Doing Business in PORTUGAL

FINANCIAL TIMES **SPECIAL REPORT** | Wednesday April 11 2012

Wealth from water
The country has a long maritime tradition and is now seeking to exploit the sea in fresh ways, writes **Victor Mallet**
Page 4

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Resolved to see reforms through

Structural adjustment targets are being met but at enormous cost, writes **Peter Wise**

Pedro Passos Coelho, the prime minister, who took office without any previous government experience, addresses the PSD congress Epa

A decision to cancel construction of a high-speed rail link between Lisbon and Madrid has thrown into sharp relief the disappointment of Portugal's hopes that joining the euro would put the country on the fast track to becoming a mainstream European economy.

Once seen as a milestone of modernisation, the €3.3bn project was abandoned in March, less than a year after an imminent financial collapse forced the country to follow Greece and Ireland in seeking a multi-billion-euro bailout from the European Union and International Monetary Fund.

For the indefinite future, Europe's high-speed rail network will stop at the Spanish border, after Pedro Passos Coelho, Portugal's prime minister, ruled definitively against building the Portuguese stretch of a line that would have connected the two capitals in three hours, three times faster than today.

In terms of living standards, since joining the single currency, Portugal has moved further away from the rest of Europe, rather than closing the gap as it had hoped. According to Peter Weiss, a European Commission economist, income per capita fell from 70 per cent of the EU average in 1999 to 63 per cent in 2011 and is expected to fall to "close to 60 per cent" this year.

After the euphoria of becoming a founding member of the single currency, Portugal is having to come to terms with the cost of belatedly adapting its economy to life in the eurozone: a debt crisis, painful austerity measures, its deepest recession for more than 30 years and record unemployment, 15 per cent in February and is still climbing. One in three people under 25 is out of a job.

José Adelino Maltez, 60, a political scientist at Lisbon's Technical University, says: "Compared with the suffering and effort of many central Europeans, my generation hasn't done much to deserve the living standards we enjoy. But, like the 2m people who left Portugal for Europe from the 1960s, the generation below 30 is becoming genuinely European. They know the state is not going to employ them, that they will have to go out and compete for a job."

In return for €78bn in bailout funds, the previous Socialist government agreed in May 2011 to a three-year adjustment programme based on three main components: fiscal consolidation, measures to strengthen the financial sector and wide ranging economic reforms to tackle low growth and weak competitiveness, seen to be at the heart of Portugal's difficulties.

Mr Passos Coelho, whose centre-right Social Democrats (PSD) won a general election less than three weeks after the rescue agreement was signed, took office without any previous government experience, but a firm belief in the adjustment programme as the best and only way forward. He formed a government coalition with the conservative Popular party (CDS-PP), ensuring a comfortable majority in parliament.

Having promised to "go beyond" the requirements of the bailout, Mr Passos Coelho told a PSD congress in March that Portugal was engaged in a "tranquil revolution" of economic reform. "The country will not have a second chance," he said. "We cannot [afford to] fail."

The prime minister has lived up to his promise to press scrupulously ahead with the adjustment programme, establishing a reputation for Portugal as the quiet, diligent student among the eurozone's three bailed-out countries.

Presenting the conclusions of the third quarterly review of the agreement by the so-called troika – the European Commission, IMF and European Central Bank – in early April, Mr Weiss, who is deputy head of the EC mission to Portugal, said Lisbon had fulfilled the agreement "almost to the letter". Compliance was "extraordinarily good".

The government cut the budget deficit from 9.8 per cent of gross domestic product in 2010 to 4.2 per cent last year. This was significantly below the official target of 5.9 per cent, but included the one-off impact of revenue from a transfer of bank pension funds to the state, equivalent to about 3.5 per cent of GDP.

Lisbon was nevertheless on track for a structural adjustment in the deficit amounting to 7.5 per cent of GDP over 2011 and 2012, according to the troika report. "This is enormous," said Mr Weiss. "This is very ambitious." He also noted that two-thirds of fiscal consolidation was being accomplished through spending cuts. The deficit target for this year is 4 per cent of national income, falling to 3 per cent in 2013.

Targets are being met at enormous cost. Public sector employees will see their income cut by up to 30 per cent over 2011 and 2012. Private sector pay is also falling sharply. Social payments have been reduced and taxes, particularly VAT, increased.

Continued on Page 2

Inside this issue

Hardships fail to diminish enthusiasm for euro

Single currency

Commitment to the project remains strong, reports Peter Wise

When a waiter accidentally split a tray of beers over Angela Merkel, the German chancellor, in February, a Portuguese TV comedy programme quickly adapted the scene, making the employee a mischievous Portuguese immigrant intent on revenge for the perceived wrongs a German-led Europe was inflicting on his country.

The sketch may have raised a laugh, but the Portuguese are not given to blaming Germany, Europe or the euro for the sovereign debt crisis or the hardships many people face as a result of a deep and protracted recession.

António Pinto Costa, a politics professor at Lisbon's Institute of Social Sciences, says: "Euroscepticism has increased as living conditions have worsened, but these feelings have not been mobilised politically and there is virtually no anti-German or nationalistic anti-European sentiment."

Portugal's qualification as a founding member of the eurozone in the late 1990s was greeted with euphoria, as the country began to enjoy the benefits of falling interest rates and a construction boom fuelled by European Union funds.

Even today, when the costs of adapting to euro membership have become starkly evident to a country facing its worst recession in more than 30 years, polls show that only 16 to 18 per cent of the population describe themselves of distrustful of European integration.

"People who remember how poor Portugal was before we joined are not going to say bad things about Europe," says José Adelino Maltez, a political scientist at Lisbon's Technical University. In terms of development, he says, Portugal has moved in a short period from a country comparable with Morocco to "somewhere near the suburbs of Madrid".

European structural funds have made an important contribution to modernisation and higher living standards. But the questionable benefits of some infrastructure investments and public-private partnerships are seen as symptoms of a past lack of fiscal rigour that led to the current debt crisis.

"We, the passive majority of the Portuguese, have seen our lifestyles improve over the past two decades, mainly for electoral reasons, without the same sense of sacrifice as some central European countries," says Prof Maltez.

"But we haven't achieved the same levels of education or professional training."

Portugal, he believes, has begun making those sacrifices, particularly the younger generation, as the unemployment rate among under-25s rises above 35 per cent and many graduates emigrate in search of jobs befitting their qualifications.

Before joining the euro, the country kept its exports competitive through low wages and by devaluing its currency, a policy that had the effect of stoking inflationary pressures and lowering living standards.

One of the most important factors now contributing to the lower costs needed to make exports more competitive is a sharp reduction in public sector pay – a loss of up 30 per cent in real terms in 2011 and 2012 – which, to varying degrees, is being replicated in the private sector.

The Portuguese, however, have a tradition of resilience.

Some commentators express support for the view that it is German and French banks that lent unwisely, rather than Portugal itself that is being bailed out.

But by every discernible sign, the Portuguese remain committed to keeping the euro, whatever the cost.

The radical Left Bloc (BE) lost eight of its 16 seats in last June's election. The party had declined to meet representatives of the so-called "troika", the European Commission, International Monetary Fund and European Central Bank, when they visited Lisbon to discuss the bailout.

"I was furious that they refused even to talk to the troika and put their views across," says a young biologist, who had previously been a BE supporter. The hardline Communist party gained 16 of the 230 parliamentary seats in the election, compared with 15 previously.

Neither party campaigns for Portugal to leave the euro, calling instead for "a more social Europe".

"Euro-scepticism has no party political representation in Portugal," says Prof Costa Pinto.

"No extremist groups or patriotic anti-European parties have emerged in the way they have in Austria, the Netherlands, France and elsewhere."

"The political parties that formed in Portugal after the return of democracy in 1974 are all based on German models," says Prof Maltez. "Many of our leading politicians were educated in German institutes.

"Portuguese democracy is European from the inside out."

Resolved to see reforms through

Continued from Page 1

The unemployed, who have had their benefits cut, workers earning the minimum wage of €485 a month and elderly people receiving state pensions of even less, find it increasingly difficult to make ends meet.

José Cordeiro of Cáritas Portuguesa says requests to the Catholic Church welfare agency for assistance rose more than 40 per cent over 2010 and 2011, a growing number of them coming from previously self-sufficient families on modest incomes.

"Portugal has a tradition of 'honourable poverty'; people don't like to show it. They keep it to themselves," says Prof Maltez. "But every day, you see people in shops asking for half a cutlet, one piece of fruit."

Despite the hardships, protests have been peaceful and relatively low key. Following the biggest general strike to date, in November, a second 24-hour stoppage in March drew less support after the second-largest trade union confederation agreed a labour pact with government and employers.

Uppermost in people's minds, says Antonio Costa Pinto, a professor at the Institute of Social Sciences (ICS), is uncertainty over whether the sacrifices being asked of them will produce the promised results.

The risks are many. A deeper than expected downturn in the EU, which accounts for 75 per cent of exports, has already led to a downward revision in growth forecasts, with the economy expected to contract by 3.4 per cent this year and stagnate in 2013.

A recession in Spain, the country's biggest export market, would be even more disruptive. Heavy dependence on imported oil also makes Portugal vulnerable to any further increase in crude prices.

In common with other countries implementing austerity programmes, Portugal also runs the risk that drastically cutting public spending will aggravate its fiscal problems, killing the patient with the cure.

Some economists believe the bailout package was up to €20bn below what Portugal needed, having failed to take into account public sector debts of about that amount.

It has helped fuel a belief that Lisbon may not be able to resume financing its debt in the market by September 2013, as envisaged in the rescue agreement, but will need more funds from international lenders.

Mr Passos Coelho insists he will not be asking for more money or more time to pay. He points out, however, that the EU and the IMF are committed to continuing their support for Ireland and Portugal if they cannot return to the market as scheduled due to "circumstances beyond their control".

In a positive sign, yields on 10-year government bonds have fallen from above 17 per cent in January to below 12 per cent.

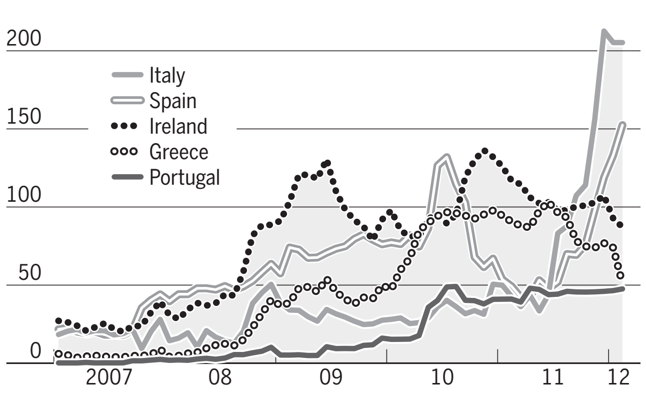
"Our assumption is that the [adjustment] programme will be enough," said Mr Weiss. "The programme is very ambitious and we don't believe the government can do more. Whether Portugal is able to convince the markets is, of course, another question."

Banks expect they will soon be in a better state

Financial services

Recovery is forecast to begin next year, says Victor Mallet

ECB liquidity provision
€bn



Source: National central banks

The first thing a Portuguese banker will tell a visitor is how different the country's financial sector is from those of Ireland and Greece, the other two eurozone members bailed out by the European Union and the International Monetary Fund.

Unlike in Ireland, they will say, it was not the banks that sank the nation with rash financial management, but the other way round.

Unlike in Greece, they will add, the crisis-stricken economy of Portugal is well placed for a recovery because of its international investments and relatively strong exports. Bank deposits have risen, not fallen, since the crisis began.

"In Portugal, the banking sector was not at the heart of the crisis," says a senior executive at one of the country's big five banks. "It was the result of fiscal policy developments and the downgrades of the economy [by credit rating agencies]."

José Maria Espírito Santo Ricciardi, president and chief executive of the investment banking arm of Banco Espirito Santo (BES), says that Portuguese banks were well provisioned and profitable until the state's debt and deficit problems deepened the sovereign bond crisis and forced the bailout.

Again, unlike Spain or Ireland, Portugal has not recently gone through a boom and bust in the property market. Its banks have not needed rescuing because of sour property loans.

"In Portugal, it was exactly the other way round," says Mr Ricciardi. "It was the republic that created the problems for the banks ... The lowering of the ratings of the republic brought down the banks with it. For the banks, that closed the funding markets, which were substituted by the European Central Bank."

Even if Portugal's bankers are not to blame – and there were problems at two small banks, including Banco Português de Negócios, nationalised in 2008 after the collapse of Lehman Brothers when it ran up €700m of losses – they are still dependent on life support in the form of ECB liquidity. And, like the state, they still need to find a way to move beyond crisis management to recovery and growth.

As recently as the end of March, Moody's, the rating agency, again downgraded or partially downgraded the five main banks: the state-controlled Caixa Geral de Depósitos; Banco Comercial Português, or Millennium BCP; BES; Banco BPI; and Banco Santander Totta, subsidiary of Spain's Santander group.

Moody's said it expected deterioration in the banks' domestic asset quality and profitability, given the poor outlook. It also blamed the downgrade – all are now classed as "junk" or non-investment grade – on the banks' risks arising from their large holdings of government-related debt, as well as lack of access to private wholesale funding.

> 'The lowering of the ratings of the republic brought down the banks with the republic'

The agency said: "While none of these pressures are new, in Moody's view they continue to mount against the backdrop of the euro debt crisis."

Portugal's €78bn bailout package included €12bn to recapitalise banks, and executives have been deciding whether they need the money being pressed on them by the EU, the IMF and the ECB to achieve the enhanced capital ratios applied across Europe.

Bankers and analysts estimate only about half the offered money will be taken up, with Mr Riccardi saying BES does not think it will take even "one cent", while Millennium BCP, for example, is expected to accept €2bn.

If all goes to plan and the economy begins to recover after this year, the state should actually profit from its bank recapitalisation lending, with escalating interest rates to encourage early repayment.

In the meantime, Portuguese banks are being asked to recapitalise, reduce their debts, and simultaneously continue to provide credit to the real economy. It is a tall order.

"Banking sector deleveraging is the linchpin of private sector deleveraging," says Cristina Casalinho, BPI's chief economist. "But if the credit tap is closed by the banks ... that seeps into the economy and the private sector acts accordingly. You see investment shrinking, you see real estate in the doldrums. Housing credit has just stopped. Portugal is very reliant on bank credit, as are most continental European economies."

Mr Ricciardi also notes the contradiction between the desire to strengthen banks, while wanting them to lend more to drag the economy out of recession.

Nearly half of BES's banking income comes from abroad, and it is clear that involvement in emerging markets is a source of strength for European banks when the eurozone is stagnant, just as net exports could be a lifesaver for the economy as a whole when domestic business is so mired in gloom.

Mr Ricciardi insists that Portugal is not Greece. "I think the markets are perceiving that we are doing our work well," he says. "People are aware that now it's time to work, time to suffer, and time to get out of this situation – and hopefully never to return to it."

Country prepares for life after debt

Economy

Positive signs are emerging, writes Peter Wise

Even in the good years before the global crisis, the Portuguese economy was stagnant.

This was the alert sounded by Poul Thomsen of the International Monetary Fund said in May 2011, when the European Commission, European Central Bank and IMF negotiated Lisbon's €78bn bailout package.

The idea that low growth and a lack of competitiveness form the crux of the country's difficulties is an almost universally accepted diagnosis.

As a consequence, the rescue programme has been designed to place more emphasis on raising productivity and reducing labour costs than those agreed with Greece and Ireland.

"The country needs to become more open to competition," said Mr Thomsen, who headed the IMF mission in the bailout talks.

In the decade ending in 2010, annual growth averaged 0.7 per cent, compared with an average of 1.1 per cent for the eurozone as a whole.

Employment was static over the same period. The figures underline the extent to which Lisbon has underperformed its European partners, but, as Cristina Casalinho, chief economist at Banco BPI points out, Portugal was not alone.

"People worry about Portugal growing so poorly," she says. "But the fact is that over the past decade Portugal, Germany, Denmark, Italy and Japan all had similar growth rates."

But while Germany enjoyed export-led growth of 3 per cent in 2011, Portugal entered its worst recession in more than a generation.

The economy, hit by stringent austerity measures, shrank 1.6 per cent last year and is expected to contract 3.4 per cent this year, according to the Bank of Portugal.

The central bank has also revised its growth projection for 2013 to zero, from 0.3 per cent, a more pessimistic view than government forecasts, which envisage a mild recovery next year. If the bank is right, Portugal will have seen minus or zero growth in four out of the five years from 2009 to 2013.

Chronic annual trade deficits of 7 to 11 per cent of gross domestic product over the past decade led to a steady accumulation of private and public sector debt.

By 2009, combined household and non-financial corporate debt had reached almost 240 per cent of GDP, one of the highest levels in Europe. Amid the gloom, however, some light is beginning to appear.

Whether growth next year is slightly below or above zero, economists hope the trough of the recession will be in 2012.

Ms Casalinho says: "If we can avoid a quarterly contraction of more than 4.5 per cent this year, compared with the same period in 2011, we should be able to escape a vicious downward cycle."

Public debt is forecast to peak at 115 per cent of GDP in 2013 – below the 120 per cent considered unsustainable – before gradually falling to about 80 per cent.

The risks are nevertheless high. Recession in Europe, which buys three-quarters of Portugal's exports, and particularly in neighbouring Spain, which accounts for a quarter, would be bad news. A further rise in oil prices would make the outlook even worse.

On the domestic front, the principal danger is that the austerity programme being implemented to tackle the debt crisis will fatally undermine the growth the country needs to boost tax revenues and reduce social spending.

"The treatment is so strong, I fear that we may kill the patient with the cure," says Carlos Loureiro, a tax partner with Deloitte.

Export engine: car sales overseas make up 13.3% of total

But positive signs are also emerging. Exports grew 13.5 per cent in value in 2011 to €61bn, the highest annual figure to date, with goods accounting for about €42bn and services for €19bn. At the same time, a sharp drop in domestic demand has seen annual import growth fall in value terms from 10.4 per cent in 2010 to 1.8 per cent last year with a contraction of 4 per cent expected in 2012.

From an exceptionally high average of about 10 per cent of GDP in the decade to 2010, the current account deficit is estimated to have fallen below 7 per cent of GDP in 2011. Some economists believe a zero trade deficit is within reach by the end of this year. The decade-long loss in competitiveness has also been halted and is beginning to be reversed.

"Something is definitely changing," says Ms Casalinho. "Imports are no longer such a huge drain on growth. Exports are the only engine we have and there are encouraging signs that exporters are consistently making inroads into new markets outside Europe."

China was the biggest growth market for exports in 2011, increasing by 68 per cent from a low base, largely due to car exports by AutoEuropa, a Volkswagen plant near Lisbon. Vehicles are the second biggest exports, accounting for 13.3 per cent of the total, after machinery and tools, including auto components, at 14.5 per cent.

Germany, the second largest market, made the biggest contribution to export growth last year, as companies supplying components benefited from its export boom and the Portuguese-based plants of companies such as Bosch, Siemens, Leica and Volkswagen increased overseas sales.

"Foreign investment is an important means of increasing our exports," says Pedro Reis, head of Aicep, the investment and trade agency. "Portugal can serve investors both as a door to Europe and a window overlooking Latin America and Africa."

Extensive sell-offs constitute irreversible retreat by government

Privatisation

'A rapid and full divestment' is in train, writes Peter Wise

Pedro Passos Coelho, the prime minister, scored a big success as a pro-market reformer by selling stakes in two state-owned energy utilities at high premiums within eight months of coming to office

The sales raised close to €10bn in investment and financing commitments.

But his plan to include water utilities and RTP, the state television broadcaster, in an extensive list of sell-offs, expected to raise up to €7bn in direct investment over three years, is also one of the most politically sensitive issues on the government agenda.

There is potential conflict between the prime minister's pledge to reduce the high subsidies paid to producers of renewable energy and government commitments made to the two Chinese utilities that acquired the state holdings in Energias de Portugal, the dominant power utility, and Redes Energéticas Nacionais, operator of the national grid.

According to a Portuguese analyst, "short-term cash pressures may have held sway over more long-term perspectives".

In December, China's Three Gorges Corporation outbid rivals from Germany and Brazil, to acquire 21 per cent of EDP for €2.69bn, a 53 per cent premium over the market price.

The deal involves a total investment and credit package of up to €8bn, much of which will be focused on overseas markets, including Brazil, the US and elsewhere in Europe.

Two months later, State Grid Corporation of China, the country's biggest utility, paid €387m for 25 per cent of REN, a 40 per cent premium on the market price.

The privatisation programme will clear almost every saleable asset off the state's books.

Pedro Reis, head of Aicep, Portugal's investment and trade agency, says: "These privatisations represent a structural shift in the role of the state in Portugal, marking a positive point of no return. The state will no longer be an active player in the economy."

Mr Passos Coelho signalled his commitment to this philosophy by quickly abolishing the special voting rights, or "golden shares", held by the state in Energias de Portugal (EDP) and Portugal Telecom.

Despite European Union Court of Justice rulings against them, previous governments had resisted relinquishing these rights, which enabled the government to veto strategic decisions by the former state-owned monopolies.

Most of the privatisations were already part of Mr Passos Coelho's election manifesto. But the economic adjustment programme agreed with the EU and International Monetary Fund requires the government to accelerate the plan by pursuing "a rapid and full divestment" from EDP and TAP, the state airline.

TAP and Aeroportes de Portugal, the airports authority, both 100 per cent state-owned, are the next companies scheduled to be sold.

CP Carga, the state railway freight service, Correios de Portugal, the post office, and Caixa Seguros, the insurance arm of state-owned bank Caixa Geral de Depósitos will also go on the block, as well the state's remaining 7 per cent stake in Galp Energia, the dominant oil and gas utility.

In addition to the stated aim of the privatisations to "reduce government financing needs, stimulate competition and attract foreign capital", Mr Reis sees a strong alignment between the sell-off programme and Portugal's efforts to expand its export markets beyond Europe.

"The premiums paid by the investors who bought stakes in EDP and REN show that they see value in them that goes beyond their market value, their technical competence or the quality of their management – that is their growth potential abroad."

Investors buying into Portuguese companies are interested not only in the domestic economy, he says, but also in the country's "natural markets" in Africa and Latin America, particularly, but not only, former colonies such as Angola, Brazil and Mozambique.

State Grid Corporation of China is committed to finance totalling €1bn, including joint ventures in Angola and Mozambique. Both the EDP and REN sales are also expected to provide the Portuguese utilities with a toehold in China.

"If it was not for these privatisations," says Mr Reis, "it would have taken Portugal years to register on China's strategic radar."

External pressure 'best chance for change'

Competitiveness

For the first time, there is appetite for structural reform, reports **Peter Wise**

A statue of José Maria de Eça de Queirósm, 'a cynical writer who criticised corruption, the malfunctioning of the judicial system and the poor quality of politicians' Dreamstime

Our situation is comparable only with that of Greece: the same poverty, the same political disgrace, the same economic mess." This caustic observation, written in 1872, is one of numerous commentaries by José Maria de Eça de Queirós, widely considered Portugal's greatest 19th century novelist, being given a new airing by modern pundits.

Cristina Casalinho, chief economist at Banco BPI, says: "Eça de Queirós was a very cynical and sceptical writer who everyone likes to quote nowadays. He criticised corruption, the malfunctioning of the judicial system, the poor quality of politicians, the lack of business drive and much more."

A number of Portuguese commentators are suggesting the problems underlying the country's lack of competitiveness stem from traits that are not just a few decades old but go back more than a century.

Ms Casalinho is not wholly convinced by the pessimism. "The progress on the trade balance couldn't have materialised unless the Portuguese economy was more competitive than people think," she says, pointing to a 13.5 per cent increase in the value of exports last year and the possibility of a zero trade deficit by the end of 2012.

Miguel Sousa Tavares, one of the country's most trenchant columnists and himself a best-selling novelist, commented recently: "Eça was perhaps more caustic than we are today and that's cause for optimism. A hundred years ago, he saw no future for Portugal, but we're still here."

Portugal and Greece were viewed "in foreign books and magazines" as two "chaotic" countries that could be "erased from the map of Europe", wrote Eça de Queiroz.

Until recently, many international analysts thought both countries would be forced out of the eurozone. But most European leaders and economists now acknowledge that it would be wholly unfair to equate Portugal with Greece in terms of the scale of its debt difficulties, the transparency of its public accounts or its cross-party commitment to reform.

Eça de Queirós's scathing commentaries have been revived amid a debate over economic reforms seen as vital to making Portugal more competitive and productive. The need for structural reforms has been widely acknowledged for more than a decade, but successive governments have shied away from the political cost of implementing them.

The reforms now lie at the heart of the economic adjustment programme Lisbon has agreed with the European Union and the International Monetary Fund, which see them as vital to the sustained export-led growth needed to lift the economy out of debt and recession.

The agreement sets out tight deadlines for implementing them over three years.

Many believe this external pressure is the best chance Portugal will have to push the reforms through.

Carlos Loureiro, a tax partner at Deloitte, says: "This time, we have a window of opportunity to do something less cosmetic and more structural than in the past, especially in those areas where it will be politically punishing."

New labour laws, expected to take effect within months, are among the most politically contentious reforms. The new legislation will make it easier to fire workers and substantially reduce the cost of doing so.

According to the Organisation for Economic Co-operation and Development, employees in Portugal with open-ended contracts have been among the most protected in Europe, with dismissal compensation averaging about a month's pay for every year worked.

The new laws will increase working hours, introducing an "hour bank" of up to 150 hours a year.

The aim is to introduce greater flexibility by enabling employers to draw on this bank and extend the working week to a maximum of 50 hours during peak periods, compensating workers with time off during slack times or pay at normal rates.

Overtime pay will also be cut, four of the 10 bank holidays a year will be eliminated and annual leave restricted to a maximum of 22 days, from a previous potential maximum of 25 days. Unemployment benefits will be reduced and paid for shorter periods than previously.

Portugal's slow-moving justice system is also due to undergo what Mr Loureiro describes as a "courageous" reform.

The current bureaucratic system, in which cases, including tax disputes, can take many years to resolve, is seen as a serious deterrent to foreign investment.

Specialised courts are to be created to deal with business litigation, with priority for tax cases involving more than €1m.

Procedures are to be simplified and measures introduced to clear the backlog of existing cases, including arbitration to increase out-of-court settlement and justices of the peace to handle small-claims disputes cases.

"The justice system is one of Portugal's most serious problems and for the first time, structural changes that were obvious to many people are going ahead," says Mr Loureiro.

Getting these and other reforms (*see box above*) on the statute book will represent an important step toward greater competitiveness that no previous government has attempted so comprehensively or so fast.

If they also produce the desired results in practice, even Eça de Queirós would have had to formulate a rare accolade.

Legislation

Other business-related reforms tabled or under way:

- A bankruptcy law, based on the US "Chapter 11", to replace current legislation which, according to Carlos Loureiro, a tax partner at Deloitte, condemns companies to a "slow and painful death", but offers no hope of recovery for many that face financial difficulties but are viable.
- A competition law to give regulators greater powers and resources to gather evidence and ensure fairness. Under the current system, consultants say regulators are losing too many cases on appeal.
- An industrial licensing law that Álvaro Santos Pereira, the economy minister, describes as the "most advanced in Europe", aligned with the best practices in the world and exempting the vast majority of companies from the need for an industrial licence.
- Tenancy regulations to replace antiquated controls that stopped many rents from being increased significantly for decades, leaving flats empty in city centres and hampering labour mobility.

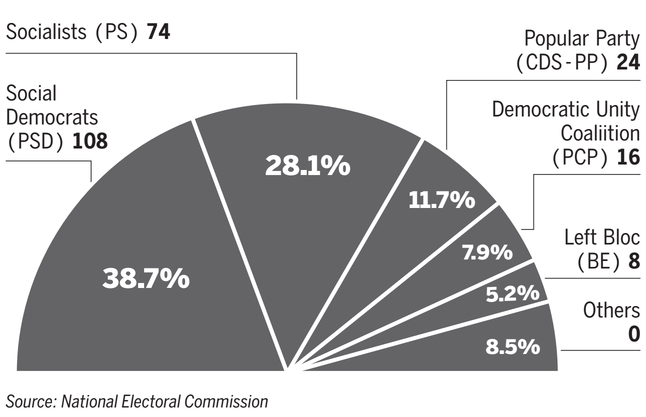
Bailout agreement enjoys support across party lines

Politics

But there is no guarantee that austerity will pay off, says **Peter Wise**

Portuguese General Election

Jun 5 2011 (% and number of seats)



Source: National Electoral Commission

If Portugal's €78bn bailout agreement fails to produce the desired results, it will almost certainly not be because of political opposition, social unrest or a lack of government belief.

As Antonio Costa Pinto, a political scientist at Lisbon's Institute of Social Sciences, puts it: "All the political conditions are in place to fulfil the programme: a secure government coalition that firmly believes in what it's doing; support from the main opposition party; and a low level of social confrontation."

When Pedro Passos Coelho, the prime minister, led his centre-right Social Democrats (PSD) to a general election victory in June 2011, he inherited a rescue agreement that the previous Socialist government had negotiated only a month earlier with the European Union and International Monetary Fund.

But Mr Passos Coelho, who formed a majority coalition with the small, conservative Popular party (CDS-PP), is decidedly more committed to the three-year programme than the centre-left Socialists (PS), who were forced to negotiate the agreement to avert an imminent financial collapse.

Prof Costa Pinto comments: "The government is not implementing the programme because it is obliged to, but because it truly believes this is best way forward."

The sovereign debt crisis led to an early general election less than three weeks after the rescue agreement was signed. José Sócrates, the Socialist leader who had been prime minister for the previous six years, suffered a heavy defeat and withdrew from active politics.

Mr Passos Coelho, who had no previous government experience, formed a coalition government with the CDS-PP that commands a comfortable majority of 34 seats in the 230-seat parliament. Including the PS, now the main opposition group, the three parties that support the bailout programme won more than 77 per cent of the vote, although the turnout was only 58 per cent.

The prime minister has promised to "go beyond" the agreement in an effort to restore confidence in the debt-stricken economy, saying he will "surprise" financial markets by achieving deficit-reduction targets ahead of schedule.

As important ministers, he has appointed technocrats with no political experience.

Álvaro Santos Pereira, the economy minister, was previously a professor at a Canadian university. A book he published a month before negotiations on the bailout began advocates many of the same reforms.

Vítor Gaspar, a previous head of the European Central Bank's research department, brings impeccable technical credentials to his job as finance minister. One Lisbon newspaper has described him as "the voice of Portugal's sat nav", unemotionally guiding the country along the route to fiscal rectitude.

'All the conditions are in place' Álvaro Santos Pereira

Nuno Crato, education and science minister, is a prizewinning mathematician who has written books on educational reform, but not previously held political office.

Paulo Macedo, the health minister, is a banker who was headhunted by the previous PS government to beef up tax collection.

Almost half the ministers in the government are technical experts without previous experience of political office, far from unusual in Portugal and a little below the average for the past 20 years. According to one sociologist, academics and "independents" in government are seen as symbols of competence and openness to civil society.

Antonio José Seguro, the PS leader who succeeded Mr Sócrates, accuses the government of ideological zeal in implementing the adjustment programme, resulting in excessive austerity that he says will choke off any potential for growth and result in a downward spiral of debt and recession.

The PS opposes plans to extend the privatisation programme beyond the bailout agreement to include assets such as water utilities and RTP, the state television broadcaster.

Only the hardline Communist party (PCP) and the radical Left Bloc (BE) oppose the bailout deal. The BE saw its share of the vote drop sharply in the election. The two parties polled just under 13 per cent of the vote between them.

The Communist-leaning CGTP, the main trade union confederation failed to mobilise substantial support for a 24-hour general strike in March, the second in four-months, reflecting a relatively low level of labour unrest and social resistance to the adjustment programme.

Union leaders said a sharp reduction in purchasing power meant that many workers could not afford to lose a day's pay.

Prof Costa Pinto comments: "The chief difficulty facing the government is not political opposition, a lack of commitment or labour unrest. It's uncertainty.

"Uncertainty among the population over whether the sacrifices they are being asked to make will bring the promised reward of an economic recovery, or whether a recession across Europe will leave us even worse off than we are now."

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Hopes pinned on a new economic model

Business climate

Miles Johnson considers the prospects for foreign investment

If attracting outside investment can be difficult during a recession, tempting foreign capital into a country that has received an international bailout is a gruelling task.

At present, Portugal would not appear likely to attract a queue of investors. Anyone pondering whether the country's current business climate may present a contrarian opportunity must at the same time consider a series of alarming data.

Unemployment, while lower than Spain's, stands at 15 per cent and gross domestic product is expected to shrink by 3.4 per cent this year.

Meanwhile the yield on 10-year government debt still hovers above 11 per cent, following Standard & Poor's decision in January to cut Portugal's credit rating to junk.

Such an environment is hitting many businesses hard, as consumers retrench and credit remains difficult to come by, as the banking system hoards funds so as to meet higher capital requirements.

John Duggan, a former partner with PwC in Portugal, says: "It is going to be difficult to get the economy working properly until we see credit come back.

"When you speak to people you hear that trading conditions are difficult in service industries. Demand is there, but pricing is under pressure and people are working twice as hard for the same money. Many retailers also had a terrible Christmas, with sales starting early."

Ernst & Young expects a fall in consumer spending of 6.2 per cent this year, followed by a further contraction of 3.1 per cent in 2013, while investment in the non-financial corporate sector fell 19 per cent year-on-year in the fourth quarter of 2011.

Yet the shopping streets of Lisbon bear witness to continued consumption by the wealthy, and some shops have opened in the city since the crisis began.

The recent opening of a flagship store by Gucci on Lisbon's Avenida da Liberdade may be of little consolation to those who are struggling to make ends meet, but it is one of a small group of companies expanding into the country during its difficulties.

Other encouraging examples include Yo! Sushi, the British restaurant company, which opened in Lisbon last year, while Klépierre, the French shopping centre operator, opened its fifth site in the Algarve last April.

More recently, there has been some encouraging progress in reducing the deficit, and in the health of the banking sector, with the loan exposure of its eight largest banks being assessed as better than expected by troika inspectors in a report released at the end of last year.

At the end of March, Portugal reported that its 2011 general government deficit had come in at 4.2 per cent of GDP, lower than the 5.9 per cent projected by the troika in December, and down from 9.8 per cent in 2010.

> Reform of labour laws, among the most inflexible in the EU, will relax rules on hiring and firing

While fewer investors are willing to commit themselves to the country against the backdrop of the European debt crisis, and with foreign direct investment plunging by 46 per cent in 2010 compared with the previous year to €1.1bn, this fall does not look as gruesome when viewed against the fortunes of some non-eurozone countries. In the same period, the UK saw FDI fall 53 per cent.

Pedro Reis, head of Aicep, Portugal's investment and trade agency, sees the economic situation as "challenging", but a series of labour market reforms intended to boost the country's competitiveness are expected to help.

"The new economic model of Portugal and the way out of this situation will be through the openness of our economy," he says. "By that I mean both the attractiveness for foreign investment and the internationalisation of our companies".

Privatisations will bring in foreign investment, with partners likely to be selected not only for the price they will pay but also for their ability to attract subsequent investment.

The sell-off of the state's 21 per cent stake in Energias de Portugal (EDP), the utility, to China's Three Gorges for €2.7bn in December was contingent on further Chinese investment.

Reform of the labour laws, regarded as among the most inflexible in the European Union, will relax rules on hiring and firing workers and reduce the costs of extra hours.

This, says João Alves, country managing partner at Ernst & Young, will help market the relatively young and educated workforce better.

"There are many qualified young professionals working abroad, and many Portuguese are very comfortable working in the English language," he says.

Cultural ties to Brazil, Angola and Mozambique can also provide its companies with a unique selling point to foreign investors looking to enter those fast growing markets.

"Portugal no longer stops at the borders of Europe,' says Mr Reis.

"It is well positioned, historically, culturally, economically, logistically, to have an important role in the new global economy," he adds.

Oceangoing nation opens new chapter

Maritime industry

A hard-headed business approach seeks ways to profit from the sea, says **Victor Mallet**

In the midst of an apparently interminable eurozone crisis, the Portuguese can be forgiven for wallowing in nostalgia when it comes to their maritime history.

After all, this small nation on the Atlantic shore discovered most of the "new world" previously unknown to Europe, with the result that it became the richest nation in the west in the 16th century.

The names of Bartolomeu Dias (Africa), Vasco da Gama (India) and Fernão de Magalhães – Magellan, who led the first circumnavigation of the globe but was killed in the attempt – echo down the centuries.

None of this is of much practical use, however, for a country trying to extract itself from recession and from dependence on bailout money from the European Union and the International Monetary Fund.

The crisis has spawned a clutch of schemes to revive Portugal's marine industries – or create new ones – and monetise its maritime traditions.

Professor José Ferreira Machado, dean of the Nova School of Business and Economics, has this year launched a Major in Maritime Business subtitled "creating value with the oceans". He says: "If you had asked me two years ago, I'd have said the only thing I know about oceans is that I swim."

The idea is to train a group of bright students who can make the most of the country's marine resources, whether in areas such as fisheries, offshore alternative energy, shipping and port management or coastal tourism.

"We have this discourse, this narrative of the oceans that is very romantic and nostalgic," he says. "This is not the way of doing it. We have to have a hard-nosed business approach. How can we make money with the oceans? How can we create sustainable value?"

The government has even more ambitious long-term plans. Manuel Pinto de Abreu, secretary of state for the sea, is negotiating at the UN for an extension of the country's continental shelf and the associated seabed rights.

Portugal, with its Atlantic coastline and the island groups of Madeira and the Azores, already dominates an area of nearly 2m sq km and hopes to double that if the negotiations are successful over the next six years.

"We are not looking only at fisheries," Mr Pinto de Abreu says. "We think there's much more. Marine biotechnology, metallic and non-metallic minerals, everything that's on the bottom."

Commenting on the resources, he says: "We need to discover them, prove they are there and create incentives for investment in this area."

Generating value from the sea in the short term remains difficult.

In freight, the container terminal at Sines, south of Lisbon, on the routes from the Americas and Asia to Europe, could become a hub, but there is stiff competition from busier ports in northern Europe and in Valencia, Spain.

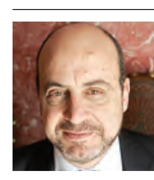
In fisheries, there is scant capacity for further exploitation of strained resources, except perhaps through marine aquaculture.

"The fisheries industry is not a heavyweight economic sector in the context of the domestic economy," says António Schiappa Cabral, secretary-general of Adapi, an association of 42 commercial fishing groups representing 74 vessels up to 80 metres in length.

Mr Schiappa notes that Portugal, whose national dish is salted cod, consumes about 600,000 tonnes of fish a year, twice as much as it produces, and is the world's third highest fish consumer per capita after Iceland and Japan.

Mr Schiappa insists that, for all the talk of offshore wind farms and the development of maritime tourism, it makes sense to invest in research and sound management of the established business of fishing. "There's recreational fishing, there's sailing, but to contribute to the economic growth of the country, I see only [industrial] fisheries."

Others believe that there are immediate benefits to be had from promoting



How can we make money with oceans? Prof José Ferreira Machado

sports and leisure tourism connected with the sea.

Last summer, Cascais, near Lisbon, hosted the first round of the America's Cup World Series – a televisual sailing competition featuring high-speed, wing-sailed catamarans leading up to the battle for sport's oldest extant trophy in San Francisco next year. And Lisbon will this year be one of the stopover ports to welcome the round-the-world crews of the Volvo Ocean Race.

Mário Ruivo, an oceanographer who heads Portugal's permanent forum on maritime affairs, says the ocean-themed 1998 World Expo in Lisbon showed the way towards examining new sectors from biotechnology to tourism. "We have created a broader perception that the ocean is more than shipping, more than fishing," he says.

John Duggan, a former PwC partner who helped prepare a report on the marine leisure industry, says that promoting marinas and all the associated maintenance and repair facilities is a good way to create jobs and generate growth.

"No matter how you measure it, water-based leisure activity is punching far below its weight," he says. "Portugal should be taking advantage of its location and its resources to develop economic activity and employment."

Outlook bright despite VAT rise

Tourism

Luckily, the industry has several factors working in its favour, reports **Jill James**

The financial crisis is taking a long time to resolve, but there are three big factors working in favour of the tourism sector in Portugal, one of the country's upmarket leisure companies believes.

José Carlos Pinto Coelho, president and chairman of Onyria, a family group that runs resorts, villas, hotels, golf courses and restaurants, says the country has resisted the temptation to overbuild. In addition, its prices remain competitive, so that there are still margins to improve.

And thirdly, the Arab spring called attention to "the importance and stability of long-term investments," he says.

Like many businesspeople, Mr Coelho thinks that rises in VAT were bad news for the tourism sector. (In most cases VAT in Portugal is now 23 per cent). He says business will try to persuade the government to correct this. The Association of Hotels, Restaurants and Related Businesses is pushing for the restaurant rate to be put back to 13 per cent this year and 6 per cent next year.

"All the tourism sector is under pressure and [because it has] invested strongly in the past 10 years, it needs time to recover investments," says Mr Coelho. "To increase VAT now is to take off from revenues important amounts that were not foreseen when investment decisions were made."

His own company has opened two properties, a luxury boutique hotel near Lisbon and a golf course near Lagos in the Algarve.

Mr Coelho says the Lisbon coast is now very attractive to the leisure and MICE (meetings, incentives, conferences and exhibitions) segments of the market.

He thinks Portugal can build a better future for its tourist industry by developing Lisbon as a business centre to challenge Madrid and Barcelona and to emphasise the year-round potential of the Algarve as a destination.

He has a point where Lisbon is concerned. City tourism has become an engine of economic growth in Europe in recent years, particularly in capital cities that have a tourism concept in place, says a report by consultants Roland Berger published at the end of last year. It says Lisbon and Amsterdam had by far the most overnight stays relative to the number of inhabitants.

"If a city can be reached easily by air, it stands an excellent chance of attracting many tourists. Low-cost airlines are very important in this respect," the report says.

It adds that accessibility by air has an influence on a city's positioning as an conference location, too.

Cities with fewer than 60 direct flight connections to other locations are not accessible enough, says the report. This makes them "suboptimal locations" for conferences. Cities with between 60 and 180 direct flight connections, on the other hand, have established themselves as perfect conference locations in recent years. Lisbon has about 100.

In this year's Global Economic Forum competitiveness index, Portugal was ranked 45th out of 142 countries. From a list of 15 factors, respondents were asked to select the five most problematic for doing business in their country and to rank them between one and five. Access to finance, restrictive labour practices and inefficient government bureaucracy came out top.

Positive developments are largely led by an increase in information and communication technology use and improved infrastructure, especially roads.

> Although the population is about 11m, there are strong links with 200m people in former colonies

The World Travel and Tourism Council says real growth in travel tourism as a direct contribution to gross domestic product slowed from 3.6 per cent in 2010 to 3.5 per cent last year.

Figures produced by the National Institute for Statistics for last year showed that French visitors are the biggest spenders followed by UK citizens and the Spanish.

Good news for investors is that the size of Portugal's market is larger than it first appears. Although the population is about 11m, worldwide 200m people speak Portuguese. Former colonies such as Macao, Mozambique, Angola and Brazil, still retain business ties.

As Latin American businesses expand and individuals there become wealthier, turning to European countries such as Portugal as a leisure and travel destination may be seen as an attractive long-term investment.

UK and north European investors eyeing Portugal automatically think of golf, chic villas and upmarket resorts centred around the Algarve and Lisbon. But for those who take the time to look, there is a lot more. North of the Algarve is the Alentejo, with fine inland scenery and quiet beaches.

Central and north Portugal are still relatively unspoilt and property prices lower than those in the south and around the capital.

Unlike the Algarve, where many properties are attuned to British and German tastes, houses in the interior cater very much for the local population and there is the undoubted appeal of an authentic lifestyle, albeit with a very slowly improving infrastructure.

Talking of which, there is no more touchy subject now than that of tolls. The recent imposition of tolls on the main A22 motorway along the Algarve coast has prompted public petitions, action groups and even ministerial ire.

Local charm: town square in Aveiro in the north provides the undoubted appeal of an authentic lifestyle Alamy

Regulatory uncertainty clouds outlook for power sector

Energy

The government wants to escape expensive legacy contracts, says **Miles Johnson**

Before the crisis struck, Portugal's energy sector was lauded as an example for others in Europe to follow, with its use of green technology placing it among the vanguard of those trying to diversify away from fossil fuels.

Renewable energy accounts for more than 40 per cent of electricity consumption and is estimated to have saved about €2.5bn in fuel imports since 2005, making Portugal one of the few countries in Europe on track to meet the European Union's target for a fifth of energy consumption to be green by 2020.

For a country blessed with a long and windy coastline, and long hours of sunshine, Portugal is seen as a natural geographical fit for turbines and solar panels.

Wind power has dominated, with 4,300 of the 18,000 installed megawatts of capacity in the electricity grid powered by gales from the Atlantic and the hills to the north.

This success, however, has come at a cost. Partly to stimulate investment, previous governments adopted a strategy of feed-in tariffs, meaning the state would undertake to buy electricity from green producers at an above-market rate for a fixed period.

Another issue has been the "tariff deficit" built up over the past decade because of the gap between the subsidised price consumers pay and the higher cost of producing electricity as oil prices have risen.

This difference, guaranteed by the state, stems from longstanding contracts signed with producers such as Energias de Portugal (EDP), the former power monopoly, in the late 1980s.

Under the terms of the financial aid package, Portugal is required to try to renegotiate these contracts.

These deals have come under increasing scrutiny because of high consumer energy prices and a perceived lack of competition.

"The Portuguese energy market has been one of the least competitive in Europe," says Carlos Pimenta, former secretary of state for the environment who now runs a wind energy company.

As the economic situation has deteriorated, the high price of electricity has become increasingly controversial. With public sector workers forced to accept pay cuts and unemployment continuing to rise, households suffered an increase in the VAT paid on electricity from 6 to 23 per cent last October.

For a country seeking to boost its competitiveness, shrink its budget deficit, and boost confidence following the trauma of the European Union and International Monetary Fund bailout, high electricity prices do not help to attract investment.

While the EU has praised the progress with economic

Market has been one of the least competitive, says Carlos Pimenta

reforms, the troika (European Commission, IMF and European Central Bank) has remained underwhelmed by the lack of action in the energy sector.

The most recent troika report argued "substantial further action will be necessary to set the surging debt of the electricity system [the tariff deficit] on a sustainable path by correcting the excessive rents associated to the production of renewable energy".

So far, efforts to renegotiate contracts with electricity producers and reduce subsidies, have not only been slow, but occasionally chaotic.

In March, the government suffered its first significant casualty when Henrique Gomes, secretary of state for energy, resigned after clashes over the direction of the sector under reforms ordered by the troika.

The government was also placed in the awkward position of running the process to sell off a 21.35 per cent state stake in EDP, which was eventually bought by China's Three Gorges in a €2.7bn deal.

To lower the high prices would have reduced EDP's value while a sell-off was being attempted.

To try radically to alter the contracts now risks damaging international credibility at a time when the country is striving to attract foreign investment.

With a new energy minister in place, analysts are expecting progress to accelerate. How policy will look in the end, however, remains a guessing game for a nervous sector.

"The regulatory uncertainty is the most important thing in Portugal's energy sector right now," says Felipe Echevarria Olaso, an analyst at Espirito Santo investment bank.

The government is aware that, as a member of the Energy Charter, an international agreement to protect investors in energy projects, it is unable unilaterally to alter the feed-in tariff agreements without triggering legal battles.

This means it will be forced to negotiate a settlement.

Whether this will erode the country's competitive advantage in wind energy, a sector estimated to have created more than 5,000 jobs, is also likely to play on the minds of ministers.

"It is important we can reach a mutual agreement," says Mr Pimenta. "Both for the renewables sector, and the country."