Summary for non-specialists
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Post-Programme Surveillance for Portugal

Autumn 2014 Report

This report discusses the main findings of the first post-programme surveillance (PPS) review for Portugal. Staff from the European Commission (EC), in liaison with ECB staff, visited Lisbon between 28 October and 4 November under the first PPS review. The mission was coordinated with the IMF's post-programme monitoring mission and staff from the European Stability Mechanism (ESM) participated in meetings of relevance to their Early Warning System. The report gives an overview of the main findings of the mission and of the challenges faced by Portugal.

The economic and financial conditions in Portugal have further improved since the end of the EU/IMF-supported programme in June 2014. Sovereign yields remain low and normal market-financing is being gradually restored. Nevertheless, economic recovery is constrained by high levels of public and private debt and by a weak external environment which highlights the need for further competitiveness gains. The pace of budgetary consolidation has been adversely affected by a series of one-off factors, despite strong revenue performance. Moreover, efforts to reduce the underlying structural budget deficit have clearly slackened. Progress in structural reforms has lost momentum, with an uneven pace of implementation across policy areas.

The composition of growth in the Portuguese economy has shifted in recent months. Weaker external demand and a number of temporary factors weighed on export performance in the first half of the year and led to a notable decline in the growth contribution from the external side. At the same time, domestic demand – and more specifically private consumption – has strengthened, supported by a strong labour-market performance.

The Government expects a nominal budget deficit of 4.8% of GDP in 2014. On 15 October, the Government presented its draft budget for 2015 which targets a nominal deficit of 2.7%. This target is higher than the 2.5% of GDP required under the Excessive Deficit Procedure (EDP). The Commission's Autumn Forecast projects a nominal budget deficit of 3.3% of GDP for 2015 based on less optimistic assumptions on the budgetary impact of macroeconomic developments, the impact of the measures to fight tax evasion and fraud and of the consolidation measures. Meanwhile, the adjustment in the structural deficit also falls considerably short of what is required under the EDP, reflecting a fading consolidation effort. The 2015 draft budget confirms the reversal of some of the measures that contributed significantly to the consolidation effort in the last few years, but does not contain replacement measures. The debt-to-GDP ratio, which stood at 128% at the end of 2013, is expected to be lower by the end of this year and to continue on a downward path thereafter. Fiscal-structural reforms are advanced, but strong implementation needs to continue.

Portuguese banks continue to deleverage amid improving liquidity conditions. Internal capital generation amid low profitability and only slowly recovering non-performing loan ratios remain a key challenge for the sector. Banking-sector developments in recent months have been marked by the collapse and resolution of Banco Espírito Santo (BES). BES's resolution effectively preserved financial, but the recapitalisation of Novo Banco leaves the banking system exposed to a contingent liability depending on the sale price of the new bank. Looking ahead the opportunity provided by the Comprehensive Assessment by the ECB to strengthen further the resilience of the banking system as a whole needs to be seized.

Progress in implementing structural reforms in different areas was monitored by the mission. While some measures have been taken, for instance, in the educational system, the judiciary and in the energy sector, overall the pace of structural reform appears to have diminished considerably since the end of the Programme, in some cases reversing past achievements. Notably, while it remains to be seen whether recent policy measures relating to collective wage bargaining could on balance contribute to a better alignment of wages to productivity developments, the decision to increase the minimum wage could make the transition into employment for the most vulnerable even more difficult. Finally, there is a need to more systematically monitor and evaluate the impact of reforms. Looking ahead, maintaining an ambitious reform agenda to increase the flexibility and competitiveness of the Portuguese economy is not only important to enhance the medium-term growth potential, but also to underpin the still nascent economic recovery.

On the basis of the analysis in this report, repayment risks for the EFSM and EFSF loans are low at present. However, for this situation to persist going forward, it is essential that the authorities implement with resolve further structural reforms, public finances continue to be consolidated in a durable manner and access to credit markets is maintained.