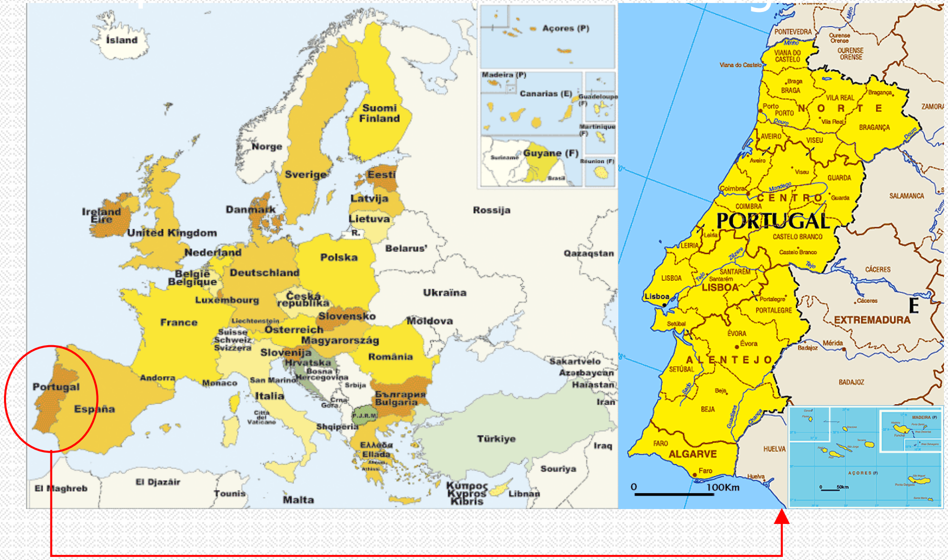
Ministry of Finance

PORTUGUESE ECONOMY

November 2011

GPEARI - *Office for Strategic Planning, Economic Policy and International Affairs*



Share of EU27, in 2009	
Population	2.1%
Gross Domestic Product	1.4%
Exports	
Percentage of GDP	
in 1986	28,0%
in 2008	32,5%
Geographic Distribution in 2009	
EU-15	**64.7**
Non EU-15	**35.3**

Main Economic Events:

1986 - Portugal joins the European Communities

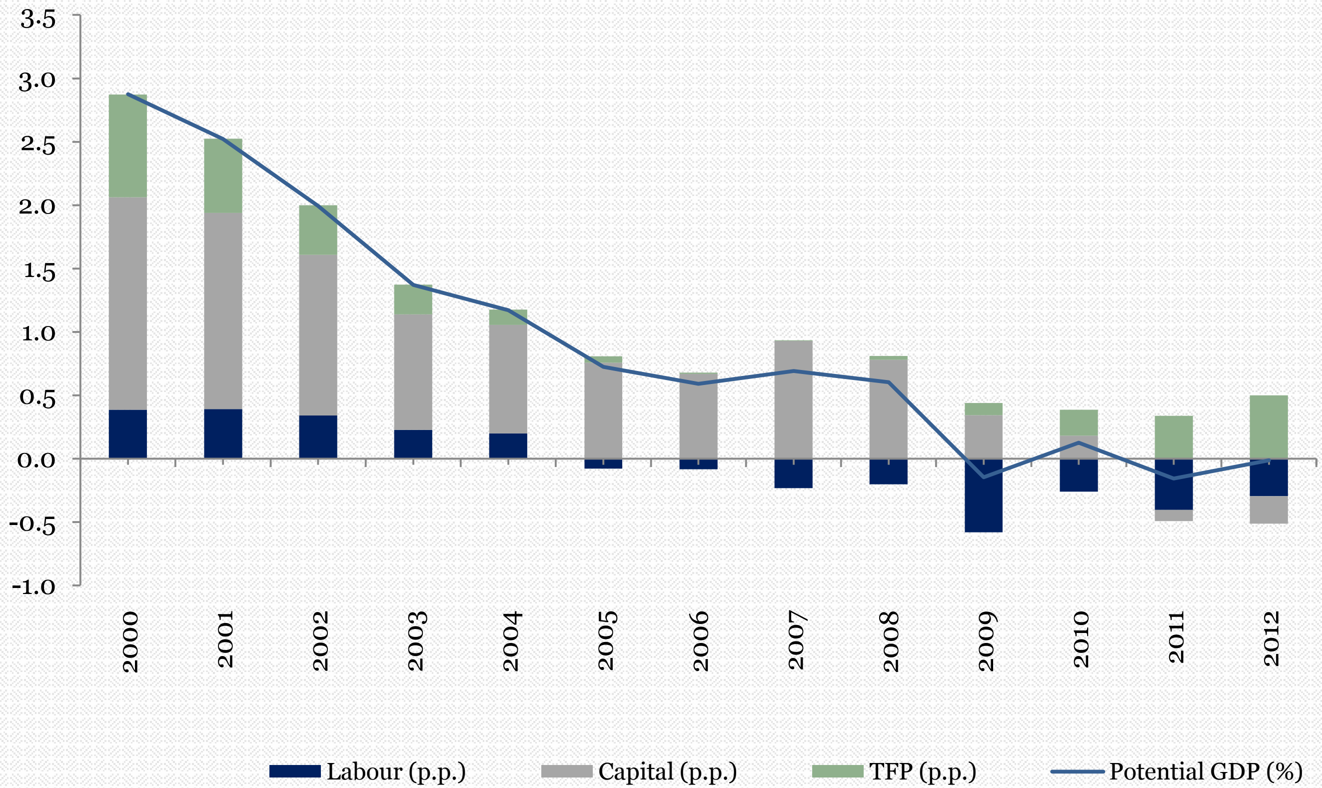
1992 - The Treaty of Maastricht is signed

1992 - The Escudo enters into the European Monetary System

1993 - The Single European market enters into force

1999 - Portugal becomes a founding member of the euro area

1. Main Macroeconomic Indicators: Potential GDP

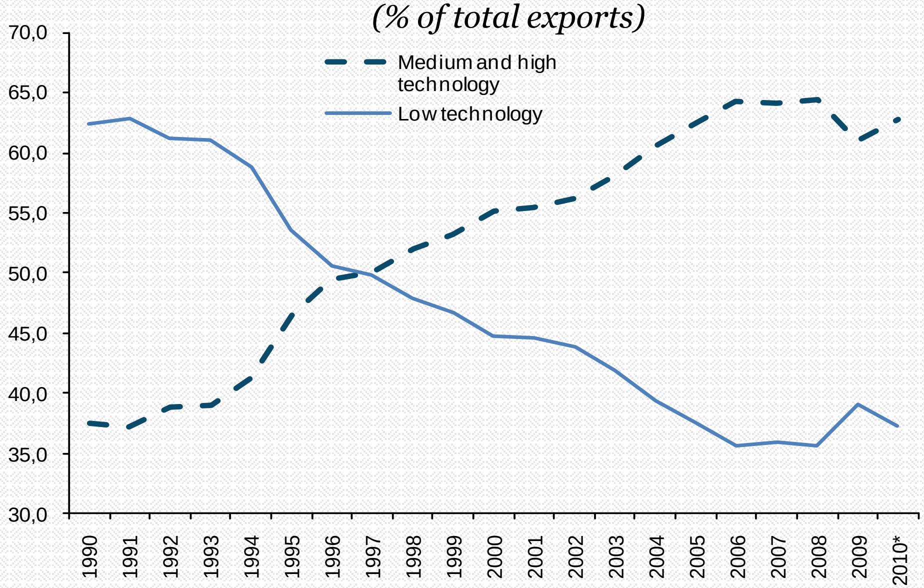


1. Main Macroeconomic Indicators: Exports Performance

- Increase in the importance of medium and high-tech exports;
- Positive Technological Balance of Payments since 2007.

Technological Intensity of Portuguese Exports

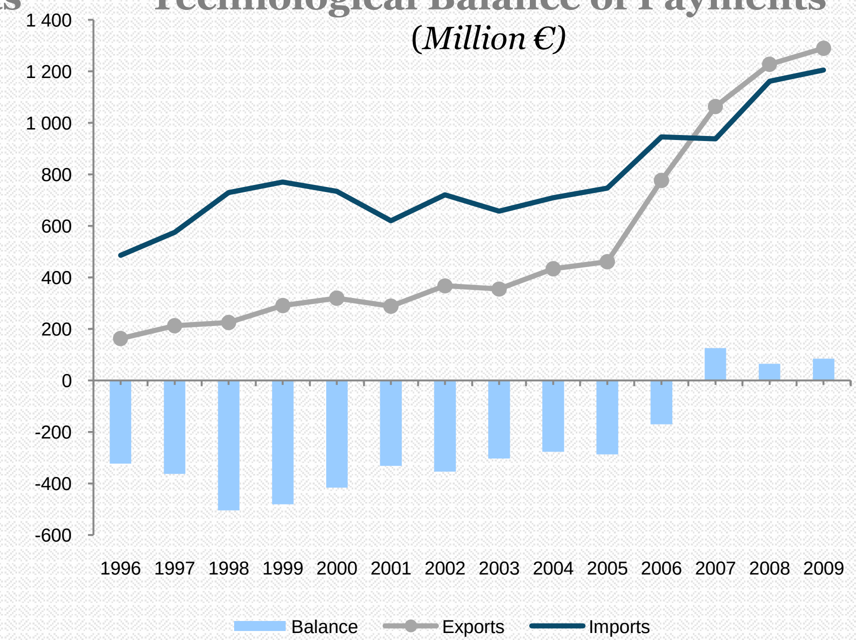
(% of total exports)



Sources: INE and MFAP; *Data available only for the Jan-September period.

Technological Balance of Payments

(*Million €*)

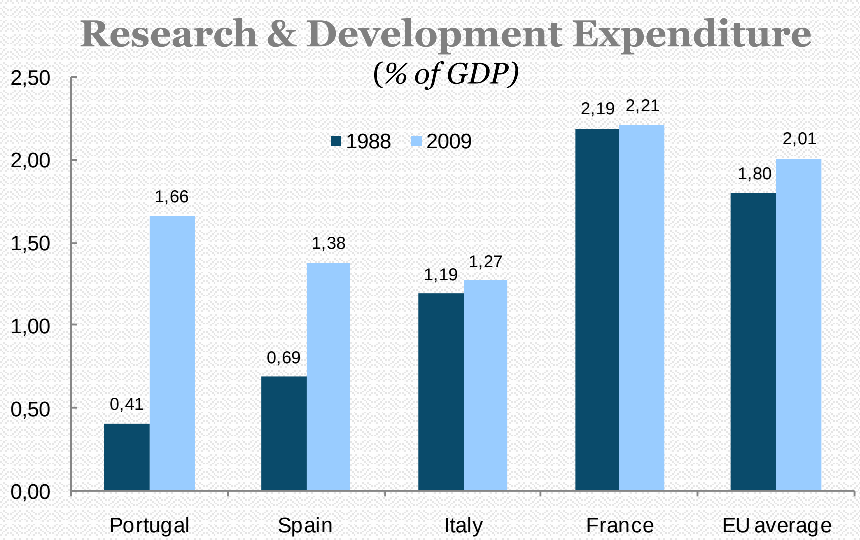


Source: Banco de Portugal .

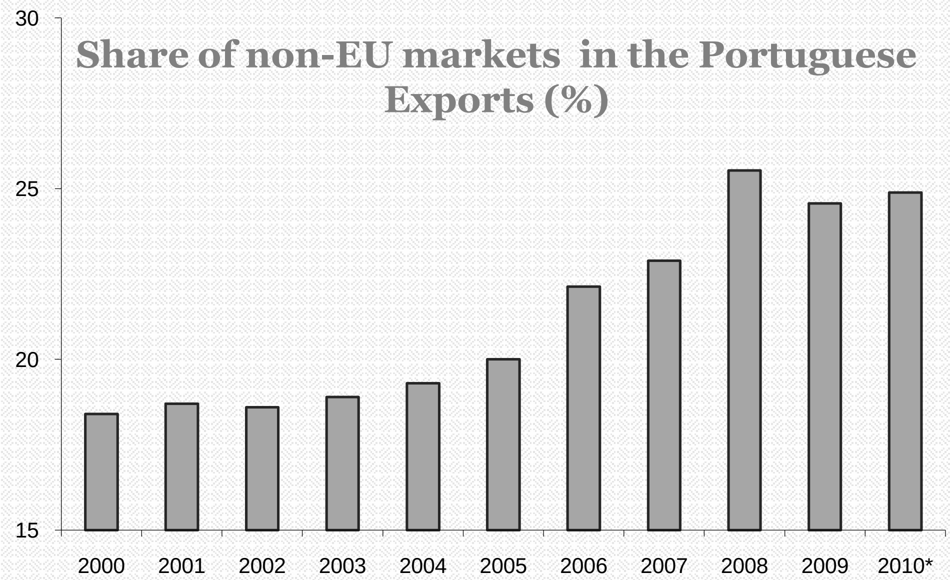
1. Main Macroeconomic Indicators: Exports Performance

- Big Effort in R&D investment - Eurostat (Nov, 2010): "*Among the EU27, the highest proportions of enterprises with innovation activity in this period [between 2006 and 2008] were recorded in Germany (80% of enterprises), Luxembourg (65%), Belgium and Portugal (both 58%) and Ireland (57%).*"

- Diversification of Portuguese Exports to non-EU markets.



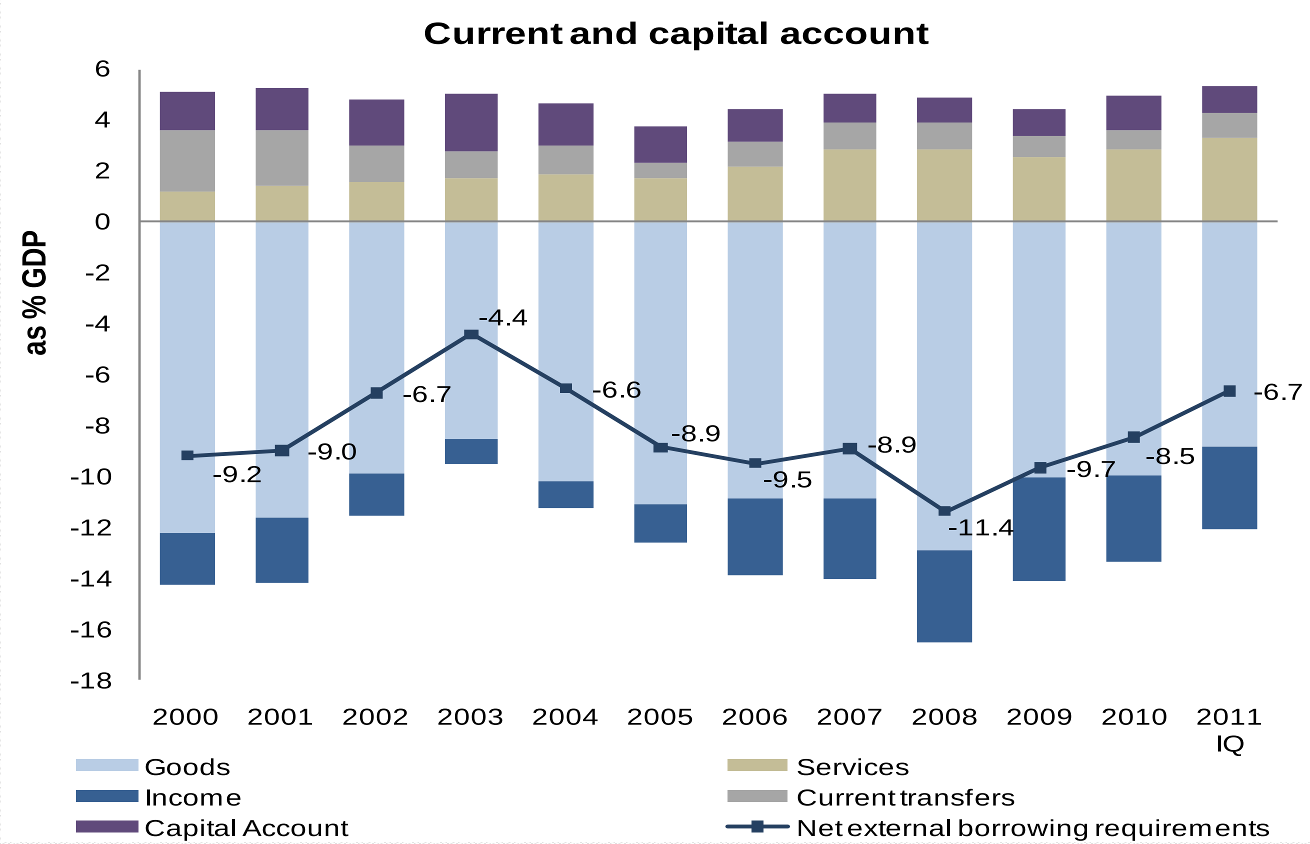
Source: Eurostat



Source: INE; * data available until November.

1. Main Macroeconomic Indicators: Most Recent Data

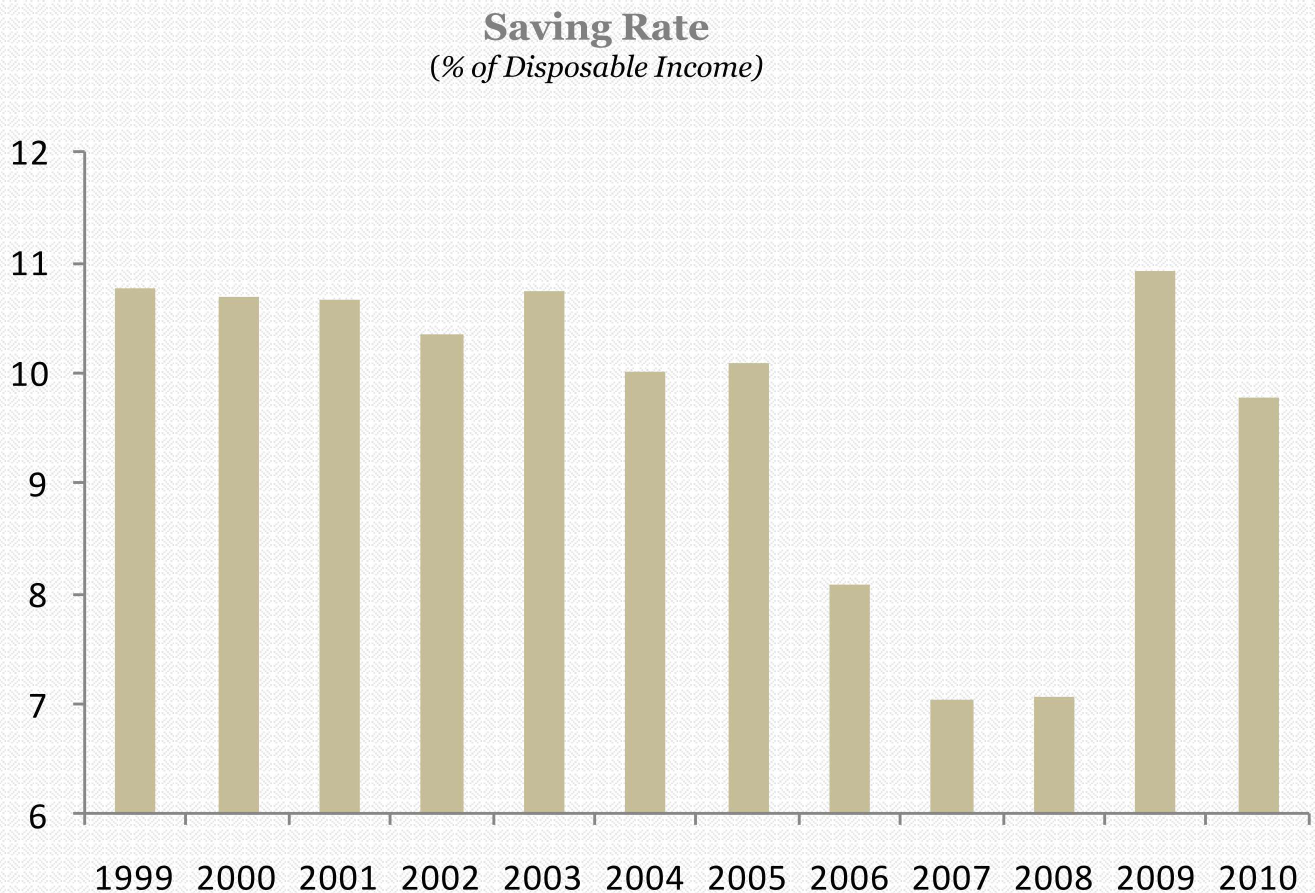
- … and a decline in financing needs of the economy



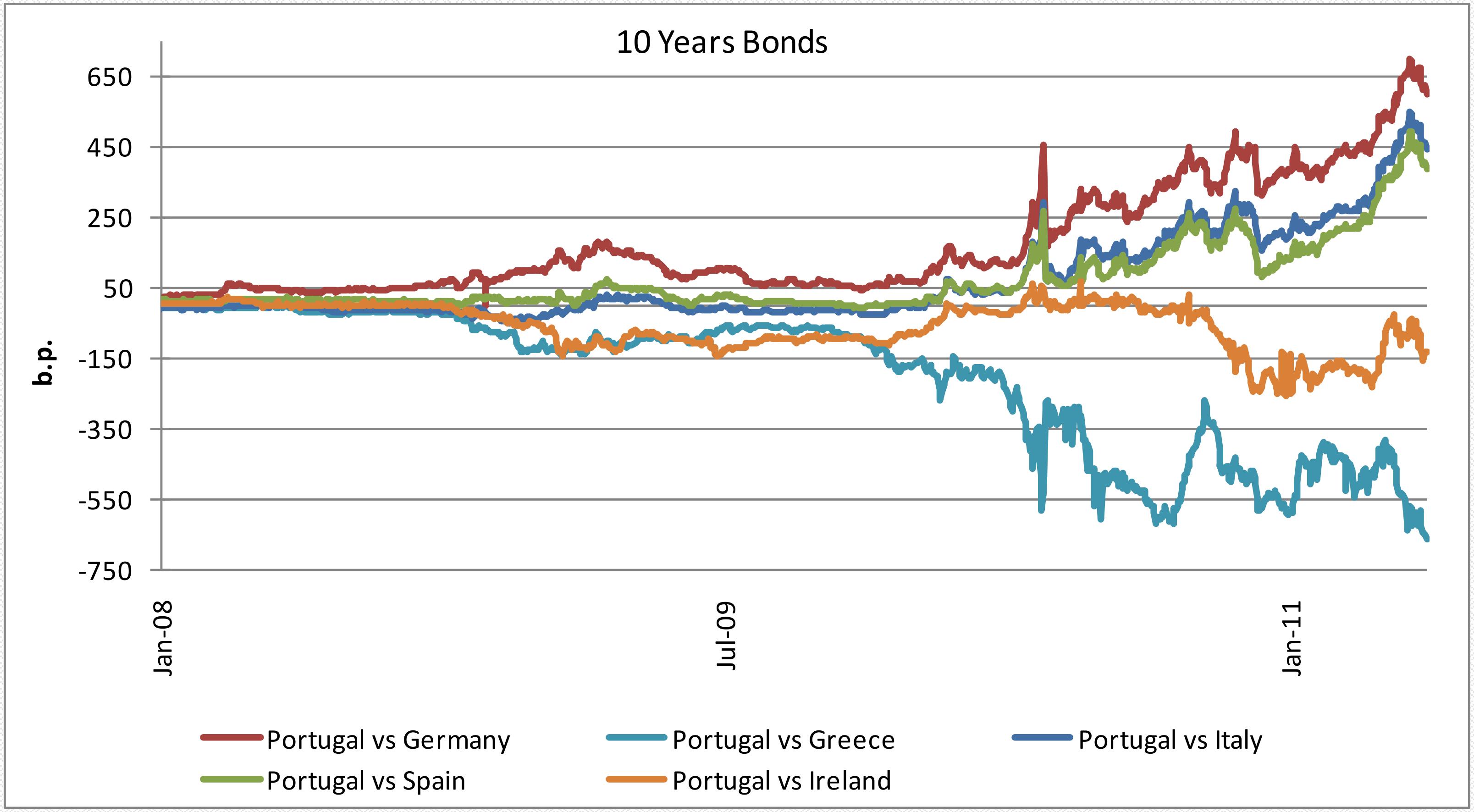
Source: INE

1. Main Macroeconomic Indicators: Saving Rate

- … and a increase in saving rate



Increase in sovereign market (became unsustainable)

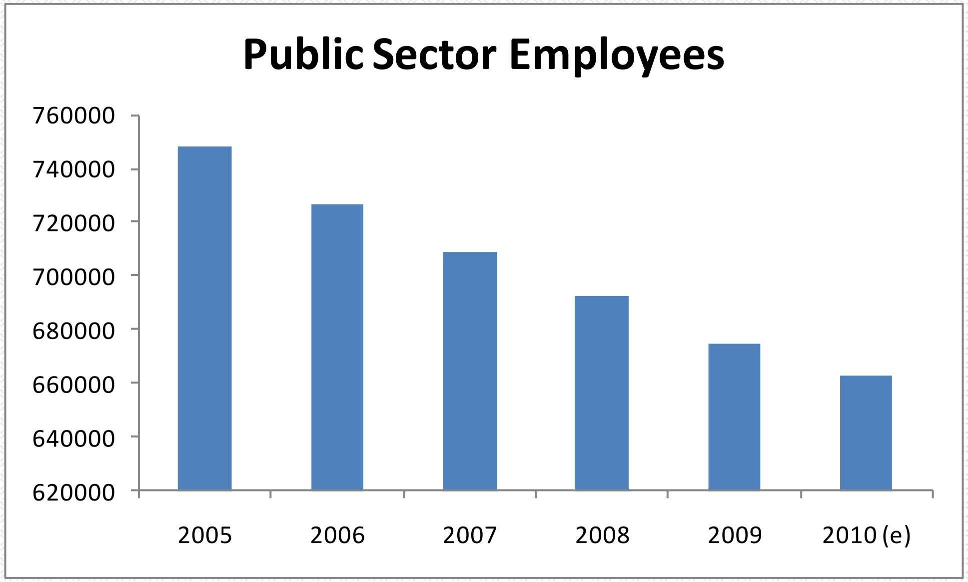


STRUCTURAL CHANGES SINCE 2005

Policy Response: Deepening the Structural Reforms launched before the crisis to Promote Competitiveness and Economic Growth

Reform of Public Administration

✓ Public Administration Resizing and Human Resources Management Improvement



Source: MF.

✓ Simplex Programme;

✓ e-Government;

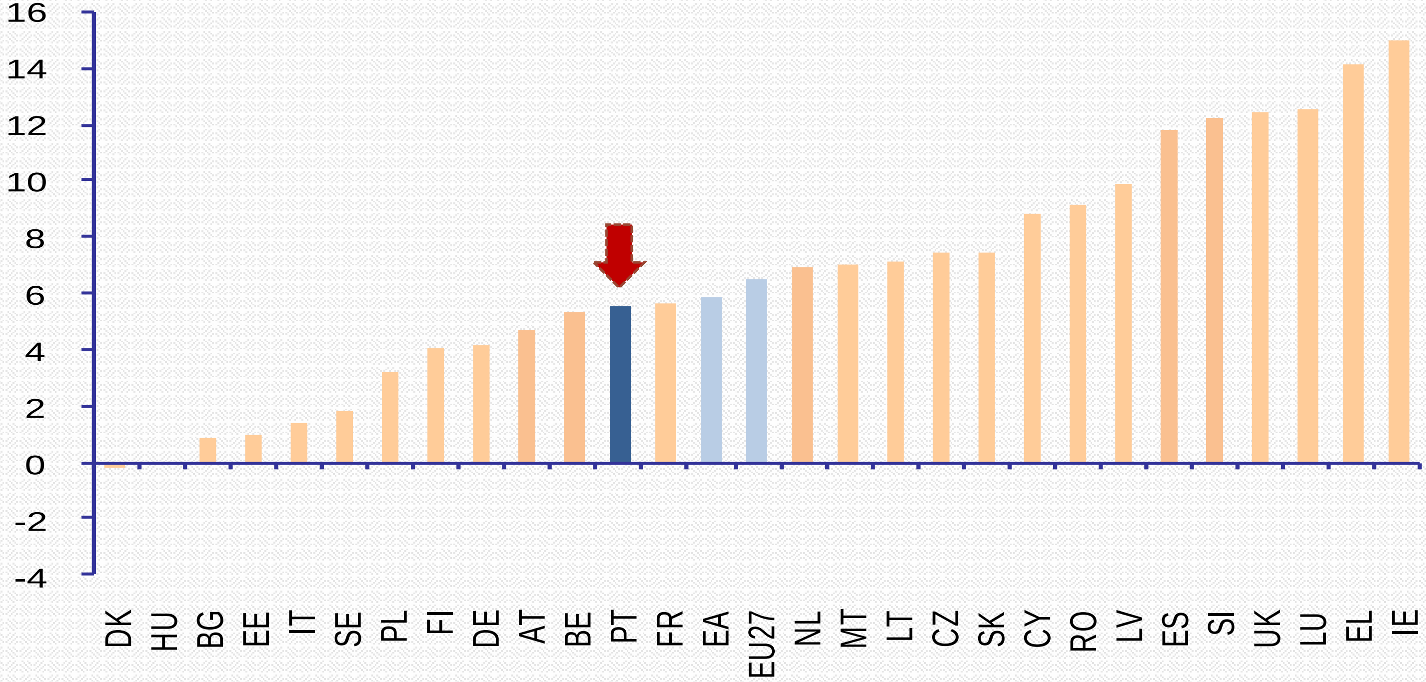
✓ Governance Indicators and Improved Business Environment (internationally recognized; e.g., World Bank Governance Indicators, 2008; Doing Business 2011 Report)

Further Policy Response: Social Security

Reform of Social Security System, which placed Portugal in a good relative position in terms of fiscal sustainability.

Sustainability gap S2 calculated by the EC (2009)

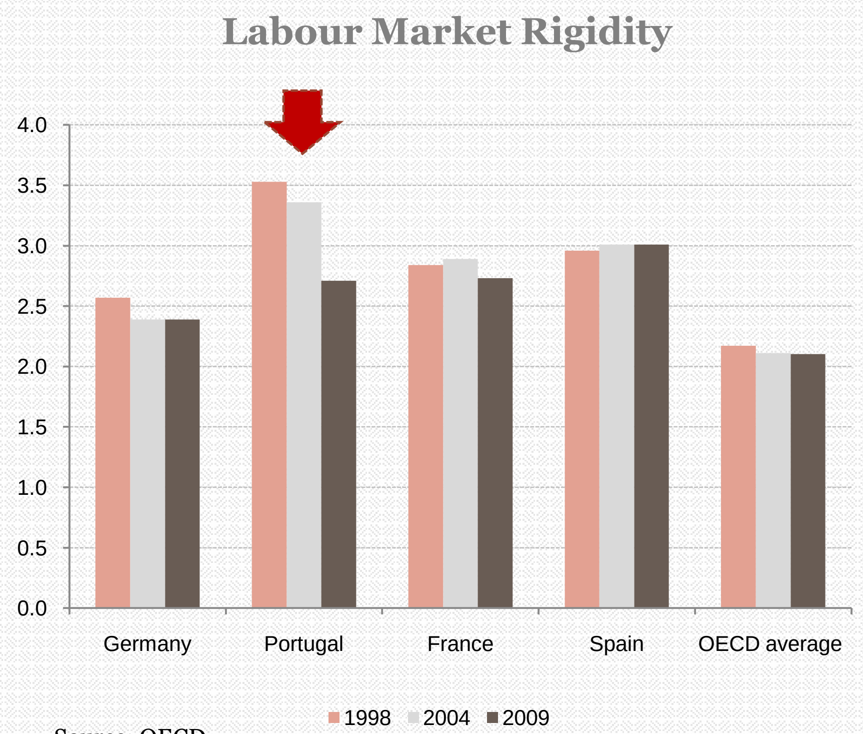
(baseline scenario, % GDP)



Source: European Commission, "The Long-term Sustainability of Public Finances in the European Union", 2009 EE no.9 and Commission Services.

Further Policy Response: Labour Market

Positive effect of the reform of the Labour Law on market dynamics



Source: OECD
Note: This indicator is calculated on a scale from 0 (less restrictive) to 6 (more restrictive) .

The OECD index on EPL (employment protection legislation) improved significantly after the labour market reform of 2009.

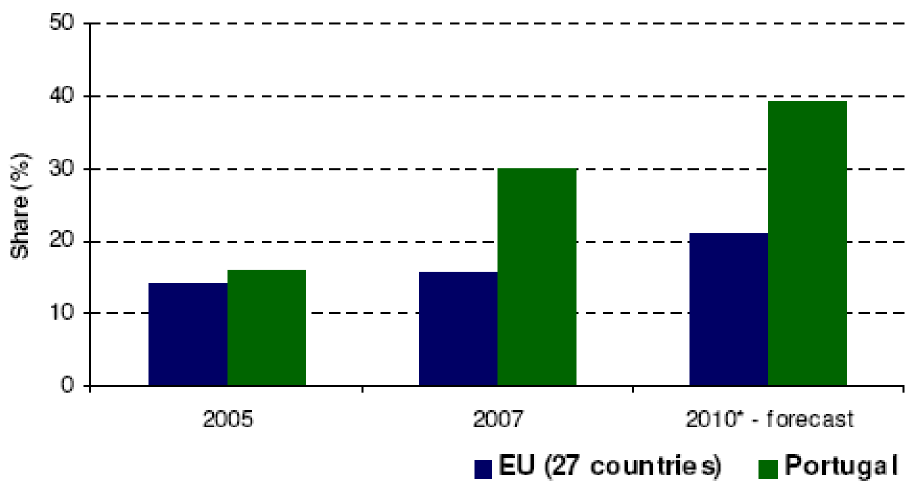
Current priority: improve competitiveness in the short run -> Control unit labour costs

- ✓Wage restraints in the public sector will be kept in place – private sector tends to follow;
- ✓Strengthen the link between wage setting and productivity dynamics;
- ✓Decrease employers' social security contributions (not possible at the current juncture).

Encourage the return to work and reduce long-term unemployment

Further Policy Response: Energy Strategy

Electricity generated from renewable sources
(as % of gross electricity consumption)



Sources: BdP and INE

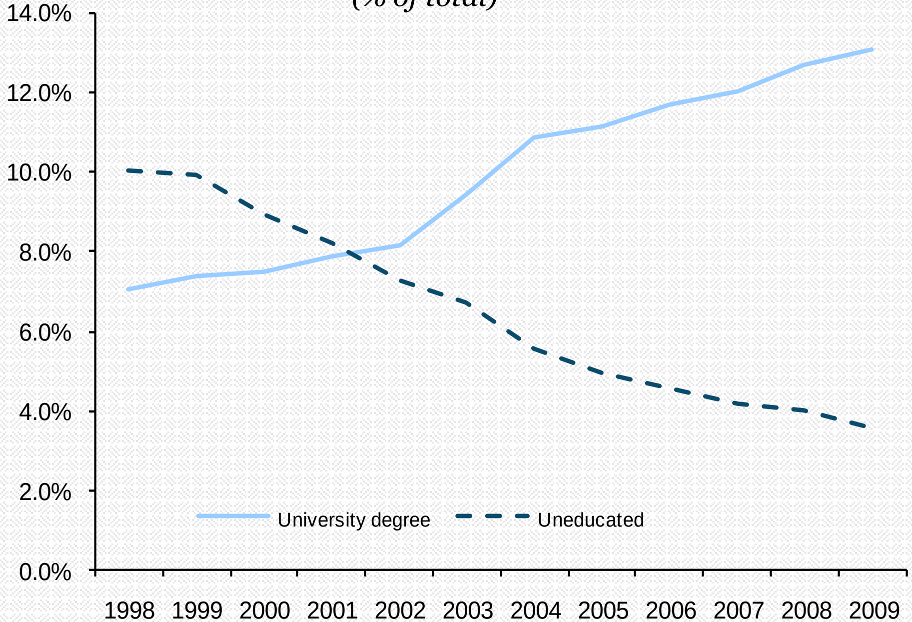
National Energy Strategy 2020

- *Promoting renewable energy*: Portugal has now a leading role in the use of renewable sources of energy (e.g., wind, hydro systems and sunlight);
- *Consolidating the electrical mobility programme*;
- *Promoting smart grids: energy transport networks*;
- *Improving energy efficiency*;
- *Increasing competition in energy markets*;
- *Introducing green taxation measures.*

Further Policy Response: Human Capital

❖ Qualifications as a key factor for productivity

Qualification of the Labour Force: University degree and uneducated
(% of total)



Sources: I NE and MF.

Number of graduates in the labour force increased sharply

Some measures already implemented

Basic and Secondary Education:

- English teaching generalised tin basic education
- Thorough technological upgrade of schools
- ICT: PC *Magalhães* and broadband for students
- Programme of entrepreneurship education

Higher Education:

- Reorganisation of universities;
- Internationalisation: R&D partnerships
- Financial support to postgraduates
- 1,000 new doctorates hired by Universities

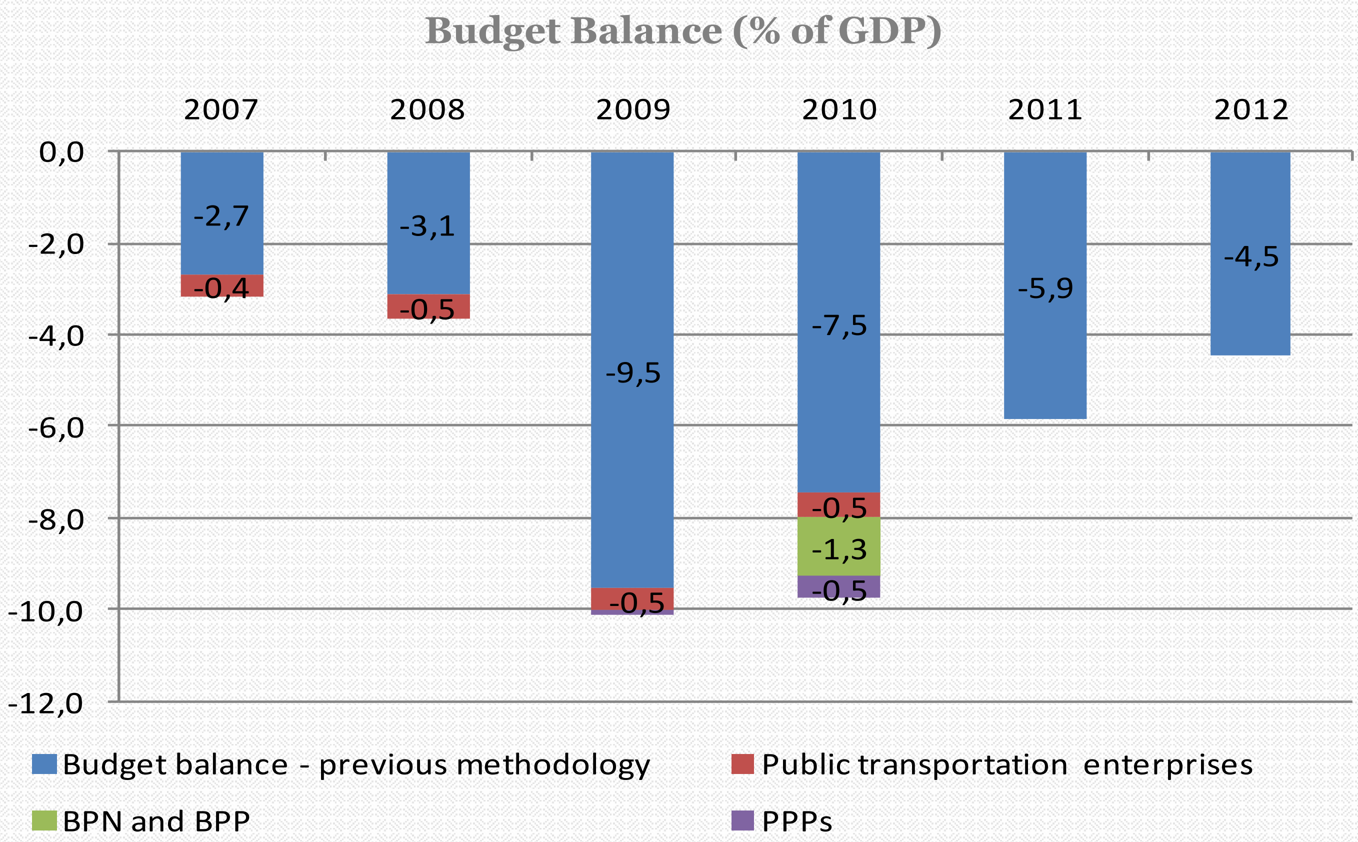
Qualifications and employability:

- New Opportunities Initiative: qualify 1 million working people by 2010.

Budget balance

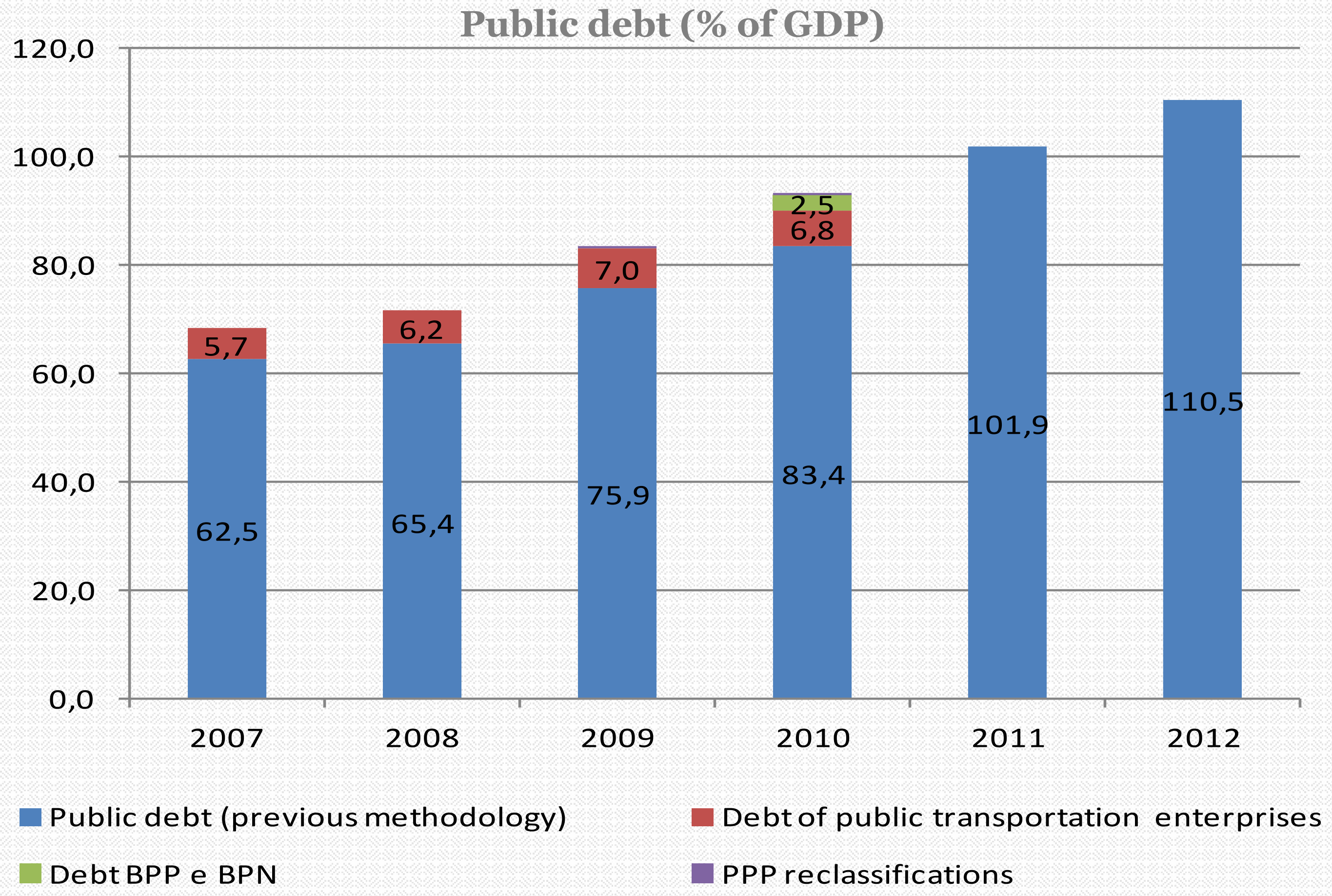
The budget deficit increased sharply in 2009

some methodological changes have occurred



Sources: Eurostat (EDP), MF

Public debt



Sources: Eurostat (EDP), MF.

ECONOMIC AND FINANCIAL ADJUSTMENT PROGRAMME

MAY 2011

MAIN GUIDELINES

***Main challenges faced by the Portuguese economy*:**

- ✓ Consolidate public finances;
- ✓ Promote economic growth and correct macroeconomic imbalances;
- ✓ Strengthen the financial sector and improve the financing conditions of the economy.

***The Programme is based on three pillars*:**

- ✓ Ambitious fiscal adjustment strategy;
- ✓ Comprehensive set of structural reforms;
- ✓ Safeguarding the financial sector against disorderly deleveraging through market-based mechanisms supported by back-up facilities.

Fiscal Adjustment

- **Targets**
  - ✓ Public Deficit (%GDP): 5.9% in 2011, 4.5% in 2012 and 3% in 2013;
  - ✓ Public Debt: stabilisation by 2013.
- **Positive Primary Balance already in 2012**

A) Reduction of Expenditure:

- Freezing of wages in the public sector and freezing of pensions until 2013 (except for lowest pensions);
- Special contribution over pensions above €1500;
- Civil servants reduction (1%/year in central adm. and 2%/year in local and reg. adm.);
- Tighter cost control on Health, Education and Defence;
- Reduce costs of health benefit schemes for State employees;
- Rationalisation in Public Administration;
- Reduction of expenditure on social benefits (including UB);
- Costs reduction in SOEs and Other Public Entities and Bodies;
- Reduction in transfers to local and regional governments;
- Reduction of capital expenditure.

B) Increase of Revenue:

- Freeze in tax expenditure;
- Reduction of tax benefits and deductions in personal and corporate income taxes;
- Set tighter limits to lower taxation in regional administration;
- 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;
- Rationalisation of VAT tax structure:
- Review of excise taxes (tobacco, vehicles, electricity) and indexation to core inflation;
- Combat to informality and tax evasion;
- Reassessment of property values; reduction of temporary exemptions of the recurrent property tax (IMI); gradual rebalance of taxation on real estate.

Broad scope of application: central, regional and local administration

C) Accelerate the privatization programme

Structural reforms

Deepening of reforms to boost potential growth, create jobs, and improve competitiveness

Fiscal-Structural Measures

Following the **amendment of the Budgetary Framework Law**, recently approved by the Parliament, which includes a multi-annual framework with expenditure and budget balance rules:

- Further *integrate the budget process*, in particular in what concerns SOEs and PPPs, and reinforce monitoring/assessment mechanisms;
- Improve transparency (additional information provided on a regular and comprehensive basis): arrears, budget execution, number of civil servants;
- Reinforce the monitoring powers of the Ministry of Finance;
- Set up the Fiscal Council;
- Fully adapt the local and regional financing framework to the principles and rules adopted by the recently revised Budgetary Framework Law.

State-Owned Enterprises (SOEs)

Operational costs reduction; Comprehensive assessment of tariffs structure; Tighter debt ceilings; Strength of governance in accordance with international best practices; Report reviewing the operations and finances of SOEs; no additional SOEs will be created until this review is completed.

Public Private Partnerships (PPPs)

Assessment of the 20 most significant PPP contracts; Assess the feasibility to renegotiate any PPP or concession contract to reduce the Government financial obligations; Detailed study to identify major contingent liabilities; Strengthened legal and institutional framework for assessing fiscal risks; Commitment of avoiding engaging in any new PPP or concession before the completion of the review and the legal and institutional reforms.

Public Administration: improvement in business environment at central, regional and local levels

- Reduction of management positions and administrative units (by 15%);
- Cost/benefit analysis of all public and quasi-public entities (foundations, associations and other bodies); identification of potential duplication of services;
- Regulate by law the creation and functioning of these entities;
- Reorganisation of local government administration.

Fiscal devaluation: Reducing labour costs and boost competitiveness

- Reduction of the social security contribution compensated by tax measures (that do not affect negatively competitiveness) and by additional permanent cuts in public expenditure;
- Budget neutral recalibration of the tax system;

Labour Market

- Implementation of the Agreement with Social Partners;
- Severance payments;
- Definition of dismissals;
- Promote the use of flexible working time arrangements;
- Wage Setting;
- Review of unemployment benefits, including by introducing a declining profile of benefits over the unemployment spell;
- Review of employment protection legislation, fostering flexibility;
- Clarification of criteria underlying collective agreements extension.

Education: Improve the quality of secondary education and of vocational education and training; facilitate labour market matching; tackle early school leaving ; raise the quality of human capital

Public Procurement: review of the legal framework and reinforcement of transparency and efficiency of public spending.

Business Environment: reinforce previous measures of simplex programme, extending it to all levels of public administration.

Goods and Services Markets

(energy, telecommunications, postal services, transports)

- Elimination of "golden-shares" and other special rights to the State in publicly quoted companies;
- Foster competition, namely in the energy and telecommunications sectors;
- Reduction in the number of regulated professions.

Housing Market

- Promote the rental market;
- Reduce incentives to households indebtedness;
- Foster labour mobility.

Judicial System

Health: improve efficiency and effectiveness in the health care system; increase moderating fees; reduce tax allowances substantially; reinforce means-testing mechanisms; reduce public expenditure on pharmaceuticals.

STATE BUDGET
2012

Macro Scenario

GDP is expected to fall by 2.8% in 2012;
All domestic demand components are expected to decline in 2012;
GDP is seen to resume a positive growth trend from mid-2013 onwards

Budget 2012 - Macro Scenario

	2011	2012
GDP	**-1.9**	**-2.8**
Private consumption	-3.5	-4.8
Public consumption	-5.2	-6.2
Investment (GFCF)	-10.6	-9.5
Exports	6.7	4.8
Imports	-4.5	-4.3
Unemployment rate (% labour force)	12.5	13.4
Inflation rate (%)	3.5	3.1

Public Finances

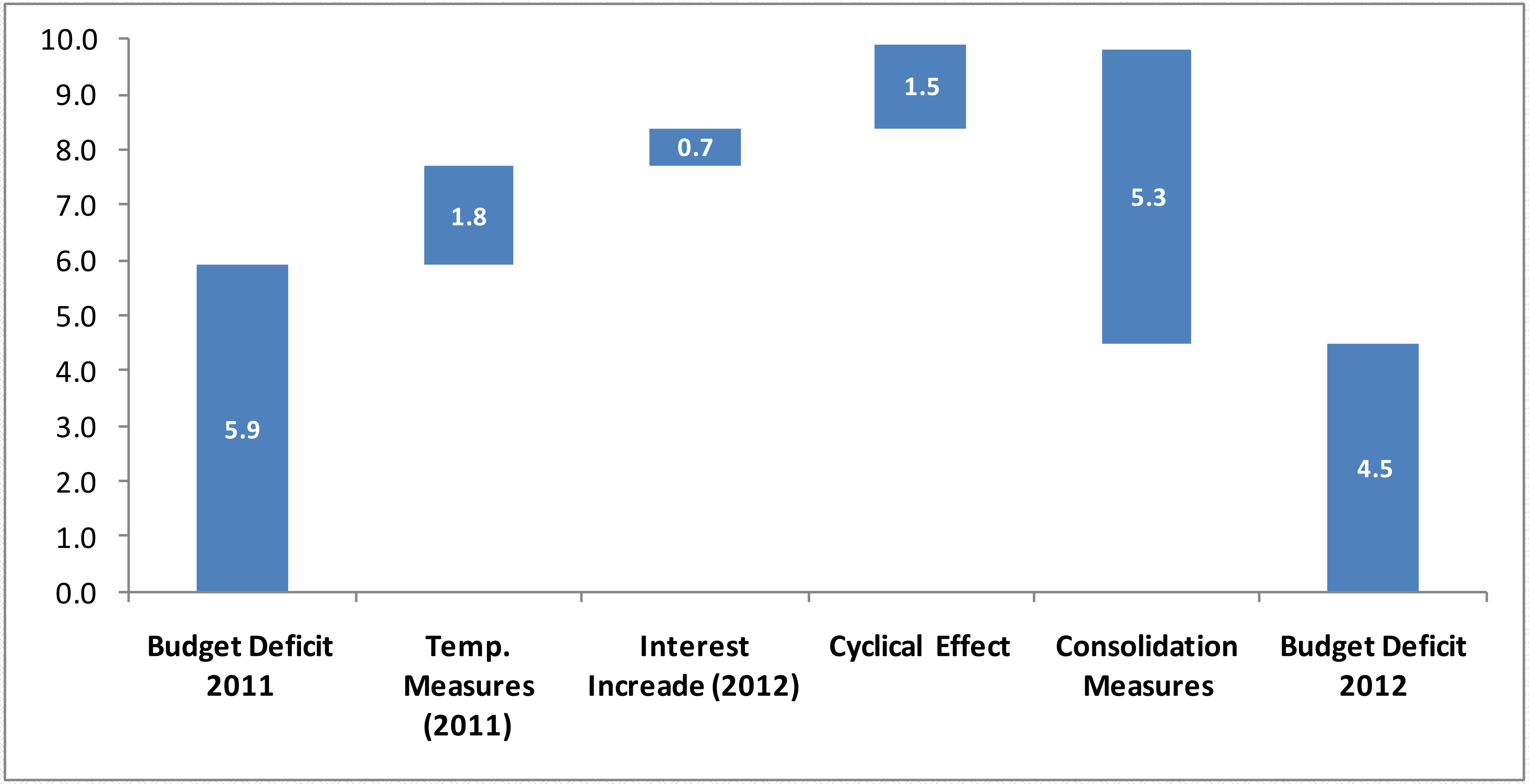
Deficit target for 2012 was set at 4.5% of GDP, a reduction of around €2.5bn in the budget deficit vis-à-vis previous year;
Fiscal consolidation will be based on current primary expenditure, which is forecasted to decrease by 2.4p.p. of GDP in 2012;
Primary balance will be positive for the first time since 1999:

Budget 2012 - Main Indicators

	2011		2012	
	EUR million	% GDP	EUR million	% GDP
Total Expenditure	**84,431**	**49.3**	**79,557**	**47.0**
of which:				
Current primary expenditure	70,333	41.1	65,545	38.7
Interest payments	7,296	4.3	8,824	5.2
Capital spending	6,802	4.0	5,188	3.1
Total Revenues	**74,411**	**43.4**	**72,000**	**42.5**
of which:				
Taxes and social contributions	61,492	35.9	61,481	36.4
Budget Balance	**-10,020**	**-5.9**	**-7,557**	**-4.5**
Primary Balance	**-2,724**	**-1.6**	**1,267**	**0.7**

Important dates: 2012 general vote on the budget expected for November 4 th and final vote for November 29 th.

Budget deficit
(2011 – 2012)



General Government Account (national accounts basis)

	% of GDP			Change in p.p. of GDP		
	2010	2011	2012	2010	2011	2012
Current revenue	**38.9**	**40.4**	**41.2**	**0.1**	**1.5**	**0.8**
Tax revenue	**22.2**	**23.4**	**24.4**	**0.5**	**1.2**	**0.9**
Taxes on production and imports	13.3	14.0	15.2	0.7	0.7	1.2
Taxes on income and wealth	8.9	9.5	9.2	-0.2	0.6	-0.2
Social contributions	12.2	12.5	12.0	-0.3	0.2	-0.5
Other current revenue	4.4	4.5	4.9	-0.2	0.0	0.4
Capital revenue	**2.7**	**3.1**	**1.4**	**1.8**	**0.4**	**-1.7**
Total revenue	**41.6**	**43.4**	**42.5**	**1.8**	**1.9**	**-0.9**
Current expenditure	**45.7**	**45.3**	**43.9**	**-0.1**	**-0.4**	**-1.4**
Intermediate consumption	5.0	4.6	4.6	0.1	-0.4	0.0
Compensation of employees	12.2	11.6	10.0	-0.4	-0.6	-1.6
Social transfers	21.9	21.7	21.1	0.0	-0.2	-0.7
Subsidies	0.7	0.9	1.0	-0.1	0.2	0.1
Interest	3.0	4.3	5.2	0.1	1.3	1.0
Other current expenditure	2.8	2.2	2.1	0.3	-0.6	-0.1
Capital expenditure	**5.6**	**4.0**	**3.1**	**1.5**	**-1.7**	**-0.9**
Gross fixed capital formation	3.6	2.4	2.1	0.6	-1.2	-0.3
Other capital expenditure	2.1	1.6	0.9	0.9	-0.5	-0.6
Total expenditure	**51.3**	**49.3**	**47.0**	**1.5**	**-2.0**	**-2.3**
Overall balance	**-9.8**	**-5.9**	**-4.5**	**0.4**	**3.9**	**1.4**
Current primary expenditure	42.7	41.1	38.7	-0.2	-1.6	-2.3
Primary expenditure	48.3	45.0	41.8	1.3	-3.3	-3.3
Current primary balance	-3.8	-0.7	2.5	0.3	3.1	3.2
Primary balance	-6.8	-1.6	0.7	0.5	5.2	2.3

Sources: NSI and Ministry of Finance.

Measures for 2012
(no policy change)

	Programme		State Budget	
	2012		2012	
	10^6 Euro	% GDP	10^6 Euro	% GDP
Reduction of expenditure	4 506	2.7	7 460	4.4
Compensation of employees	740	0.4	2 694	1.6
Social transfers	1 073	0.6	2 066	1.2
Social transfers in kind	684	0.4	1 000	0.6
Intermediate consumption	702	0.4	690	0.4
Subsidies	312	0.2	88	0.1
Other current expenditure	150	0.1	0	0.0
Capital expenditure	846	0.5	923	0.5
Increasing of revenue	1 535	0.9	2 890	1.7
Taxes on production and imports	1 085	0.6	2359	1.4
Taxes on income and wealth	450	0.3	683	0.4
Social Contributions	:	:	-335	-0.2
Non-tax revenue	:	:	183	0.1
Total	6 041	3.6	10350	6.1
Impact vis-à-vis previous year	5073.0	3.0	9042.3	5.3

2012 Budget – Main Policy Measures

On the expenditure side:

a) Reduction in public sector wage bill €2.7bn (1.6% of GDP). Mainly through:
   i) Wage freezing (maintaining the 5% on average wage cut of 2011);
   ii) Reduction in number of public sector workers (close to 10,000 workers);
   iii) Elimination of the holiday and Christmas payments (yearly salary is paid in 14 equal installments, this measure fully cuts 2 of those payments, equivalent to a pay cut of over 14%);

b) Cuts in social transfers. Social payments will be reduced by €2.1bn (1.2% of GDP), mainly through the cut of two pension payments out of the 14 yearly payments. Social payments in kind will be cut by €1bn (0.6% of GDP), mainly through reductions in health related spending;

c) Cuts in intermediate consumption amounting to €690m (0.4% of GDP), and in subsidies, €88m (0.1% of GDP);

d) Cuts in expenditures of public institutes, SOEs and Local and Regional Government, €923m (0.5% of GDP).

On the revenue side:

a) Change in the VAT rate structure – for most goods and services VAT will increase from 6% to 23% and from 13% to 23%;

b) Increase in property taxes (lower exemptions, higher rates, revaluations);

c) Increase in specific consumption taxes (for example tobacco and excise taxes on electricity);

d) Benefits and deductions will be strongly limited or cut, both in personal and corporate income taxes;

e) Households with higher taxable incomes will pay a special tax of 2.5%. The tax on capital gains will increase from 20% to 21.5%;

f) Corporate profits above €1.5m will be subject to a surtax of 3%. Profits above €10m will be subject to a 5% surtax.

70% of the adjustment will come from the expenditure side.

Structural Agenda

Economic growth should be supported by the ongoing structural reforms:

(i) increased flexibility in the labour market:
- Reduction in severance payments (from 36 days per year to 20 days per year with a cap of 12 months)
- Individual dismissals linked to productivity objectives
- Reduction of the maximum duration of unemployment insurance benefits to no more than 18 months

(ii) stronger competitive environment in the product market, through changes in:
  - New Competition Law,
  - New Competition and Regulation Court
  - Privatizations Programme
  - The end of golden shares and special rights
  - The ability for the private sector to increase daily working hours by ½ hour

(iii) reduction of the weight of the state in the economy:
  - Reduction of 15% of the SOE's Operating Costs and 20% decrease on the number of companies
  - Number of Managers in the Public Service to be reduced from 6,286 to 4,575 (-27%)
  - Number of Administrative Units to be reduced from 359 to 217 (-40%)

(iv) rental market reform

(v) Judicial system reform:
  - New Arbitration Law
  - New out-of-court procedures for companies
  - New Insolvency Law

(vi) goods and services markets:
- Increase on Transportation tariffs by 15% and road map for the phasing out of regulated tariffs for electricity and gas