26 March 2018

Excessive Deficit Procedure

1st Notification 2018

Excessive Deficit Procedure (1ST notification for 2018)

According to EU regulations, Statistics Portugal presents the first notification for 2018 associated with the Excessive Deficit Procedure (EDP) sent to Eurostat[1]. According to these provisional results, the net borrowing of General Government (GG) in 2017 amounted to € 5 709.4 million, corresponding to 3.0% of GDP (2.0% in 2016). This balance includes the effect of the recapitalisation process of Caixa Geral de Depósitos (CGD), in the amount of € 3 944 million, implying an increase in net borrowing of 2.0% of GDP[2]. Gross debt of GG amounted to 125.7% of GDP in 2017.

Table 1: Reporting of government deficit/surplus and debt levels and provision of associated data

Member State: Portugal Data are in millions of euros Date: 26/03/2018	ESA 2010 codes	2014 Final	2015 Final	2016 Half-finalized	2017 Half-finalized	2018 [3] Planned
Net borrowing (-)/ net lending (+)	B.9					
General government	S.13	**-12 402,3**	**-7 917,8**	**-3 665,2**	**-5 709,4**	**-2 216,9**
- Central government	S.1311	-13 850,8	-9 817,7	-6 080,7	-8 530,8	-4 178,0
- Local government	S.1313	650,5	771,3	854,7	588,0	970,1
- Social security funds	S.1314	798,0	1 128,6	1 560,8	2 233,5	990,9
		Final	Final	Half-finalized	Half-finalized	Planned
General government consolidated gross debt [4]						
Level at nominal value outstanding at end of year		**226 040,5**	**231 512,6**	**240 882,5**	**242 620,3**	**246 144,1**
By category:						
Currency and deposits	AF.2	14 921,9	18 646,7	22 537,0	25 188,6	
Debt Securities	AF.3	111 476,4	121 722,6	132 856,2	142 260,4	
Short-term	*AF.31*	*12 681,4*	*10 537,9*	*14 956,8*	*15 400,4*	
Long-term	*AF.32*	*98 795,0*	*111 184,7*	*117 899,4*	*126 860,0*	
Loans	AF.4	99 642,2	91 143,4	85 489,4	75 171,4	
Short-term	*AF.41*	*2 591,2*	*3 377,3*	*2 772,9*	*1 344,0*	
Long-term	*AF.42*	*97 051,0*	*87 766,0*	*82 716,5*	*73 827,4*	
General government expenditure on:						
Gross fixed capital formation	P.51	3 446,3	4 045,4	2 733,8	3 415,4	4 577,5
Interest (consolidated)	D.41 (uses)	8 483,0	8 209,9	7 760,7	7 475,1	7 126,5
Gross domestic product at current market prices	B.1*g	173 079,1	179 809,1	185 494,0	193 048,6	199 998,3
Memorandum items:						
Net lending (+)/Net borrowing (-) on GDP		-7,2%	-4,4%	-2,0%	-3,0%	-1,1%
General government consolidated gross debt on GDP		130,6%	128,8%	129,9%	125,7%	123,1%

[1] Together with this press release is published on INE's website the list of units classified in the GG sector, relevant for National Accounts.

[2] Considering two decimal places, the net borrowing of GG corresponded to 2.96% of GDP and the effect of the CGD recapitalization process was 2.04% of GDP in 2017. Consequently, excluding this impact, the net borrowing was 0.92% of GDP.

[3] For the current year (2018), the estimates of Net lending / net borrowing and Gross debt are a responsibility of the Ministry of Finance, based on the macroeconomic scenario underlying the 2018 State Budget.

[4] As mentioned in previous press releases, Eurostat is analysing the wording of the Manual on Government Deficit and Debt, in order to further clarify and ensure harmonized application by all Member-States, on the definition of the face value of the currency and deposits instrument, as the accumulated capitalization of the respective interest should be included in the gross debt of GG. This clarification is being analysed in a permanent discussion forum of the European Statistical System which addresses methodological issues relevant for the compilation of the deficit and debt, leading to the revision of the GG debt where applicable. In the case of Portugal, the issue is the amount of capitalized interest on Savings Certificates, which has always been reported in Table 4 of the notification (attached to this press release) and is not included in the GG consolidated debt.

Responsibilities in the notification

The present notification was prepared under a new Institutional Agreement in the field of General Government (GG) Statistics, signed on the 27th March 2017, where Statistics Portugal, Banco de Portugal and the Budget Directorate-General (Ministry of Finance) are responsible for the reporting according to the following terms.

For 2017 and precedent years, the compilation of the Net lending / net borrowing is prepared by Statistics Portugal and the Gross debt is compiled by the Banco de Portugal.
For the current year (2018), the estimates of Net lending / net borrowing and Gross debt are a responsibility of the Ministry of Finance.

Under Council Regulation (EC) No. 479/2009 **the notifications initiate a joint work between national statistical authorities and Eurostat** which, within a three weeks deadline, should examine the notifications and publish the final results for all Member States.

Public to National Accounts adjustments

In the compilation of General Government (GG) net lending / net borrowing in National Accounts it is necessary to make several adjustments to Public Accounting data. Indeed, Public Accounting data is on a cash-basis, meaning that expenditures are recorded in the accounting period in which they are paid. In National Accounts, expenditure is recorded on an accrual-basis, that is, in the accounting period to which it refers to, regardless of the period of its payment. Accordingly, payments referring to expenditure due on other periods are not considered. Another important adjustment is related to sector delimitation of GG. As the classification of a public entity may differ under National Accounts and Public Accounting viewpoints, not all the entities included in the GG sector are coincident with those considered in the Public Accounting balance. Finally, there are transactions that, according to the conceptual framework of the National Accounts, have a specific classification, notably in the cases where entities from the GG sector acquire shares from other entities, which are recorded as expenditure (capital transfer) and not as financial transactions.

The table below details the main adjustments for 2016 and 2017, presented in tables 2A, 2C and 2D of the EDP notification attached to this press release, namely the Public to National Accounts adjustment.

		Unit: million euro
	2016	**2017**
Balance in Public Accounting	**-4 438.2**	**-2 807.0**
Accrual adjustment and sector delimitation in National Accounts	2 924.5	3 030.3
Difference between paid and due interest	- 87.5	- 77.6
Other receivables:	- 643.2	- 705.2
Temporal adjustment to taxes and contributions	*- 123.9*	*264.4*
Others	*- 519.4*	*- 969.5*
Other payables:	248.5	362.2
Expenditure already incurred but not yet paid	*181.5*	*114.4*
Others	*45.3*	*143.4*
Other adjustments:	-1 669.3	-5 512.1
Capital injections and debt assumptions	*-2 516.3*	*-6 372.4*
Others	*846.9*	*860.3*
Balance in National Accounts	**-3 665.2**	**-5 709.4**

The previous table shows an improvement in the balance in public accounting, as the increase in revenue was larger than the increase in expenditure.

Total revenue grew in 2017 as the increase of current revenue more than compensated the decrease of capital revenue. The positive behaviour of current revenue, particularly tax revenue and social contributions, is explained to a large extent by the evolution of the economic activity and employment. Capital revenue decreased as a result of the decrease in other capital transfers received. In part, the drop of other capital transfers is related with the recording, in 2016, of the reimbursement of the prepaid margins by the European Financial Stability Facility to the GG, as the maturity of the loans granted under the Economic and Financial Assistance Programme was reached (€ 302 million).

Current expenditure grew due to the combined effect of the increase of the compensation of employees and of the increase of social benefits (excluding social transfers in kind) and the decrease of interest payments.

The significant increase in capital expenditure is largely explained by the effect of the recapitalisation process of CGD. Notwithstanding, capital expenditure, net of this operation, continues to show a positive variation, due to the increase in investment (gross capital formation).

For a more detailed analysis of the changes in expenditure and revenue, please consult the press release “Main Aggregates of General Government”.

One of the main adjustments in the public accounting balance refers to the item *Capital injections and debt assumptions* that includes, in 2017, the capital injection of € 3 944 million in CGD.

Recapitalisation Process of *Caixa Geral de Depósitos*

The recapitalisation process of CGD was implemented in the first quarter of 2017, and consisted of the following four components:

i. A capital increase in kind in the form of the transfer of 49% equity share of *Parcaixa SGPS, S.A.,* worth € 499 million, *via Parpública - Participações Públicas, SGPS, S.A.*.

ii. Conversion of the hybrid financial instruments issued in 2012, subscribed by the Portuguese State, worth € 945 million.

iii. A capital increase in cash by the Portuguese State, in the amount of € 2.5 billion.

iv. The issuance of 930 million euro in Additional Tier 1 (AT1) hybrid instruments to be subscribed by private investors, split in two phases: 500 million euro issued vis-à-vis the direct State capital injection, and the remaining 430 million euro to be issued within a 18 months period.

The capitalization of CGD in the first quarter of 2017 has, therefore, amounted to € 4 444 million, of which € 3 944 million were supported by the Portuguese State (2.0% of GDP).

The treatment of the recapitalisation plan in national accounts is complex. As is public knowledge, the European Commission (DGComp) has considered that the recapitalisation process should not be regarded as State aid. In this decision, the European Commission refers that the CGD recapitalisation is made in similar conditions to the ones required by a private investor.

This decision of "no state aid", which introduced a singular element not foreseen in the Manual on Government Deficit and Debt, raised doubts regarding the treatment of the public share of the recapitalisation as capital transfer, with negative impact on the GG net lending/net borrowing, as CGD has recorded losses over the last years. Indeed, the European Commission (DGComp) decision points to a financial investment.

Given the singularity of this operation, Statistics Portugal and the European Commission (Eurostat) have been in close dialog and interaction regarding its treatment in National Accounts, as mentioned in previous press releases.

In this process several arguments have been exchanged regarding the correct treatment of this operation in National Accounts, considering the concepts and definitions of the European System of National and Regional Accounts 2010 (ESA 2010), namely in the interpretation of paragraphs 20.198 and 20.199.

Item a) of paragraph 20.198 refers that *"a payment to cover accumulated, exceptional or future losses, or provided for public policy purposes, is recorded as a capital transfer. Exceptional losses are large losses recorded in one accounting period in the business accounts of a corporation, which usually arise from downward revaluations of balance sheet assets, in such a way that the corporation is under threat of financial distress (negative own funds, breach of solvency, etc.)",* suggesting that the appropriate treatment should be to consider the total amount as a capital transfer. But item b) of the same paragraph states that *"a payment where the government is acting as a shareholder in that it has a valid* *expectation of earning a sufficient rate of return, in the form of dividends or holding gains is an acquisition of equity. The corporation must enjoy a large degree of freedom in how it uses the funds provided. When private investors are part of the capital injection, and the conditions for private and government investors are similar, this is evidence that the payment is likely to be acquisition of equity",* therefore implying that an operation of such kind should be treated as a financial operation.

In short, § 20.198, a) refers to the general case where public corporations suffer losses because they are not operating in market conditions, notably by providing all or most of their output at prices that are not economically significant, acting mainly as instruments of specific public policies, (such as public hospitals, public transport corporations, …), whereas §20.198; b) discusses the case where the State acts as any private shareholder would, with the perspective of a sufficient rate of return (precisely in line with the DGComp decision regarding the recapitalisation plan of CGD).

Additionally, paragraph 20.199 states that *"In many cases, payments made by government units to public corporations are intended to compensate for losses in the past or in future. Government payments are treated as an acquisition of equity only if there is sufficient evidence of the corporation's future profitability and its ability to pay dividends."*

Thus, the crucial question is if the European Commission (DGComp) decision can be considered as the "sufficient evidence" mentioned in this paragraph.

Taking into account that: *i)* the losses occurred in a particularly adverse economic environment for the banking sector, where all major banks presented losses and not only CGD, thus not due to the fact of CGD being a public corporation; *ii*) the European Commission (DGComp) decision suggests that there are founded expectations that the capital injection in CGD, that follows private market terms, would enable the bank to become profitable; Statistics Portugal considers that the recapitalisation of CGD should be treated as a financial operation, with no impact in GG balance.

Eurostat considered however, in its final view, that this operation must be treated as a capital transfer, with impact in GG balance, based on the following arguments: *i)* the fact that the European Commission (DGComp) decision of not considering the recapitalisation as a state aid is not a decisive element for the statistical analysis; *ii)* the Portuguese State and the private investors do not share equal responsibilities in the capital injection; and *iii)* the accumulated losses in CGD, from 2011 to 2016, are higher than the State capital injections.

Despite considering that the most appropriate statistical treatment for this recapitalisation should be as a financial operation and without prejudice to maintaining the discussion of this subject in the permanent discussion forum of the European Statistical System which addresses methodological issues, Statistics Portugal decided to accept that final view, given the institutional responsibilities of the European Commission (Eurostat) in the field of the Excessive Deficit Procedure.

Balances of Regional and Local Government and transfers from Central Government

The table below details the net lending/ net borrowing and the gross debt of (Regional and) Local Government (S1313).

Unit: million euro	2014	2015	2016	2017
Net borrowing (-)/ net lending (+)				
- Regional and Local Government	**650,5**	**771,3**	**854,7**	**588,0**
Regional Government of Madeira	114,6	177,2	233,5	85,2
Regional Government of Azores	- 30,5	- 39,8	- 62,7	- 57,0
Local Government	566,4	633,9	683,9	559,8
Gross Debt				
- Regional and Local Government	**11 004,3**	**10 899,4**	**10 561,6**	**10 348,3**
Regional Government of Madeira	4 756,9	4 934,1	4 852,8	4 866,3
Regional Government of Azores	1 404,8	1 485,2	1 596,0	1 690,4
Local Government	4 842,6	4 480,2	4 112,8	3 791,6

It is worth noting that the transfers received by Central Government are considered in the compilation of Regional and Local Government net lending / net borrowing. These transfers are recorded as expenditure in Central Government, so that they consolidate in the General Government Account.

The following table presents these transfers, from 2014 to 2017, included in the General Government Account.

Unit: million euro	2014	2015	2016	2017
Transfers from Central Government to:				
Regional Government of Madeira	173.0	172.5	174.6	172.8
Regional Government of Azores	252.4	251.0	251.9	251.5
Local Government	2 176.2	2 208.8	2 262.3	2 004.0

As far as gross debt is concerned, and accordingly with European legislation, the following clarifications are relevant: i) Trade credits are excluded; ii) Debt of public corporations not classified inside General Government is not considered; iii) Debt of municipalities and parishes located in the territory of the Autonomous Regions is included in Local Government.