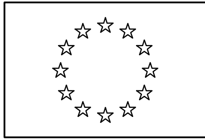

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 11.11.2009
SEC(2009) 1527 final

Recommendation for a

COUNCIL DECISION

on the existence of an excessive deficit in Portugal

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EXPLANATORY MEMORANDUM

1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn in 2008/09. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be timely, targeted and temporary and differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which have impacted on the debt position or constitute a risk of higher deficits and debt in the future[1], although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to initiate the excessive deficit procedure (EDP) whenever the deficit of a Member State exceeds the 3% of GDP reference value. The amendments to the Stability and Growth Pact in 2005 aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation, and thereby ensuring long-term sustainability of public finances.

2. PREVIOUS STEPS IN THE EXCESSIVE DEFICIT PROCEDURE

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure"[2], which is part of the Stability and Growth Pact.

According to Article 104(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is

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[1] See the Eurostat decision of 15 July 2009 on the statistical recording of public interventions to support financial institutions and financial markets during the financial crisis, Eurostat News Release No 103/2009.

[2] OJ L 209, 2.8.1997, p. 6. Account is also taken of the Opinion of the Economic and Financial Committee on the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005, available at: http://ec.europa.eu/economy_finance/other_pages/other_pages12638_en.htm.

only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 104(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State".

On the basis of the data notified by the Portuguese authorities in April 2009[3] and taking into account the Commission services' spring forecast, the Commission adopted a report under Article 104(3) for Portugal on 7 October 2009.[4]

Subsequently, and in accordance with Article 104(4), the Economic and Financial Committee formulated an opinion on the Commission report on 27 October 2009.

3. THE EXISTENCE OF AN EXCESSIVE DEFICIT

According to data notified by the Portuguese authorities in April 2009, the general government deficit in Portugal was planned to reach 3.9% of GDP in 2009, thus exceeding the 3% of GDP reference value. The Commission report under Article 104(3) considered that the planned deficit was not close to the 3% of GDP reference value, but that the planned excess over the reference value could be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact, on the basis of the information available at the time of the report. The planned excess over the reference value could not be considered temporary.

According to more recent data notified by the Portuguese authorities in October 2009, the general government deficit in Portugal is now planned to reach 5.9% of GDP in 2009, thus remaining above and not close to the 3% of GDP reference value. This deficit figure includes the fiscal stimulus package as a response to the EERP. Despite external imbalances limiting to some extent the room for manoeuvre in fiscal policy, Portugal benefited from the successful consolidation particularly between 2005 and 2007 and was able to introduce a fiscal stimulus package for 2009 of around 1½% of GDP, including mostly temporary measures, such as infrastructure investment. Based on the Commission services' autumn 2009 forecast, the planned excess over the reference value still qualifies as exceptional within the meaning of the Treaty and the Stability and Growth Pact. In particular, it results from a severe economic downturn in 2009 in the sense of the Treaty and the Stability and Growth Pact. According to the Commission services' autumn 2009 forecast, GDP would contract by 2.9% in 2009 and grow by 0.3% in 2010, respectively. This will have a significant negative impact on the budgetary position in 2009 and 2010. Furthermore, the planned excess over the reference value cannot be considered temporary in the sense of the Treaty and the Stability and Growth Pact. According to the Commission services' spring 2009 forecast, the general government

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[3] According to Council Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Portugal can be found at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/procedure/edp_notification_tables.

[4] All EDP-related documents for Portugal can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

headline deficit will increase to 8% of GDP in 2009 and 2010, and to 8.7% of GDP in 2011 under a no-policy change scenario. In 2010 and 2011, despite the discontinuation of most of the measures of extraordinary nature linked to the crisis in 2009, no improvement in the fiscal position is expected due to the continued recessionary environment, the working of automatic stabilisers and a marked growth in interest expenditure. Overall, the deficit criterion in the Treaty is not fulfilled.

According to data notified by the Portuguese authorities in October 2009, the general government gross debt has been above the 60% of GDP reference value and is planned to stand at 74.5% of GDP in 2009. According to the Commission services' autumn 2009 forecast, the general government debt-to-GDP ratio is projected to increase significantly over the forecast period from 66.3% in 2008 to 91.2% in 2011. The debt ratio cannot be considered as diminishing sufficiently and approaching the reference value at a satisfactory pace within the meaning of the Treaty and the Stability and Growth Pact. The debt criterion in the Treaty is not fulfilled.

In line with the provisions in the Treaty and the Stability and Growth Pact, the Commission also analysed in its report "relevant factors". According to the Stability and Growth Pact, these can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the deficit satisfies the double condition of closeness and temporariness. In the case of Portugal, the double condition is not met. Considered on their own merit, the relevant factors are, on balance, relatively favourable.

The opinion of the Economic and Financial Committee in accordance with Article 104(4) of the Treaty is consistent with the assessment in the Commission report under Article 104(3).

The Commission, having taken into account its report under Article 104(3) and the opinion of the Economic and Financial Committee under Article 104(4), is of the opinion that an excessive deficit exists in Portugal. This opinion, adopted by the Commission on 11 November 2009, is herewith addressed to the Council according to Article 104(5). The Commission recommends that the Council shall decide accordingly, in conformity with Article 104(6). In addition, the Commission is submitting to the Council a recommendation for a Council recommendation to be addressed to Portugal with a view to bringing the situation of an excessive deficit to an end according to Article 104(7).

4. RECOMMENDATIONS TO END THE EXCESSIVE DEFICIT SITUATION

According to Article 3(4) of Council Regulation (EC) No 1467/97, the Council recommendation under Article 104(7) has to establish a deadline of six months at most for effective action to be taken by the Member State concerned as well as a deadline for the correction of the excessive deficit, which "should be completed in the year following its identification unless there are special circumstances". Article 2(6) of the Regulation implies that the "relevant factors" considered in the Commission report under Article 104(3) of the Treaty have to be taken into account in deciding whether special circumstances exist. Article 3(4) of the Regulation specifies that the Council has to recommend that the Member State achieves a "minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation".

In the case of Portugal, special circumstances are considered to exist. In particular, it results, among other things, from a severe economic downturn in 2009 in the sense of the Treaty and

the Stability and Growth Pact in the framework of the global economic and financial crisis. The recession reflects the abrupt double-digit decline in private investment, as well as in exports and imports, as a result of the sharp drop in international trade in 2009. The current crisis has also highlighted structural weaknesses such as persistent low productivity, eroded competitiveness, rising unemployment and a sizeable external deficit, although some of those imbalances are being corrected slowly and partially. For the years 2009 and 2010, the Commission services' autumn 2009 forecast foresees that annual GDP would contract by 2.9% and grow by 0.3% respectively, with the output gap turning markedly negative. This will have a significant negative impact on the budgetary position in 2009 and 2010.

Considering the special circumstances and the EERP framework, an average annual structural budgetary adjustment is recommended. The required adjustment should take into account the fiscal room for manoeuvre which is assessed on the basis of all factors relevant for achieving the fiscal policy objectives, starting with the level of the general government deficit and gross debt as well as other indicators, such as the current account position, the level of contingent liabilities of the financial sector, interest payments, risk premia swaps and the expected change in age-related expenditure in the medium term. In calculating the average annual adjustment, the 2011 deficit in the Commission services' autumn 2009 forecast is taken as the starting point. The total structural adjustment needed to reach the nominal deficit target of 3% by the deadline is then calculated by assuming a gradual closure of the output gap by 2015.

Against this background, it is appropriate to consider a correction of the excessive deficit in a medium-term framework with a deadline for the correction of 2013. In particular, in view of the high general government deficit, gross debt and the related interest payments, as well as of the current account position, a credible and sustainable adjustment path would require the Portuguese authorities to start consolidation in 2010 as envisaged, and ensure an average annual structural budgetary adjustment of 1¼% of GDP over the period 2010-2013; specify the measures that are necessary to achieve the correction of the excessive deficit by 2013 cyclical conditions permitting and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected. The budgetary consolidation should also contribute to bringing the government gross debt ratio back on a declining path that approaches the reference value at a satisfactory pace by restoring an adequate level of the primary surplus.

General government gross debt has been above the 60% of GDP reference value since 2005 and, according to the data notified by the Portuguese authorities in October 2009, is planned to stand at 74.5% of GDP in 2009. According to the Commission services' autumn 2009 economic forecast, the general government debt-to-GDP ratio is projected to increase by 18 percentage points over the forecast period from 66.3% in 2008 to 91.2% in 2011. Rapid budgetary consolidation is therefore also necessary with a view to bringing the government gross debt ratio on a declining path that approaches the 60% of GDP reference value at a satisfactory pace. Moreover, the Portuguese authorities should seize any opportunity beyond the structural budgetary adjustment, to accelerate the reduction of the gross debt ratio back towards the reference value

In general, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy. Concerning the institutional aspects of public finances, important steps have been taken, or are due to enter into force, in particular in the area of public administration reform. A consolidation of public services networks in several sectors, including the reform of the health and pension systems are

underway. Whilst the impact of these measures on the efficiency and effectiveness of public expenditure has not yet fully materialised, they have the potential to yield a more efficient use of public resources in several areas of the public sector. The overall efficiency and effectiveness of public spending could also benefit from further improvements in the governance of public finances, such as an improved medium-term budgetary planning and reinforced fiscal institutions. In this domain, the Portuguese authorities have put forward plans to develop performance-based budgeting, with a multi-annual budgetary framework and numerical budgetary rules, but implementation has not yet materialised.

As regards the sustainability of public finances, while the long-term budgetary impact of ageing is somewhat higher than on average in the EU, enacted pension reforms have helped to contain the projected increase in pension expenditure over the coming decades. In order to reduce the risk to the long-term sustainability of public finances as defined by the Commission Communication[5] on 'Long-term sustainability of public finances for a recovering economy' and endorsed by the ECOFIN Council[6] on 10 November 2009, Portugal should improve its structural primary balance in a durable manner by 5.5% of GDP.

Enhanced surveillance under the EDP, which seems necessary in view of the deadline for the correction of the excessive deficit, will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy to ensure the correction of the excessive deficit. In this context, a separate chapter in the updates of the Portuguese stability programme which will be prepared between 2010 and 2013 could usefully be devoted to this issue.

Key macroeconomic and budgetary projections

	2007	**2008**	**2009**	**2010**	**2011**
Real GDP (% change)	1.9	0.0	-2.9	0.3	1.0
Output gap[1] (% of potential GDP)	0.6	-0.1	-2.9	-3.0	-2.6
General government balance (% of GDP)	-2.7	-2.8	-8.0	-8.0	-8.7
Primary balance (% of GDP)	0.2	0.2	-5.0	-4.9	-5.2
Cyclically-adjusted balance (% of GDP)	-2.8	-2.6	-6.6	-6.7	-7.5
Structural balance[2] (% of GDP)	-3.0	-3.5	-6.6	-6.7	-7.5
Government gross debt (% of GDP)	63.6	66.3	77.4	84.6	91.2

Notes:
[1] Based on estimated potential growth of 0.6%, 0.6%, 0.0%, 0.3% and 0.7% respectively in the years from 2007 to 2011.
[2] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are specified as 0.8.% of GDP in 2008 and as 0% for the period 2009-2011 according to the Commission services' autumn 2009 forecast.
Source: Commission services' autumn 2009 forecasts; Commission services' calculations.

[5] Available at: http://ec.europa.eu/economy_finance/publications/publication15996_en.pdf
[6] Available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/111025.pdf.

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(6) thereof,

Having regard to the recommendation from the Commission,

Having regard to the observations made by Portugal,

Whereas:

(1) According to Article 104 of the Treaty Member States shall avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) The excessive deficit procedure (EDP) under Article 104, as clarified by Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[7] (which is part of the Stability and Growth Pact), provides for a decision on the existence of an excessive deficit. The Protocol on the excessive deficit procedure annexed to the Treaty sets out further provisions relating to the implementation of the EDP. Council Regulation (EC) No 479/2009[8] lays down detailed rules and definitions for the application of the provision of the said Protocol.

(4) The 2005 reform of the Stability and Growth Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. It aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

(5) Article 104(5) of the Treaty requires the Commission to address an opinion to the Council if the Commission considers that an excessive deficit in a Member State exists or may occur. Having taken into account its report in accordance with Article 104(3) and having regard to the opinion of the Economic and Financial Committee in

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7 OJ L 209, 2.8.1997, p. 6.
8 OJ L 145, 10.6.2009, p. 1-9.

accordance with Article 104(4), the Commission concluded that an excessive deficit exists in Portugal. The Commission therefore addressed such an opinion to the Council in respect of Portugal on 11 November 2009.[9]

(6) Article 104(6) of the Treaty states that the Council should consider any observations which the Member State concerned may wish to make before deciding, after an overall assessment, whether an excessive deficit exists. In the case of Portugal, this overall assessment leads to the following conclusions.

(7) According to data notified by the Portuguese authorities in October 2009, the general government deficit in Portugal is planned to reach 5.9% of GDP in 2009, thus exceeding and not close to the 3% of GDP reference value. The planned excess over the reference value can be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. In particular, it results, among other things, from a severe economic downturn in 2009 in the sense of the Treaty and the Stability and Growth Pact. For the years 2009 and 2010, the Commission services' autumn 2009 forecast foresees that annual GDP would contract by 2.9% and grow by 0.3% respectively. Furthermore, the planned excess over the reference value cannot be considered temporary, since according to the Commission services' autumn 2009 forecast, taking into account the measures already adopted in the current year the general government headline deficit will increase to 8% of GDP in 2010. In 2010 and 2011, despite the discontinuation of most of the measures of extraordinary nature linked to the crisis in 2009, no improvement in the fiscal position is expected due to the continued recessionary environment, the working of automatic stabilisers and a marked growth in interest expenditure. The deficit criterion in the Treaty is not fulfilled.

(8) According to data notified by the Portuguese authorities in October 2009 the general government gross debt (which has been above the 60% of GDP reference value since the year 2005) is planned to stand at 74.5% of GDP in 2009. According to the Commission services' autumn 2009 forecast, the general government debt-to-GDP ratio is projected to significantly increase by 18 percentage points over the forecast period from 66.3% in 2008 to 91.2% in 2011. The debt ratio cannot be considered as diminishing sufficiently and approaching the reference value at a satisfactory pace within the meaning of the Treaty and the Stability and Growth Pact. The debt criterion in the Treaty is not fulfilled.

(9) According to Article 2(4) of Council Regulation (EC) No 1467/97, "relevant factors" can only be taken into account in the steps leading to the Council decision on the existence of an excessive deficit in accordance with Article 104(6) if the double condition - that the deficit remains close to the reference value and that its excess over the reference value is temporary - is fully met. In the case of Portugal, this double condition is not met. Therefore, relevant factors are not taken into account in the steps leading to this decision.

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[9] All EDP-related documents for Portugal can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

HAS ADOPTED THIS DECISION:

Article 1

From an overall assessment it follows that an excessive deficit exists in Portugal.

Article 2

This decision is addressed to the Republic of Portugal.

Done at Brussels,

For the Council
The President