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COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL OPINION

**in accordance with the third paragraph of Article 5 of
Council Regulation (EC) No 1466/97 of 7 July 1997**

On the updated stability programme of Portugal, 2008-2011

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

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. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. In particular, it introduced greater flexibility in the application of the rules governing the excessive deficit procedure, notably with regard to definition of "exceptional circumstances" and the setting of deadlines for the correction of an excessive deficit.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies¹, which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the stability programme of Portugal, submitted on 30 January 2009, and has adopted a recommendation for a Council opinion on it².

In order to set the scene against which the budgetary strategy in the updated stability programme is assessed, the following paragraphs summarise:

- (1) the Commission Communication of 26 November 2008 ("A European Economic Recovery Plan");
- (2) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the stability programme).

2.1. The Commission Communication of 26 November 2008 ("A European Economic Recovery Plan")

In view of the unprecedented scale of the global financial and economic crisis, the European Commission has called for a European Economic Recovery Plan³. The plan proposes a co-

¹ OJ L 209, 2.8.1997, p. 1. The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

² The Stability and Growth Pact requires the Commission to prepare a report under Article 104(3) of the Treaty when an actual or planned deficit exceeds the 3% of GDP reference value. In view of the great uncertainty surrounding the current economic juncture, the Commission considers it appropriate that reports based on planned deficits for 2009 in excess of the reference value take account of further information as provided in the forthcoming EDP notification and Commission services' forecasts.

ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to €200 bn. (1.5% of EU GDP), made up of a budgetary expansion by Member States of €170 bn. (around 1.2% of EU GDP) and EU funding in support of immediate actions of the order of €30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan calls for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability of government finances and competitive positions. In particular, for Member States outside the euro area with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008. The examination of how measures relevant in the context of the EERP (budgetary measures as well as structural measures) contribute to the recovery process in the short term, is made in the opinions of stability convergence programmes.

2.2. The assessment in the Council opinion on the previous update

In its opinion of 4 March 2008, the Council summarised its assessment of the previous update of the stability programme, covering the period 2007-2010, as follows: “The overall conclusion is that the programme is consistent with a correction of the excessive deficit no later than 2008. If the better than expected budgetary execution is confirmed, the deficit outturn will be below 3% of GDP already in 2007. The programme aims at further fiscal consolidation over the medium term, including the achievement of the MTO by 2010, and foresees a declining path for the government debt *ratio* over the entire programme period. However, achieving these objectives is subject to an effective implementation of the measures announced in the programme and may require additional efforts, notably in the light of the risk of lower-than-projected economic growth. Further progress with fiscal consolidation, as planned, could also help to address the external imbalances and improve the prospect of the long-term sustainability of public finances, for which Portugal is considered to be at medium risk, after the significant reform of the pension system. Finally, envisaged improvements in the quality and efficiency of public expenditure, including the public administration and the budgetary framework, can have a favourable impact on potential GDP growth and thereby help resume the catching-up process”.

³ Communication from the Commission to the European Council of 26 November 2008 - COM(2008) 800.

Against this assessment and while maintaining a strong budgetary position, the Council invited Portugal to

- “(i) implement with determination the fiscal consolidation envisaged in the programme so as to secure the correction of the excessive deficit;
- (ii) carry out the planned adjustment towards the MTO, backing it up with reinforced measures if necessary; and, also in view of the risks to the sustainability of public finances, ensure a rapid reduction in the debt-to-GDP *ratio*, notably by continuing to allocate any better-than-expected budgetary results to deficit reduction;
- (iii) maintain expenditure moderation in a permanent way and enhance the quality of public expenditure, also by pursuing the ongoing reform of public administration and further improving the budgetary framework as outlined in the programme”.

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On the updated stability programme of Portugal, 2008-2011

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies⁴, and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

- (1) On [10 March 2009] the Council examined the updated stability programme of Portugal, which covers the period 2008 to 2011.
- (2) The Portuguese economy has been growing below the euro-area average and below potential during the current decade. GDP stagnated in 2008, primarily influenced by sluggish external demand, reflecting the financial crisis and the weak economic situation of main trading partners. External imbalances have widened, which has led to rapidly growing indebtedness, and concomitantly, rising interest payments abroad. Moreover, the competitiveness gap has not been reduced, reflecting mostly a feeble productivity growth, which remains a major weakness of the Portuguese economy. Domestic demand growth also fell, driven by the poorer performance of private consumption and especially gross fixed capital formation. Slow growth, however, did not prevent the government deficit to be reduced in recent years, standing at 2.2% of GDP in 2008. The Portuguese authorities have adopted various measures to stimulate economic activity in 2009 in line with the European Economic Recovery Plan (EERP), amounting to 0.8% of GDP. The discretionary measures on public finances limit the space for further fiscal impulses without risking the long-term sustainability of public finances.

⁴ OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

- (3) The macroeconomic scenario underlying the programme envisages that GDP will contract by 0.8% in real terms in 2009 and recover in 2010 and 2011 with real GDP growth at 0.5% and 1.3% respectively. These projections take into account the stimulus measures adopted in response to the economic downturn. Assessed against currently available information⁵, this scenario appears to be based on favourable growth assumptions over the programme period, which is mainly reflecting relatively optimistic projections for domestic demand, notably the modest contractions of gross fixed capital formation in the programme scenario. The fiscal stimulus package for 2009 is expected to boost GDP. On the back of a reduction in the balance of goods and services deficit, the programme envisages a decline of net foreign borrowing from 10½% of GDP in 2008 to 7½% of GDP in 2011. The programme's projections for inflation appear to be realistic.
- (4) The 2008 general government deficit is estimated at 2.2% of GDP in the Commission services' January 2009 interim forecast and in the stability programme update, which is slightly better than the deficit target of 2.4% of GDP included in the previous update. The 2008 budgetary execution benefited from the better-than-expected outcome of 2007, since the deficit outturn for that year was almost ½% of GDP lower than foreseen. In addition, the 2008 outturn was affected by the slowdown in activity and the reduction of the standard VAT rate by one percentage point in July 2008, which dampened tax revenue growth in the final part of 2008. This was partly offset by unforeseen one-off sales of concessions by the government, mainly for the construction and exploitation of electric dams and motorways, worth some ¾% of GDP.
- (5) The updated programme plans a general government deficit of 3.9% of GDP in 2009. The worsening of the budget balance is explained mainly by the impact of discretionary measures. Some of these measures had been announced earlier in 2008 to support households and firms and to reduce the standard VAT rate by one percentage point as from July 2008 as it will also impact the 2009 budgetary execution. However, the programme assumes that these two effects will be mitigated by the impact of consolidation measures taken in earlier years to contain expenditure, particularly on compensation of government employees and social transfers. Measures amounting to 0.8% of GDP through a combination of higher expenditure and tax exemptions have been taken in the context of the EERP. In addition, the worsening of the balance will also reflect the flooring of the sizeable one-off sales of concessions recorded in 2008, as well as the impact of automatic stabilisers. Overall, with the structural balance loosening by about 1 percentage point, the stance of fiscal policy is expected to be expansionary in 2009, which is in line with the EERP⁶.
- (6) The headline deficit is projected to fall to 2.9% of GDP in 2010 and further to 2.3% of GDP in 2011. Similarly, the primary balance is aimed to improve gradually from a deficit of 0.6% of GDP in 2009 to surpluses of 0.4% and 1.1% of GDP in 2010 and 2011 respectively. After 2009, the budgetary strategy outlined in the programme aims

⁵ The assessment notably takes into account the Commission services' January 2009 interim forecast, but also other information that has become available since then.

⁶ Using the recalculated cyclically-adjusted balance, based on the information in the programme, and the definition of one-offs and other temporary measures applied by the Commission services - which indicates higher values for these measures than the programme, especially in 2008 - the structural balance would be -2.8% of GDP in 2007, -2.7% in 2008, -3.1% in 2009 and -1.8% of GDP in 2010.

at resuming the convergence to the Medium-Term Objective (MTO) of a structural balance (i.e., the cyclically-adjusted balance net of one-off and other temporary measures) of -0.5% of GDP. Nonetheless, the structural deficit would still be in excess of the MTO in the final year of the programme. The improvement in the fiscal balance projected for 2010 is mainly explained by the reversal of the temporary stimulus package adopted for 2009. In addition, the improvements targeted for 2010 and 2011 are assumed to reflect past consolidation efforts to contain expenditure, namely the lagged effects of measures taken at the level of public administration, mainly to rein in compensation of government employees, and of old-age pension systems reforms. The update does not present new sizeable fiscal consolidation measures. Finally, according to the programme, the headline deficit is expected to fall also thanks to the expected upswing in economic activity. Government gross debt, estimated at 65.9% of GDP in 2008, is projected to increase further to a peak of 70.5% of GDP in 2010 as the result of the rise in the deficit, low GDP growth and a significant stock-flow adjustment in 2009 mainly reflecting commercial debt repayments and acquisition of financial assets in the context of the financial rescue package put in place by the Portuguese authorities. Some reversion of these factors is expected to allow a small decline in the debt ratio to 70% of GDP in 2011.

- (7) The budgetary outcomes are subject to downside risks throughout the programme period. A major source of uncertainty is related to the macroeconomic scenario, which appears to be based on favourable growth assumptions. Hence, a scenario where lower-than-expected GDP growth would dampen revenue growth and jeopardise the fall in the expenditure-to-GDP ratio envisaged in the programme is a distinctive possibility. To a lesser extent, the additional expenditure savings that can be rendered by recently taken measures, namely at the level of public administration, are subject to uncertainty. The evolution of the debt ratio may be less favourable than projected in the programme, given the risks to the macroeconomic and budgetary scenarios and the uncertainty about the impact of guarantees granted and of financial assets acquired in the context of the financial rescue package. However, the increase in debt linked to recapitalisations could be (partly) reversed at a later stage if the support scheme and the financial operations linked to it were successful.
- (8) While the long-term budgetary impact of ageing is somewhat higher than on average in the EU, recently enacted pension reforms have helped to contain the projected increase in pension expenditure over the coming decades. The budgetary position in 2008, as estimated in the programme, is almost sufficient to stabilize the debt ratio over the long term before the budgetary impact of population ageing is taken into account. If the 2009 budgetary position as projected in the Commission services' January 2009 interim forecast was taken as the starting point, the sustainability gap would worsen. Moreover, the current level of gross debt is above the Treaty reference value. Achieving higher primary surpluses over the medium term, as already foreseen in the programme, would contribute to reducing the medium risks to the sustainability of public finances.
- (9) The programme presents a number of measures aimed at strengthening the budgetary framework. The main elements are the gradual implementation of programme budgeting and of multi-annual cycles with the preparation of budgetary plans for the entire legislative period associated with annual expenditure ceilings. Besides these changes to ex-ante budget planning, further changes towards a swifter and more integrated reporting of ex-post budgetary execution are also envisaged. Overall, these

efforts recognise the importance of strengthening the budgeting process and address two aspects where the Portuguese budgetary framework has shown needs of continued improvement, in particular planning fiscal policy in the broader medium-term setting and controlling expenditure developments in a more thorough way. In addition, the programme outlines measures to improve the efficiency and effectiveness of government services and changes to the governance of state-owned enterprises.

- (10) The Portuguese authorities have adopted various measures to help stabilising the financial sector. These include strengthening information disclosure obligations by financial institutions; increased bank deposit guarantees (from 25 000 to 100 000 euro per account holder and bank); granting of guarantees to borrowing by Portuguese banks up to a total of 9½% of GDP until end 2009; possibility of reinforcing the core capital of domestic banks through government investment up to a total of 2½% of GDP.
- (11) The Portuguese government adopted significant discretionary fiscal measures in response to the economic downturn. The stimulus package for 2009 adopted in December 2008 is in line with the European Economic Recovery Plan (EERP) agreed in December 2008 by the European Council and represents an adequate response to the economic downturn. This package yields a temporary support to economic activity in 2009 and will be discontinued in 2010. It mainly focuses on investment, support to firms and exports and support to employment and social protection. This budgetary effort is intertwined with a frontloading of EU funds of almost ½% of GDP, which is neutral for the budget balance. These measures add to other measures amounting to a total of 0.4% of GDP that had already been announced over the course of 2008 to support households and firms. The stimulus package is timely, targeted and temporary and the measures broadly respond to the main policy objectives in terms of the short-term challenges posed by the downturn. In addition, the package includes various structural measures that support the longer-term policy reform agenda, to the extent that they can help enhancing potential GDP growth, strengthening competitiveness and employment as well as supporting incomes of disadvantaged groups, for instance by financing upgrades of physical infrastructure or reducing personnel hiring costs. These measures are related to the medium-term reform agenda and the country-specific recommendations proposed by the Commission on 28 January 2009 under the Lisbon Strategy for Growth and Jobs. Financial operations are also outlined in the programme, notably subsidising credit lines for corporations and the speeding up of commercial debt payments by the government to the private sector (financed mainly by the recourse to financial debt).
- (12) The overall fiscal stance in the programme is expansionary in 2009 and restrictive in 2010. More specifically, the programme targets for 2010 a reversal of the 2009 fiscal expansion, such that the headline deficit would be brought below the 3% of GDP reference value in 2010 after exceeding it in 2009. A structural improvement is envisaged for 2010 and 2011. However, taking into account the negative balance of risks to the budgetary plans, the reversal in 2010 could require further action to be effective to the extent planned in the programme. Finally, taking into account the risks to the debt projections mentioned above, the debt-to-GDP ratio may be increasing over the whole programme period.

- (13) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data⁷.

The overall conclusion is that the programme aims at a significant temporary fiscal impulse in 2009 in line with the EERP, which represents an adequate response to the economic downturn. The programme rightly plans the resumption of fiscal consolidation as soon as the economy recovers. Yet, in the light of the favourable macroeconomic assumptions, economic growth may underpin fiscal consolidation by less than envisaged in the programme. Progress with fiscal consolidation is also necessary to strengthen the long-term sustainability of public finances. In addition, further strengthening the budgetary framework can be instrumental to achieve the planned fiscal path. Finally, fostering the quality of public finances is important also to underpin a smooth adjustment of the economy in the light of the imbalances it is faced with, notably by supporting potential GDP growth, helping improving competitiveness and supporting the correction of the external deficit.

In view of the above assessment, Portugal is invited to:

- (i) implement the measures in line with the EERP as planned, while avoiding a further deterioration of public finances in 2009;
- (ii) carry out with determination the planned structural adjustment in 2010 and beyond, strengthening the pace of budgetary consolidation if cyclical conditions are better than projected;
- (iii) further strengthen the budgetary framework and ensure that fiscal consolidation measures are also geared towards enhancing the quality of the public finances in the light of the needed adjustment of the economy to address existing imbalances.

⁷ In particular optional data on deflators of public consumption and of investment (Table 1b) and on government consumption (Table 2) are not provided.

Comparison of key macroeconomic and budgetary projections

		2007	2008	2009	2010	2011
Real GDP (% change)	SP Jan 2009	1.9	0.3	-0.8	0.5	1.3
	COM Jan 2009	1.9	0.2	-1.6	-0.2	n.a.
	SP Dec 2007	1.8	2.2	2.8	3.0	3.0
HICP inflation (%)	SP Jan 2009	2.4	2.6	1.2	2.0	2.0
	COM Jan 2009	2.4	2.7	1.0	2.0	n.a.
	SP Dec 2007	2.3	2.1	2.1	2.1	2.1
Output gap ¹ (% of potential GDP)	SP Jan 2009	0.2	-0.4	-2.1	-2.5	-2.5
	COM Jan 2009 ²	0.8	0.2	-1.7	-2.5	n.a.
	SP Dec 2007	-2.2	-1.8	-1.1	-0.2	0.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	SP Jan 2009	-8.7	-10.5	-9.2	-8.4	-7.6
	COM Jan 2009	-8.7	-10.2	-8.2	-8.7	n.a.
	SP Dec 2007	-7.0	-5.8	-5.6	-4.9	-4.7
General government revenue (% of GDP)	SP Jan 2009	43.2	43.5	44.1	43.6	43.6
	COM Jan 2009	43.1	44.2	42.6	42.4	n.a.
	SP Dec 2007	42.4	42.7	42.8	43.1	43.1
General government expenditure (% of GDP)	SP Jan 2009	45.7	45.8	48.0	46.5	45.9
	COM Jan 2009	45.7	46.3	47.2	46.8	n.a.
	SP Dec 2007	45.4	45.1	44.4	43.5	43.3
General government balance (% of GDP)	SP Jan 2009	-2.6	-2.2	-3.9	-2.9	-2.3
	COM Jan 2009	-2.6	-2.2	-4.6	-4.4	n.a.
	SP Dec 2007	-3.0	-2.4	-1.5	-0.4	-0.2
Primary balance (% of GDP)	SP Jan 2009	0.2	0.8	-0.6	0.4	1.1
	COM Jan 2009	0.2	0.8	-1.7	-1.3	n.a.
	SP Dec 2007	-0.1	0.5	1.3	2.2	2.5
Cyclically-adjusted balance ¹ (% of GDP)	SP Jan 2009	-2.7	-2.0	-3.0	-1.8	-1.2
	COM Jan 2009	-3.0	-2.3	-3.8	-3.3	n.a.
	SP Dec 2007	-2.0	-1.6	-1.0	-0.3	-0.4
Structural balance ^{3,4} (% of GDP)	SP Jan 2009	-2.7	-2.0	-3.0	-1.8	-1.2
	COM Jan 2009	-3.1	-3.0	-3.9	-3.3	n.a.
	SP Dec 2007	-2.1	-1.6	-1.0	-0.3	-0.4
Government gross debt (% of GDP)	SP Jan 2009	63.6	65.9	69.7	70.5	70.0
	COM Jan 2009	63.6	64.6	68.2	71.7	n.a.
	SP Dec 2007	64.4	64.1	62.5	59.7	56.7

Notes:

¹ Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

² Based on estimated potential growth of 0.7%, 0.7%, 0.4% and 0.5% respectively in the period 2007-2010.

³ Cyclically-adjusted balance excluding one-off and other temporary measures. There are no one-off and other temporary measures in the programme; according to the Commission services' January 2009 interim forecast they are 0.1% of GDP in year 2007, 0.7% in year 2008 and 0.1% in year 2009, all deficit-reducing.

⁴ Using the recalculated cyclically-adjusted balance, based on the information in the programme, and the definition of one-offs and other temporary measures applied by the Commission services, the structural balance would be -2.8% of GDP in 2007, -2.7% of GDP in 2008, -3.1% in 2009 and -1.8% of GDP in 2010.

Source:

Stability programme (SP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations.