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2011/0425 (NLE)

Proposal for a

COUNCIL IMPLEMENTING DECISION

amending Implementing Decision 2011/344/EU on granting Union financial assistance to Portugal

EXPLANATORY MEMORANDUM

Upon a request by Portugal, the Council granted financial assistance to Portugal on 17 May 2011 (Council Implementing Decision 2011/344/EU) in support of a strong economic and reform programme aiming at restoring confidence, enabling the return of the economy to sustainable growth, and safeguarding financial stability in Portugal, the euro area and the EU.

In line with Article 3(9) of Decision 2011/344/EU, the Commission, together with the IMF and in liaison with the ECB, has conducted the second review to assess the progress on the implementation of the agreed measures as well as their effectiveness and economic and social impact.

Taking into account the recent economic, fiscal and financial developments and policy actions, the Commission considers that limited changes to the economic policy conditions underpinning the assistance are necessary to secure the programme's objectives, as explained in the recitals of the proposed amendments to the Council implementing Decision.

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Proposal for a

COUNCIL IMPLEMENTING DECISION

amending Implementing Decision 2011/344/EU on granting Union financial assistance to Portugal

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism[1], and in particular Article 3(2) thereof.

Having regard to the proposal from the European Commission,

Whereas:

(1) Upon a request by Portugal, the Council granted financial assistance to Portugal (Council Implementing Decision 2011/344/EU as amended) in support of a strong economic and reform programme aiming at restoring confidence, enabling the return of the economy to sustainable growth, and safeguarding financial stability in Portugal, the euro area and the EU.

(2) Under the Commission's current projections for nominal GDP growth (-0.6% in 2011, -1.9% in 2012, 1.9% in 2013 and 3.9% in 2014), the fiscal adjustment path is in line with the Council Recommendation to Portugal of 2 December 2009[2] pursuant to Article 126(7) of the Treaty, and consistent with a path for the debt-to-GDP ratio of 107.2% in 2011, 116.2% in 2012, 118.1% in 2013 and 116% in 2014. The debt to GDP ratio would therefore be stabilised in 2013 and be placed on a declining path thereafter, assuming further progress in the reduction of the deficit. Debt dynamics are affected by several below-the-line operations, including sizeable acquisitions of financial assets, notably for possible bank recapitalisation and financing to state-owned enterprises (SOEs) and differences between accrued and cash interest payments.

(3) The quarterly quantitative performance criterion on the general government cash balance for the second quarter of 2011 was met and preliminary data suggest that this was also the case in the third quarter of 2011. However, with the information available as of early November, on a European Systems of Accounts (ESA95) basis, a budgetary gap of around 1½ percent of GDP is projected for 2011 as a whole. Part of this fiscal gap had been ascertained by August, notably due to current expenditure overruns, lower-than-projected current non-tax revenue and higher-than-budgeted capital spending. The Government had taken some

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1 OJ L 118, 12.5.2010, p. 1.

2 15759/09

measures to narrow this gap, namely a one-time surcharge in the personal income tax and an increase in the VAT rate for natural gas and electricity, which was brought forward to 1 October 2011 from 2012. But these measures were not sufficient to close the fiscal gap, particularly as further slippages have been identified more recently, including hihger interest payment, lower-than-projected capital revenue and sales of real estate. The Government is seeking an agreement with the banks on a partial transfer of their pension funds to the State social security system, to be undertaken in full compliance with the EU state aid rules, and to be used exceptionally to meet the deficit target of 5.9 percent of GDP in 2011. The Government agreed not to rely on further transfers of pension funds to meet the programme targets for the coming years.

(4) Progress is being made to strengthen public financial management through improved reporting and monitoring, and reforming the budgetary framework in line with the recommendations from European Commission services and International Monetary Fund staff.

(5) The stock of arrears will be significantly reduced over the program period. To this end, a strategy for the validation and settlement of arrears for the entities inside the general government as well as for SOEs classified outside the general government will be prepared. In this strategy, a roadmap will be provided which sets out how and when the stock of arrears will be stabilised. Moreover, various options of settling arrears will be explored, providing appropriate incentive mechanisms including the potential of rebates for early settlements and rewarding entities that no longer accumulate new arrears.

(6) Given the significant drag that the Autonomous Region of Madeira (RAM) has exerted on Portuguese public finances, the Government will prepare a financial arrangement with this region with a view to containing the high level of fiscal risks still remaining. The arrangement will be designed in line with the economic adjustment programme agreed between the Republic of Portugal and the European Union and the International Monetary Fund and comprise, among others, a debt sustainability analysis.

(7) Portuguese banks work towards meeting the higher capital requirements as stipulated by the programme, taking also into account the implications deriving from the European Banking Authority requirements of valuing sovereign debt at market prices, the special on-site inspection programme (SIP) and the transfer of banks' pension funds to the social security system. A legal framework, the purpose of which is to provide temporary public support to banks, is under preparation. A balanced and orderly deleveraging of the banking sector remains critical, while safeguarding adequate credit for the productive sectors of the economy. The sale of Banco Português de Negocios is in its final stage although the transaction still needs clearance from the EU competition authorities. Progress has also been made to strengthen the supervisory and regulatory framework, including via technical assistance.

(8) Progress in labour and product market reforms is essential to restore competitiveness and raise the growth potential. Labour market reforms to align the protection and rights under fixed and open-ended contracts and to establish an employer-financed fund for paying out workers’ severance entitlements are advancing. The privatisation programme is being implemented under the new framework law for privatisation. A deep and urgent restructuring of SOEs is at the top of the government's agenda. Further progress will be needed to lower entry barriers to the sheltered sectors with a view to fostering competiton and reduce excessive rents. Structural reforms need to be implemented decisively and closely monitored.

(9) Notwithstanding the relatively large first and second disbursements, the government's cash position remains under strain. This is explained by increasing financing needs from SOEs, a sharp increase in households' redemption of savings certificates, and persisting financial market stress.

(10) In light of these developments, Council Implementing Decision 2011/344/EU should be amended,

HAS ADOPTED THIS DECISION:

Article 1

Article 3 is amended as follows:

(1) paragraph 3 is replaced by the following:

'3. The general government deficit shall not exceed EUR 10,068 million (equivalent to 5.9% of GDP based on current projections) in 2011, EUR 7,645 million (4½% of GDP) in 2012 and 3% of GDP by 2013 in line with the Excessive Deficit Procedure (EDP) requirements. For the calculation of this deficit, the possible budgetary costs of bank support measures in the context of the government's financial sector strategy shall not be taken into account. Consolidation shall be achieved by means of high-quality permanent measures and minimising the impact of consolidation on vulnerable groups.'

(2) paragraph 5, point (a) is replaced by the following:

' (a) 2011 fiscal deficit target shall be reached by an exceptional measure. Assets acquired as a result of the transfer of banks' pensions funds to the State social security system shall not be used in a way detrimental to long-term sustainability of Portuguese public finances.'

(3) paragraph 5, point (b) is replaced by the following:

'(b) Portugal shall adopt measures to reinforce public finance management. Portugal shall implement the measures foreseen in the new Budgetary Framework Law, including setting-up a medium-term budgetary framework and establishing an independent Fiscal Council. The budgetary framework at local and regional levels shall be considerably strenghtened, in particular by putting forward the key options for the alignment of the respective financing laws to the requirements of the Budgetary Framework Law. Portugal shall step up reporting and monitoring of public finances and reinforce budgetary execution rules and procedures. The government will prepare a strategy for the validation and settlement of arrears which will present a roadmap setting out how and when the stock of arrears will be stabilised and explore various options of settling arrears. Regarding Public Private Partnerships (PPP), the Governement will not enter into any new PPPs before the study results on existing PPPs envisaged in the Programme and the legal and institutional reforms proposed become available.'

(4) paragraph 5, point (e) is replaced by the following:

'(e) Portugal shall continue opening up the economy to competition. The government shall take the necessary measures to ensure that the Portuguese State or any public body does not conclude, in a shareholder capacity, agreements which may hinder the free movement of capital or influence the management control of companies. The new Privatisation Law shall also be respectful to the principles of free movement of capital and not grant or allow special rights to the State. A revision of competition law shall be undertaken aiming at improving the speed and effectiveness of enforcement of competition rules.'

(5) paragraph 5, point (h) is replaced by the following:

'(h) Portugal shall prepare a financial arrangement with the Autonomous Region of Madeira (RAM) consistent with the financial programme between Republic of Portugal and the European Union and the International Monetary Fund. Until the agreement of this arrangement and its implementation in the RAM budget, Portugal shall closely monitor the execution of the RAM budget, will keep transfers from the State to the RAM government suspended and will not honour any new commercial or financial debt or guarantees by the RAM government and its SOEs that are not approved by the Ministry of Finance.'

(6) paragraph 6, point (a) is replaced by the following:

'(a) Portugal shall implement the privatisation programme. In particular, the sale of public sector shares in EDP shall be completed in 2012. In addition, the public sector shares in REN and GALP, and, if market conditions permit, TAP, shall be sold in 2012. A strategy for Parpublica shall be prepared, reconsidering the role of Parpublica as a public company and considering the possibility of winding down the company or consolidating it with the general government. The privatisation plan through 2013 shall also cover Aeroportos de Portugal, the freight branch of Comboios de Portugal, Correios de Portugal and Caixa Seguros, as well as a number of smaller firms.'

(7) paragraph 6, point (b) is replaced by the following:

'(b) The measures, defined in points (c) and (d), amounting to at least EUR 8.8 billion, shall be included in the 2012 Budget. Further measures, mostly on the expenditure side, shall be taken to fill any possible gap arising from budgetary developments in 2012. '

(8) paragraph 6, point (c) is replaced by the following:

'(c) The budget shall provide for a reduction of expenditure in 2012 of at least EUR 6.7 billion including a reduction in public sector wages and employment; cuts in pensions; a comprehensive reorganisation of the central administration, eliminating duplicities and other inefficiencies; reducing the number of municipalities and parishes; cuts in education and health; lower transfers to regional and local authorities; and reductions in capital expenditure and in other expenditure as set out in the Programme.'

(9) paragraph 6, point (d) is replaced by the following:

'(d) On the revenue side, the budget shall include revenue measures totalling around EUR 2.1 billion in a full year, including by broadening VAT bases through reducing exemptions and rearranging the lists of goods and services subject to reduced, intermediate and higher rates; an increase in excise taxes; broadening the corporate and personal income tax bases by reducing tax deductions and special regimes;

ensuring the convergence of personal income tax deductions applied to pensions and labour income; and changes in property taxation by substantially reducing exemptions. These measures shall be complemented by action to fight tax evasion, fraud and informality. '

(10) paragraph 6, point (j) is replaced by the following:

' (j) Portugal shall promote wage developments consistent with the objectives of fostering job creation and improving firms' competitiveness with a view to correct macroeconomic imbalances. Over the programme period, any increase in minimum wages will take place only if justified by economic and labour market developments. Measures shall be taken to address weaknesses in the current wage bargaining schemes, including legislation to redefine the criteria and modalities of the extension of collective agreements and to facilitate firm-level agreements. Until then, the application of extensions will be suspended.'

(11) paragraph 6, point (k) is replaced by the following:

'(k) An action plan shall be prepared to improve the quality of secondary and vocational education and training.'

(12) paragraph 6, point (o) is added:

' (o) Local govermnemnt administration in Portugal has currently 308 municipalities and 4 259 parishes. Portugal shall develop a consolidation plan to reorganise and significantly reduce the number of such entitites. These changes will come into effect by the beginning of the next local elections cycle. '

(13) paragraph 6, point (p) is added:

'(p) Portugal shall adopt measures to ensure the sustainability of the national electricity system leading to the elimination of the tariff debt by 2020 and ensuring it will stabilise by 2013. These measures shall correct excessive rents and cover all their sources.'

(14) paragraph 7, point (a) is replaced by the following:

'(a) The 2013 budget shall include fiscal consolidation measures amounting to at least EUR 3.4 billion aiming at a reduction of the general government deficit within the timeframe referred to in Article 3(3). '

(15) paragraph 7, point (b) is replaced by the following:

'(b) The budget shall include revenue measures including notably further broadening of corporate and personal income tax bases, higher excises taxes and changes in property taxation, yielding close to EUR 0.7 billion of additional revenue. '

(16) paragraph 7, point (d) is added:

'(d) On the expenditure side, the budget shall provide for a reduction of at least EUR 2.7 billion, including: reducing expenditures in the central administration, education and health; transfers to local and regional authorities; reduction of the number of employees in the public sector; and lower costs by SOEs. '

(17) paragraph 7, point (e) is added:

'(e) Portugal shall improve the business environment by reducing administrative burden through the extension of simplification reforms (Points of Single Contact and "Zero authorisation" projects) to all sectors of the economy; and by alleviating credit constraints of small and medium-sized enterprises, including through the implementation of Directive 2011/7/EU on combating late payment in commercial transactions. '

(18) the first two sentences of paragraph 8 are replaced by the following:

'8. With a view to restoring confidence in the financial sector, Portugal shall adequately recapitalise its banking sector and ensure an orderly deleveraging process. In that regard, Portugal shall develop and agree with the European Commission, the ECB and the IMF a strategy for the future structure and functioning of the Portuguese banking sector so that financial stability is preserved. In particular, Portugal shall:'

(19) paragraph 8, point (a) is replaced by the following:

(a) Advise banks to strengthen their collateral buffers on a sustainable basis and monitor the issuance of the government guaranteed bank bonds, which has been authorised up to EUR 35 billion in line with Union State aid rules;

(20) paragraph 8, point (b) is replaced by the following:

' (b) Follow closely the plans presented by the banks to reach a core Tier 1 ratio of 9 percent by end-2011 and 10 percent at the latest by end-2012. The capital requirements stemming from valuing sovereign debt based on market prices according to the European Banking Authority will be met in June 2012 together with the capital implications from the special on-site inspection programme and the transfer of the banks' pension funds to the social security system. Banks will present in February 2012 plans how they intend to reach their capital needs in that year. If banks cannot reach the capital requirement thresholds on time, they might temporarily require public provision of capital, which for privately owned banks will be available through the EUR 12 billion bank solvency support facility established under the economic adjustment programme agreed between the Republic of Portugal and the European Union and the International Monetary Fund;'

(21) paragraph 8, point (c) is replaced by the following:

'(c) Ensure a balanced an orderly deleveraging of the banking sector, which remains critical to eliminating funding imbalances on a permanent basis. Banks’ funding plans aim at a reduction in the loan-to-deposit ratio to around 120% by the end of the programme and a reduction of the reliance on Eurosystem funding during the duration of the programme. These funding plans shall be reviewed quarterly, with the next one due before the third Programme review. The Bank of Portugal shall take appropriate action in case of deviations from the banks’ funding plans;'

(22) paragraph 8, point (d) is replaced by the following:

'(d) Complete the sale of Banco Português de Negócios respecting the Union State aid rules;'

(23) paragraph 8, point (e) is replaced by the following:

'(e) Ensure that the state-owned Caixa Geral de Depositos (CGD) is streamlined to increase the capital base of its core banking arm as needed in 2011 without relying on the sale of its insurance arm. This sale is expected to take place in 2012 directly to a final buyer and to contribute to meeting that year’s additional capital needs. Insofar as these needs cannot be met from internal group sources, CGD will be provided with government capital support outside of the bank solvency support facility.'

(24) paragraph 8, points (f), (g), (h) and (i) are added:

'(f) Ensure that the partial transfer of the banks’ pension funds to the social security system is done under actuarially balanced conditions, also respecting EU competition and state aid rules. In order to avoid having to take recourse to the bank solvency support within the programme financing envelope, the government will offer help banks to cover the impact of the transfer on capital by using part of the transfer to acquire common equity in the banks. The remainder of the transferred funds will be deposited in a blocked account until the completion of the third review.

(g) Finalise the legal framework for access to capital from public sources by end-January 2012 consistent with Union state aid rules and in line with the principles laid down in the Memorandum of Understanding.

(h) Ensure that before the third Programme review banks have incorporated the available results of the special on-site inspections programme in the stress test exercise with a 6 percent Core Tier 1 threshold;

(i) Complete the legal framework for early intervention, resolution, and deposit insurance for banks by end-2011 and by the same deadline the one for corporate and household debt restructuring.'

(25) paragraph 9 is replaced by the following:

'9. In order to ensure the smooth implementation of the Programme's conditionality, and to help to correct imbalances in a sustainable way, the Commission shall provide continued advice and guidance on fiscal, financial market and structural reforms. Within the framework of the assistance to be provided to Portugal, together with the IMF and in liaison with the ECB, it shall periodically review the effectiveness and economic and social impact of the agreed measures, and shall recommend necessary corrections with a view to enhancing growth and job creation, securing the necessary fiscal consolidation and minimising harmful social impacts, particularly on the most vulnerable parts of the Portuguese society.'

Article 2

This Decision is addressed to Portugal.

Article 3

This Decision shall be published in the *Official Journal of the European Union.*

Done at Brussels,

For the Council
The President