Notes from the 8th and 9th Reviews of the Economic Adjustment Program

- **The EC, ECB and IMF Mission to Portugal has concluded that the country's economic adjustment program remains on track, clearing the way for the disbursement of EUR 5.6 billion in November**
- **As long as implementation remains strong, euro area member states have declared they stand ready to support Portugal until full market access is regained**
- **The strong commitment to the program's targets means that by the end of 2013 a majority of the needed external and fiscal adjustments will have been achieved**
- **GDP has been revised upwards mainly on the back of stronger exports and private consumption and a +0.8% recovery is now expected in 2014**
- **The combination of structural reforms and macroeconomic adjustments will allow Portugal to gain export market share for the third year in a row in 2013, reflecting improving competitiveness**
- **Deficit targets remain unchanged and are within reach: 5.5% in 2013 and 4.0% in 2014**
- **Debt level revised upwards mainly due to higher Treasury cash balances, but remains sustainable**

"The program remains broadly on track, with the authorities determined to achieve its objectives", EU-IMF statement, Oct 3, 2013

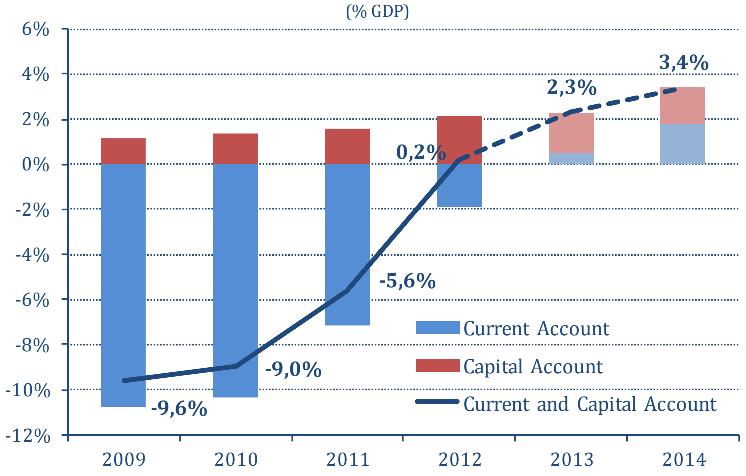
The staff teams of EC, ECB, and IMF visited Lisbon between Sep 16 and Oct 3 and concluded that the program is on track. In particular, it was noted that *"the program's agenda of structural reforms is well advanced, and effective implementation will be key to sustaining competitiveness gains"*.

Crucially, both the external and fiscal adjustment occurred thus far were very significant.

The external adjustment achieved in 2010-13 already surpasses what was initially projected in the Program...

On the external side, the current account deficit has decreased from 10.4% of GDP in 2010 to 1.9% in 2012 and is now expected to be in surplus (+0.5%) already this year.

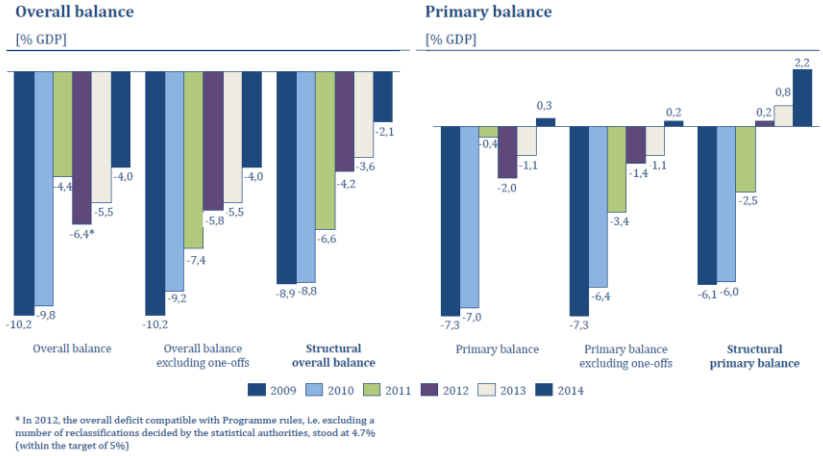
External accounts
(% GDP)



Source: Statistics Portugal and Ministry of Finance.

On the fiscal side, the structural primary balance improved from a deficit of 6.0% of GDP in 2010 to a surplus of 0.2% in 2012, according to the figures estimated in the previous review, and should improve further in 2013.

... and about 70% of the adjustment initially foreseen in the structural primary balance until 2016 was already achieved in 2010-13



Source: Ministry of Finance, 7th review.

Macro scenario: exports continue supporting GDP recovery and unemployment rate may be lower than previously foreseen

The current review has concluded that the macroeconomic scenario for 2013-2014 is now more favorable than previously envisioned.

There are early signs of a recovery in economic activity, with high frequency indicators showing a positive tone over the recent months. Domestic demand indicators suggest that a slow recovery is under way and exports performance remains strong.

Economic prospects revised upward in both 2013 and 2014

Current GDP projections point to a 1.8% contraction in 2013 (vs 2.3% previously) and a 0.8% expansion in 2014 (vs 0.6% previously).

Macroeconomic scenario				
	2013		2014	
	7th review	8th & 9th review	7th review	8th & 9th review
Real GDP (yoy %)	-2,3	-1,8	0,6	0,8
Unemployment (% labor force)	18,2	17,4	18,5	17,7
Current Account	-0,3	0,5	0,5	1,8
Current and Capital Account	1,4	2,3	2,0	3,4

Source: Ministry of Finance (8th and 9th review)

Moreover, the unemployment rate was revised downwards and is now expected to remain below 18% over the projection horizon. The current scenario estimates an unemployment rate of 17.4 and 17.7% of the labor force in 2013 and 2014, respectively (comparing with 18.2 and 18.5% previously).

After decades of persistent deficits, the current account is expected to achieve a surplus of 0.5% of GDP in 2013 (more than 13pp of GDP higher than the bottom achieved in 2008)

The external adjustment continues to gain traction at a good pace. The balance of the current and capital accounts should improve further from 0.2% of GDP in 2012 to 2.3% in the current year and 3.4% in 2014 (about 1pp of GDP higher than previously expected).

Moreover, the new estimate for the current account confirms the expectation of a surplus already in 2013, amounting to 0.5% of GDP, followed by further improvement to 1.8% in 2014.

Budget deficit targets remain within reach and unchanged

Portugal maintained its budget deficit goals as agreed in the 7th review: 5.5% in 2013 and 4.0% in 2014.

For the current year, the 2013H1 figures for the budget deficit on a National Accounts basis confirm that the deficit target is within reach.

Budget deficit stood at 7.1% of GDP in 2013H1 (6.2% excluding Banif recap) …

In the first half of the year, the General Government budget deficit decreased 0.7pp yoy, to 7.1% of GDP, a figure that includes the impact of Banif recapitalization amounting to €1.1 bn, or 0.9pp of half-year GDP. This result stems from the significant deficit reduction in 2013Q2, which stood at 4.1% of GDP, after 10.6% in 2013Q1.

… measures implemented in the Supplementary Budget are sufficient to achieve target of 5.5%

In the second half of the year, the deficit should be further reduced on the back of the implementation of the measures foreseen in the Supplementary budget that entered into force in late July, and should also be supported by a recovery of fiscal revenue given the positive signs received from recent macroeconomic indicators, in particular stronger private consumption.

Budgetary outturn until August also confirms that the budget execution on a public accounts basis is on track. Until August, the General Government (GG) balance relevant to the Program's Quantitative Performance Criteria reached €4.8 bn, more than €2.5 bn below the target defined for end-September, and €0.8 bn lower than the same period in 2012 (when excluding one-off base effects).

For 2014, achieving the deficit target crucially depends on the implementation of the Public Expenditure Review, a plan designed to improve competitiveness and medium-term fiscal sustainability to which the Government remains strongly committed, as is clearly demonstrated in the conclusions of the 8th and 9th reviews.

The Government plans to proceed with fiscal consolidation through a comprehensive and permanent public expenditure review

The measures foreseen in the 7th review amounted to permanent cuts of €4.7 bn, as presented in the following table:

The main axes of this roadmap are (i) the reduction of the public sector wage bill; (ii) the reduction of pension benefits; and (iii) sectoral expenditure cuts

Initial draft of Public Expenditure Review measures, as laid out in the 7th review
(EUR mln)

	2013	2014	Total
Wage bill	**777**	**1.395**	**2.172**
Special mobility (requalification)	48	119	**167**
Convergence public-private working rules	176	365	**541**
Mutual agreements (voluntary separation)	0	252	**252**
Single wage and supplement scale	0	445	**445**
Termination of fixed-term contracts	74	214	**288**
Attrition	479	0	**479**
Pensions	**0**	**1.378**	**1.378**
Increase in retirement age	0	270	**270**
Equality between public sector and private sector schemes	0	672	**672**
Sustainability contribution[1]	0	436	**436**
Intermediate consumption	**334**	**520**	**854**
Savings from line ministries	284	470	**754**
Other	50	50	**100**
Other	**300**	**-4**	**296**
Total	**1.411**	**3.289**	**4.700**
Memo: one-off upfront costs (severance payments)	0	507	

1: The sustainability contribution measure will be replaced by several alternative measures to be presented in the 2014 Budget, namely the reduction of 0.3% on ministries primary expenditure, a tax on energy producers rents and the reduction of fiscal benefits.

Source: Ministry of Finance, 7th review.

While the details of this plan will be revised with the presentation of the 2014 budget, a number of measures have already been put forward or are being discussed in Parliament and with social partners. Among the measures already in place, we highlight the following:

Most PER measures are either ongoing or will be presented with the 2014 budget

- ✓ Mutual agreements – the conditions for voluntary separation offered to public workers have been made public and will be available until Nov 30 (this measure does not involve legal risk, only execution risk);
- ✓ Termination of fixed-term contracts (no legal risk, only execution risk);
- ✓ Attrition – reduction of civil servants for other reasons such as retirement;
- ✓ Cost reduction with PPP contracts;
- ✓ Streamlining of State-Owned Enterprises; and
- ✓ Reprogramming of EU transfers.

In addition, the Parliament has already approved changes in the special mobility system and the convergence of public and private working rules. While the latter was already promulgated by the President of the Republic and entered into force on Sep 28, the former, following a President's request to the Constitutional Court (CC), was deemed unconstitutional, on a decision made public on Aug 29. (The latter may still be challenged by the CC at a later stage, as some members of Parliament have already requested the CC successive assessment.)

As occurred on previous occasions, the government was swift in finding an alternative to compensate the most recent CC ruling

However, the most recent decision may not have a direct impact on the 2014 budget, as the Government (as happened on previous occasions) has already re-submitted to Parliament a revised draft Law to address the CC's concerns.

The new draft law does not allow for dismissals at the end of the 12-month requalification period, but workers in this stage see their wages cut to 60% of original salary (similar to the initial draft) and this is then extended to 40% for those that finish the requalification period without finding an alternative job within the public sector (instead of 50%), which reinforces the incentive for these workers to look for alternatives and minimizes the impact of the CC decision from 2015 onwards.

Regarding pension reforms, the convergence between public and private sector schemes was presented to Parliament in September and its general terms shall be approved on Oct 17. As with any other law, upon receiving the approved law, the President of the Republic (PR) has 8 days to possibly request the CC preventive assessment, which if asked would give only another 25 days for the CC decision.

Other savings, including the definition of a single wage and supplement scale, the increase in retirement age and those needed to substitute the sustainability contribution, will be detailed in the 2014 Budget.

Public debt revised upwards, but downward trend unaffected

Public debt is now projected to stand at 127.8% of GDP at end-2013, some 5pp of GDP higher than what was foreseen in the 7th review (122.9% of GDP). This revision primarily reflects the following three technical factors, which do not alter the sustainability of public debt in a medium- to long-term perspective:

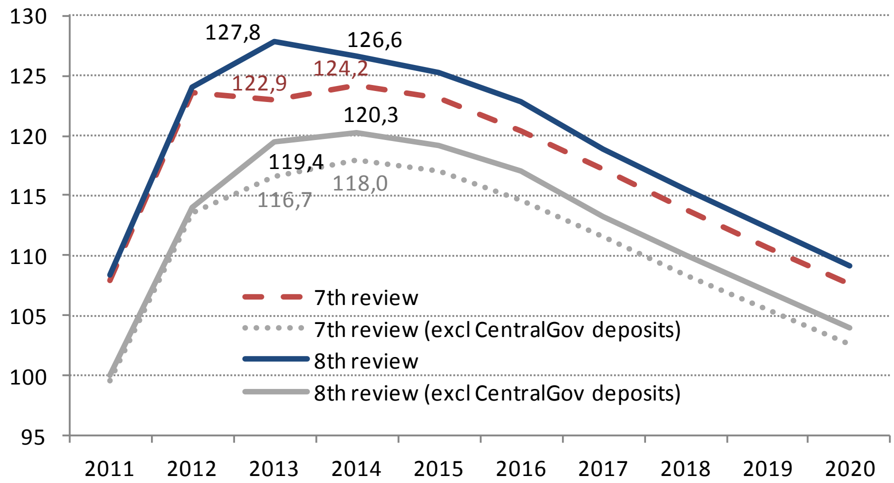
- A higher level of Treasury cash balances at year-end (estimated impact of 2.5pp of GDP);
- Lower holdings of Portuguese Government Bonds by the Social Security Fund (SSF) than initially anticipated (amounting to 1.2pp of GDP) – SSF is still expected to increase its holdings of Treasury securities by about €4 bn, but now only €2 bn shall occur until the end of 2013, with the remaining expected throughout 2014; and
- The possible reclassification of Parpública (due to the entry into force of ESA 2010 in September 2014), which would result in a one-off revision of the debt level of about 2.2pp of GDP in 2014. This effect justifies the parallel shift in the public debt projections from 2014 onwards.

Public debt peak anticipated to 2013 at 127.8% of GDP

The improvement of nominal GDP projections and other minor factors partly compensated the increase stemming from these 3 factors, with a contribution to a reduction of the debt level of about 1.1pp of GDP.

Under the current projections, public debt will peak at 127.8% in 2013 (130.9% in 2013Q2 on a quarterly basis), declining gradually from 2014 onwards.

Public debt projections
(% GDP)



Source: Ministry of Finance.

Borrowing needs for 2013 fully covered

The planned borrowing needs for 2013 are fully covered. As the IGCP converges to the financing strategy used before 2011 and returns to a more regular issuance calendar, any additional medium-long term financing will be used to pre-fund 2014 borrowing needs.

The projection of 2014 borrowing needs and sources is under preparation with the budget. The financing plan shall include both:

- ✓ PGB issuance, using exchanges, syndicates and regular auctions; and
- ✓ Retail issuance, including the launch of new instruments, which should benefit from the strong improvement in household savings (from 6% of disposable income in 2008 to 13.6% in 2013 Q2).

International institutions expect Portugal to regain full market access in the near term

The conclusions of the 8th and 9th program reviews reaffirm that the international institutions expect Portugal to regain full and regular market access in the near term: ***"Resolute program implementation and reaffirmed ownership will support the government's return to full market financing. Provided the authorities persevere with steadfast program implementation, euro area member states have declared they stand ready to support Portugal until full market access is regained. Portugal's culture of political and social dialogue remains an important asset to the program"***.

Calendar of upcoming benchmark events

Upcoming events	
Date	**Event**
Oct 15, 2013	Submission of 2014 Budget to Parliament
Oct 17, 2013	Vote on pension schemes convergence law *
Nov 2013	12th EU-IMF review of Irish Program (with expected definition of exit mechanism)
End-Nov, 2013	Final vote on the 2014 budget *
Nov-Dec 2013	10th EU-IMF review

* Upon receiving the approved law, the PR has 8 days to possibly request the CC preventive assessment. If requested, the CC has 25 days to announce a decision.
Once a law enters into force, the PR or at least 10% of members of Parliament may request the CC successive assessment, for which there is no specific deadline for the CC decision.

Official statements on the 8th and 9th reviews mission to Portugal:

- **Portugal Gov.** http://www.portugal.gov.pt/pt/os-ministerios/vice-primeiro-ministro/mantenha-se-atualizado/20131003-vmp-avaliacao-paef.aspx

  http://www.portugal.gov.pt/pt/os-ministerios/ministerio-das-financas/mantenha-se-atualizado/20131003-mef-avaliacao-paef.aspx
- **EU-IMF Mission** http://www.imf.org/external/np/sec/pr/2013/pr13384.htm

Further information on the Portuguese economy can be obtained from:

- **Ministry of Finance** www.portugal.gov.pt/en/the-ministries/ministry-of-finance
- **Banco de Portugal** www.bportugal.pt
- **Statistics Portugal** www.ine.pt
- **Portugal Economy Probe** www.peprobe.com

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