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Statement by the EC, ECB, and IMF on the Second Review Mission to Portugal

Staff teams from the European Commission (EC), European Central Bank (ECB), and the International Monetary Fund (IMF) visited Lisbon during November 7-16 for the second quarterly review of Portugal's economic program. The mission has reached staff-level agreement on economic and financial policies to meet the program's objectives. Strict implementation of these policies will be needed to restore external competitiveness, bolster confidence in the sustainability of public finances, and maintain financial stability while ensuring adequate credit in support of sustainable growth.

Growth in 2011 is likely to be somewhat better than foreseen in the program, but the recession in 2012 is now projected to be more pronounced, with GDP expected to contract by 3 percent and risks to the outlook tilted to the downside. From the external side, global headwinds are hampering exports, while, on the internal side, the fiscal consolidation measures in the 2012 budget, tighter credit and financial market conditions, and weaker confidence are dampening domestic demand. Consumer price inflation will remain elevated, reflecting significant indirect tax and tariff increases. The economy is expected to recover, albeit at a gradual pace, in 2013.

Implementation of the 2011 budget has proven difficult. While preliminary data indicate that the end-September ceiling on the cash deficit was met, spending overruns relative to program objectives for the whole year could add up to 1½ percent of GDP on an accrual basis. These unexpected budget pressures reflect in large part slippages in expenditure controls and insufficient corrective measures. Against this backdrop, the government is seeking to negotiate a voluntary agreement with the major banks to transfer part of the assets and liabilities of these banks' pension funds to the social security system, so as to allow meeting the 2011 fiscal deficit target of 5.9 percent of GDP.

The 2012 budget includes bold and welcome measures to bring the fiscal program back on track. In the mission's assessment, it is consistent with meeting the ambitious fiscal target of 4.5 percent of GDP in 2012. Moreover, key measures, particularly nominal cuts in public wages and pensions and increases in indirect taxes, are also appropriate in view of the need to switch from a consumption-based to a more export-led growth model. But implementation of the 2012 budget will need to be accompanied by flanking measures to address still rising spending arrears and to reduce other fiscal risks, particularly at the level of local and regional governments and the state-owned enterprises. In this context, the envisaged adjustment program for the troubled autonomous region of Madeira will provide an opportunity to signal that errant fiscal behaviour at the regional and local levels will no longer be tolerated.

Portugal's major banks are facing fresh challenges to strengthen their capital positions. The authorities are putting in place the rules that will regulate the temporary use of public funds for recapitalizing banks. These rules will need to respect the interests of tax payers, preserve the stability of the banking system, and comply with European Union state aid rules. A balanced and orderly deleveraging of the banking sector over the medium term will allow banks to address their funding imbalances, while safeguarding adequate credit to the more productive sectors of the economy.

Overall, the program is off to a good start. However, its success crucially depends on continued implementation of a wide range of structural reforms that will remove the rigidities and bottlenecks behind Portugal's decade-long growth stagnation. In order to improve labour cost competitiveness, wages in the private sector should follow the lead taken by the public sector in implementing sustained pay cuts. The program envisages measures to reduce dismissal costs and increase wage flexibility at the firm-level. As for tackling entrenched practices that distort competition, a strengthening of the competition framework is underway and progress has been made on liberalizing the telecommunication markets. Nevertheless, more progress on curbing rent-seeking in sheltered sectors, particularly energy and regulated professions, is needed. The mission agrees with the authorities that a fresh and determined effort is required to re-invigorate the structural reform agenda in scope, focus, and specificity.

The government's program is supported by loans from the European Union amounting to €52 billion and a €26 billion Extended Fund Facility with the IMF. Approval of the conclusion of this review will allow the disbursement of €8 billion (€5.3 billion by the EU, and €2.7 billion by the IMF). These disbursements could take place in December and January subject to the approval of the IMF Executive Board and ECOFIN and EUROGROUP. The joint mission for the next program review is expected to take place in February 2012.