging of the high indebtedness levels of the various sectors of the economy. This will imply further materialization of credit and market risk, putting additional pressure on banks' capital levels.

In this context, one of the priorities of the program is steering the banking system through a balanced and orderly deleveraging process while increasing the banks' capital position. The program encompasses many dimensions to ensure the stability of the financial system while not compromising the provision of credit to the private sector. Four of those are worth highlighting. First, the program envisages a set of measures to ensure sufficient liquidity in the banking system, including the strengthening of banks' collateral buffers, and the increase in the size of the government guarantee fund for bank bond issues from €20 billion to €35 billion. Second, Banco de Portugal and the ECB, in consultation with the European Commission and IMF staff, will ask banks for institution-specific medium-term funding plans by end-June 2011. These must be consistent with a set of periodic target leverage ratios, with the underlying macroeconomic scenario and with a reduced reliance on Eurosystem funding.

Third, Banco de Portugal has asked banks to reach a core Tier 1 capital level of 9 percent by end-2011 and 10 percent at the latest by end-2012. This follows the requirement, issued earlier this year, that banks raised their core Tier 1 capital level to 8 percent by end-2011 and shares the same goal, i.e., strengthening capital buffers under particularly challenging conditions. To support this requirement, the program includes a bank solvency support facility with resources amounting to €12 billion. According to Banco de Portugal estimates, €12 billion is sufficient — even considering the state owned bank, Caixa Geral de Depósitos (CGD), although the use of this facility by CGD is not expected — to ensure the banks' recapitalization needs. Finally, Banco de Portugal will intensify its monitoring of the banking sector and strengthen banking regulation and supervision. This includes inter alia stepping-up its solvency and deleveraging assessment framework — which will be the basis for the regular quarterly reviews by the IMF, European Commission, and ECB teams —, designing a program of special on-site inspections, adding a new ratio of non-performing loans to the published set of macroprudential indicators, and strengthening the early intervention and resolution framework.

This program is ambitious and undertakes decisive steps towards a more sustainable position of the banking system in the medium term, while ensuring consistency with the inevitable macroeconomic adjustment of the Portuguese economy. Re-establishing confidence of the financial markets in the banking system is of the essence in order to allow a smooth return to market-based financing. Given the fundamentally sound underlying position of the banking system, the full implementation of the program should prove sufficient to achieve these goals.

6) Structural Reforms

The adjustment program focuses on deep structural reforms to boost potential growth, create jobs, improve competitiveness, and achieve a credible and balanced fiscal consolidation strategy, supported by structural fiscal measures and better fiscal control over PPPs and SOEs. These reforms will promote the necessary economic adjustment and the correction of imbalances.

Recent years have witnessed the implementation of a reform agenda, addressing many of the structural weaknesses of the Portuguese economy: (i) improvement of educational attainment and skills of the workforce; (ii) improvement in research, development and innovation indicators, and change in the competitive profile of the economy; (iii) increase of labor market flexibility and adaptability through the revision of labor code; (iv) reduction of energy dependence, contributing to the correction of external imbalances; (v) approval of a Budgetary Framework law to improve budget coverage, implementation, and monitoring; (vi) modernization and streamlining of the Public Administration; and (vii) improvement of the business environment, and reduction of administrative costs and red tape (Portugal is already a top reformer in areas such as starting a business).

However, many challenges remain ahead. Hence, the program includes measures to enhance productivity, and encompasses an internal devaluation, supported by fiscal policies and labor market reforms, which will reduce labor costs and boost competitiveness. This will involve a budget neutral recalibration of the tax system, i.e., a reduction of the social security contribution compensated by tax measures (using taxes that do not affect competitiveness) and by permanent cuts in public expenditure. The program also encompasses the establishment of an independent fiscal council, and significant reforms in education, health, public administration, public procurement, business environment, competition, real estate taxation, rental market, and, last but not least, justice (including efficiency of judicial process and restructuring of the court network, review of civil process/criminal process/insolvency codes, and implementation of the arbitrage law for tax and debt enforcement cases).

7) Critical Factors for the Program’s Success

The adjustment program benefits from the experience of previous cases. It also takes into account the strong credibility of the Portuguese institutions, the absence of a real estate bubble, and the non exposure of Portuguese banks’ asset portfolios to the complex assets that were at the core of the financial crisis. Overall, it is constructed in a way to ensure an orderly adjustment, and to lay down the foundations to a convergent and sustainable economic growth.

In the eminence of general elections scheduled for June 5, the revealed social cohesion in Portugal, and the broad political support — expressed in writing by the two main opposition parties — to the adjustment program expressed in the MEFP, constitute an assurance of engagement and ownership to the program.

The authorities have worked, and will continue to work, closely with staff. The resolute implementation of the program — and the willingness to take additional measures if deemed necessary to achieve the objectives — gives the authorities, the IMF, and the European institutions confidence that the program will successfully help the Portuguese economy recover and bolster market sentiment. Progress under the program will be kept under close monitoring and review in light of internal and external developments.

The current juncture constitutes a unique opportunity to finally address the long standing structural impediments to economic growth and macroeconomic stability.