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TENTH REVIEW UNDER THE EXTENDED ARRANGEMENT AND REQUEST FOR WAIVERS OF APPLICABILITY OF END-DECEMBER PERFORMANCE CRITERIA—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR PORTUGAL

In the context of the tenth review under the Extended Arrangement and request for waivers of applicability of end-December performance criteria, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 12, 2014, following discussions that ended on December 16, 2013, with the officials of Portugal on economic developments and policies underpinning the IMF arrangement under the Extended Fund Facility. Based on information available at the time of these discussions, the staff report was completed on January 27, 2014.
- A **Press Release** including a statement by the Chair of the Executive Board.
- A **Statement by the Executive Director** for Portugal.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Portugal*
Memorandum of Economic and Financial Policies by the authorities of Portugal*
Technical Memorandum of Understanding*

*Also included in Staff Report

The policy of publication for staff reports and other documents allows for the deletion of market-sensitive information.

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January 27, 2014

TENTH REVIEW UNDER THE EXTENDED ARRANGEMENT AND REQUEST FOR WAIVERS OF APPLICABILITY OF END-DECEMBER PERFORMANCE CRITERIA

EXECUTIVE SUMMARY

The short-term outlook has improved and program implementation remains on track, notwithstanding another adverse Constitutional Court ruling. Stronger domestic demand is supporting a pick-up in activity and lower unemployment. A broad-based recovery in sentiment has led to a decline in yields, allowing Portugal to issue a 5-year bond on favorable terms. The end-September 2013 quantitative PCs were met, and preliminary estimates suggest that the end-December 2013 targets were also met. The authorities are also implementing prior actions to safeguard the 2014 fiscal deficit target, after the Constitutional Court struck down an important pension measure contained in the 2014 budget.

Portugal continues to confront major economic challenges. At above 15 percent, unemployment remains at unacceptable levels. High household and corporate indebtedness will continue to act as a brake on both consumption and investment. Portugal's public debt and external liabilities are also high. In this environment, continued efforts to rationalize public spending, encourage orderly deleveraging, and promote growth and investment in the tradable sector will be essential.

Program review discussions focused on sustaining the progress already made and exploring future reform challenges. The 2014 fiscal targets were reaffirmed. In addition to reforms of public financial management and efforts to maintain financial stability, discussions focused on the need to reorient the economy from a debt-financed and consumption-led model to an export-led growth model.

Risks to attaining the objectives of the program remain high. Beginning in mid-2012, legal challenges to fiscal measures have become recurrent, and—with key elements of the 2014 budget law now submitted to the Constitutional Court for review—these challenges have intensified in recent months. This significantly complicates the authorities' efforts to rebalance the fiscal consolidation effort toward expenditure-based measures, undermines the quality of the resulting fiscal adjustment, and introduces high policy uncertainty, with an attendant negative impact on output and employment. In addition, with its high debt ratios and large refinancing needs, Portugal remains susceptible to abrupt changes in market sentiment.

Staff supports the authorities' request for completion of the tenth review and for waivers of applicability of the end-December PCs. The purchase released upon completion of this review would be in an amount equivalent to SDR 803 million.

Approved By
Poul M. Thomsen and Sean Nolan

Discussions took place in Lisbon during December 4–16, 2013. The staff team comprised S. Lall (head), S. Ahmed, D. Gershenson, M. Goretti, H. Lin, and S. Roudet (all EUR); R. Vermeulen (SPR); M. Poplawski-Ribeiro (FAD); E. Kopp and C. Verkoren (MCM); H. Pham and B. Pompe (LEG); and A. Jaeger and M. Souto (RRs). Ms. Lopes (OED) also participated in meetings. J. Manning, U. Niman and S. Abebe (all EUR) assisted the mission from headquarters.

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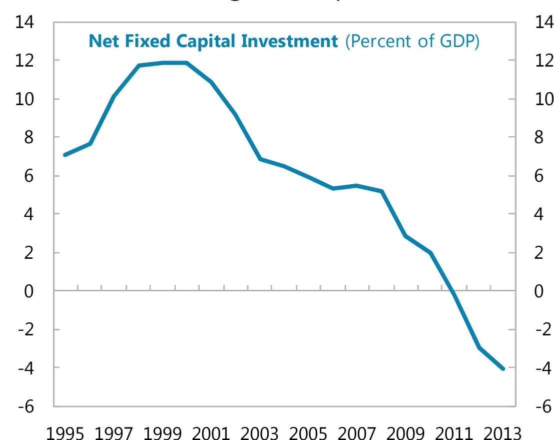
INTRODUCTION

1. **Portugal has made significant progress towards the program's objectives of ensuring fiscal sustainability, safeguarding financial stability, and enhancing competitiveness and growth**. The sizable and frontloaded fiscal adjustment has achieved more than two thirds of the structural consolidation envisaged under the program and the remaining adjustment is evenly phased over 2014–15. Against this backdrop, public debt is projected to be on a declining path from this year. Despite high private sector indebtedness, financial stability has been preserved and banks meet minimum capital requirements. Economic activity has bottomed out and a modest recovery is expected this year. External adjustment has exceeded expectations, with Portugal posting a current account surplus for the first time in several decades. Regarding program performance, the end-September 2013 performance criteria were met comfortably, while preliminary estimates indicate that those for end-December 2013 were also met with some margin.

2. **The economy, however, continues to face formidable challenges.** Despite the welcome reduction in unemployment, it remains unacceptably high at above 15 percent, with youth unemployment near 37 percent, which could have lasting negative impact on the stock of human capital. The very high levels of corporate indebtedness will continue to act as a brake on investment for the foreseeable future, with current levels of *net* private investment too low to replace the capital stock. Both high unemployment and low investment will reduce the economy's growth potential further if not addressed. Portugal's external liability position also remains worryingly high and needs to be reversed in order to safeguard external sustainability.



Source: AMECO.

3. **In light of these challenges, a return to the pre-crisis growth model is not an option.** With financial conditions not expected to revert to pre-crisis patterns, the ability for the private and public sector to accumulate additional debt to finance consumption is severely curtailed. Both public and private consumption will have to adjust to a new normal at lower levels, while creating room for private investment to recover to levels that sustain and eventually increase the economy's growth potential. Higher growth is critical to safeguarding public and private debt sustainability.

4. **In addition to continued fiscal consolidation, a continued transformation of the economy going well beyond the program period is required.** Despite the authorities' reform efforts over the program period, the required reorientation of the economy from the nontradable sector to the tradable sector has yet to gather pace. Continued vigorous efforts are required to reduce rents and increase productivity in the nontradable sector through increased competition and product market reform so that the burden of the required adjustment to achieve sustainability does

not fall excessively on labor, and especially unskilled labor. These reforms would be a critical complement to reforms to improve the functioning of labor markets.

5. Accordingly, discussions for the tenth review focused on sustaining the progress already made and exploring options for the future. The main priorities were ensuring adherence to the agreed fiscal targets; continued reforms of public financial management; maintaining financial stability and preparing for pan-European banking sector initiatives; and the scope to advance structural reforms to reorient the economy from a debt-financed and consumption-led model to an export-led growth model.

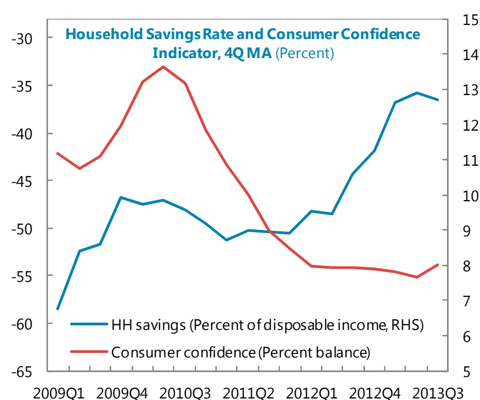
ECONOMIC AND FINANCIAL DEVELOPMENTS AND OUTLOOK

Following two and a half years of contraction, economic activity began to turn around in the second quarter of 2013. Consumption and to a lesser extent investment are recovering, unemployment—albeit still very high—declined notably, the strong growth of exports continued, and—buoyed by Europe-wide positive market sentiment—bond yields have declined to levels not seen since mid-2010. As a result, downside risks to outlook have diminished somewhat, but still remain significant.

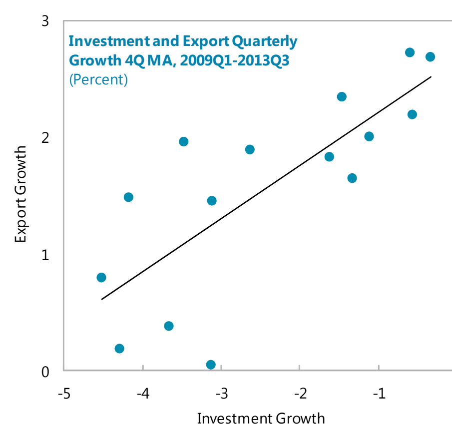
A. Recent Developments

6. Stronger domestic demand is underpinning the recovery seen since the second quarter of 2013. Domestic demand had declined by 13 percent since late 2010—with consumption and investment falling by 11 and 27 percent, respectively—which could not be sufficiently offset by the contribution of net exports. In a reversal of that trend, domestic demand expanded quarter-on-quarter in both Q2 and Q3 of 2013, reinforcing the cumulative positive contribution of net exports and leading to positive overall growth.

7. This rebound is largely a reflection of the recovery in private consumption and, to a lesser extent, in investment. While disposable income remained broadly stable since early 2012, the sharp rise in the household savings rate appears to have run its course, with an attendant increase in consumption. The stabilization of the savings rate reflects a combination of higher

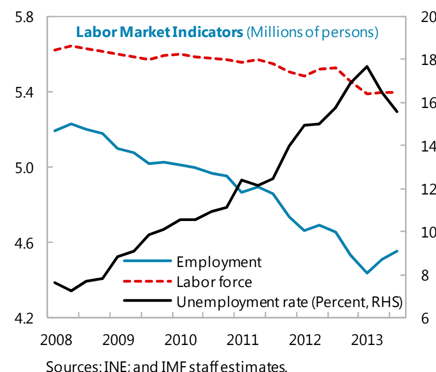


Sources: INE; and IMF staff calculations.



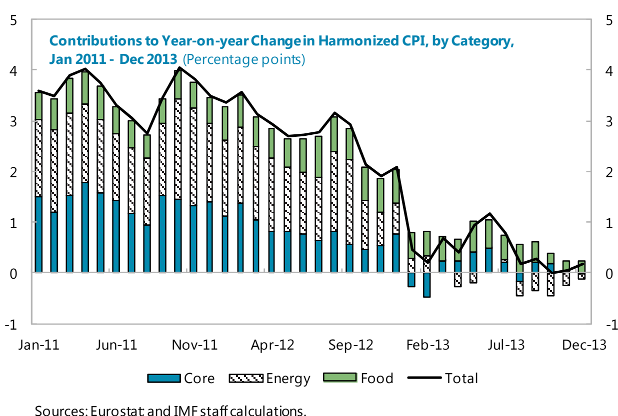
consumer confidence and perceptions of reduced policy uncertainty. The cumulative contribution of investment (excluding the change in inventories) to overall growth in Q2 and Q3 of 2013 was substantially smaller than that of consumption but positive, and reflected mainly private investment in equipment and machinery—indicative of a welcome replacement of the depleted capital stock—and a small contribution from construction, following the sizable contraction of the sector during the crisis. Reflecting the ongoing fiscal consolidation, the level of public investment in 2013 is estimated be about a half of its 2000–10 average.

8. Buoyed by stronger domestic demand and continued export growth, employment has increased. In particular, manufacturing and hotels/restaurants (the latter a proxy for tourism) accounted for almost a half of the total increase in employment; in contrast, employment in construction has continued to decline. The size of the labor force has stabilized over the course of the year and the unemployment rate is gradually trending lower.



Sources: INE; and IMF staff estimates.

9. Reflecting the still-high output gap, both headline and core inflation continue to remain near zero. Core inflation contributed on average only 0.1 percentage points to overall inflation in 2013, compared with 1.4 and 0.8 percentage points in 2011 and 2012, respectively. This—together with an earlier decline in world fuel prices and the correspondingly low energy inflation—resulted in the third-lowest overall inflation in the euro area for Portugal.

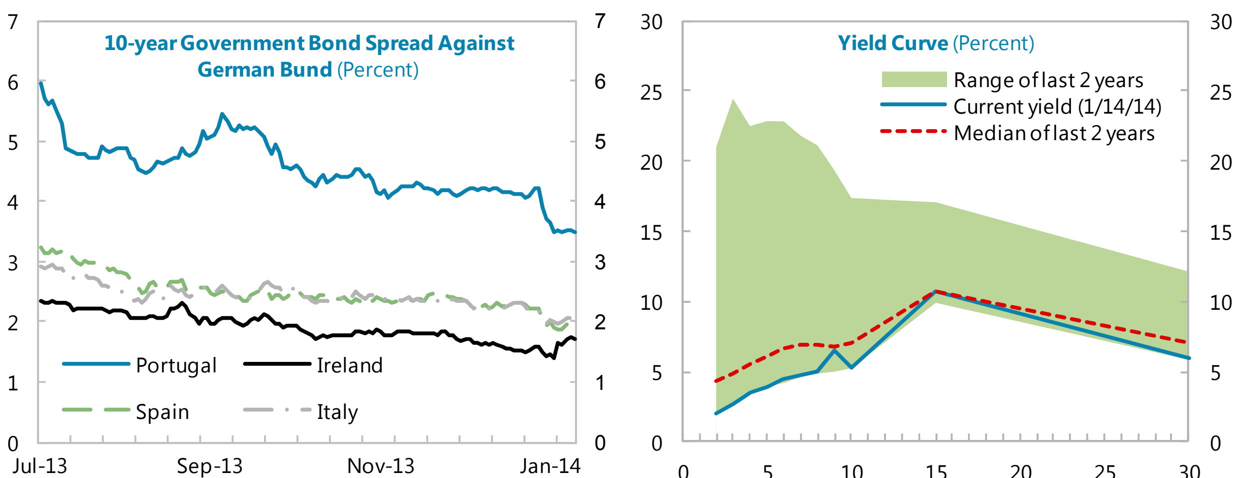


Sources: Eurostat; and IMF staff calculations.

10. After exceeding expectations, the adjustment in the external current account is beginning to stabilize, pointing to the need to ensure that efforts to strengthen competitiveness continue to be undertaken (Box 1). In the first ten months of 2013, the 5 percent rise in exports was driven mainly by fuel exports and to a lesser extent services, while growth of nonfuel goods exports was a more moderate 1½ percent. In line with the recovery in domestic demand, imports have begun to rise albeit at a more moderate pace, following a decline in 2012. The current account is estimated to have reached a surplus of ½ percent of GDP in 2013 and is projected to register a surplus of close to 1 percent of GDP this year. This brings the cumulative adjustment since the current account deficit peaked in 2008 to 13½ percentage points, more than 4 percentage points higher than originally envisaged under the program. In view of Portugal's highly negative international investment position, further gains in competitiveness will be needed to ensure sustainability.

11. Bond yields have continued to decline since mid-September 2013. The 10-year sovereign bond yield has declined by more than 200 basis points since its peak of 7.3 percent in

mid-September 2013, driven by a combination of continued program implementation and an improved external environment, with the latter characterized by still-abundant global liquidity and a recovery in growth in Portugal's main trading partners. In early December the government successfully conducted a debt swap to smooth the repayment humps in 2014–15, followed by a 5-year syndicated bond issuance in early January that met with strong demand from foreign investors, which further improved market sentiment towards Portugal. While the spread against the German Bund has been declining in tandem with yields, it remains some 180 basis points higher than that for Ireland and about 150 basis points higher than that for Italy and Spain.



Sources: Bloomberg; and IMF staff calculations.

B. Outlook

12. In line with the recent strengthening of activity, the downside risks to the near-term macroeconomic outlook have diminished somewhat, while the medium-term outlook remains unchanged. Output is now estimated to have contracted by 1.6 percent in 2013, with unemployment expected to have averaged 16.5 percent, somewhat better than projected in the previous review. This reflects the better-than-expected outcome in Q3 of 2013, when output grew by 0.2 percent quarter-on-quarter while the unemployment rate declined by 0.8 percentage points. With continued improvement in confidence and a reduction in uncertainty, household consumption is expected to continue to gradually strengthen, while investment in equipment and machinery is expected to move in line with exports. The construction sector is expected to remain a drag on activity, while the required fiscal consolidation will be expected to continue to subtract from domestic demand. Overall, the downside risks to the baseline growth outlook for 2014 have receded somewhat. Over the medium term, the outlook remains unchanged from the previous reviews, with real growth strengthening gradually to reach 1.8 percent, accompanied by a current account surplus that is projected to reach 2.8 percent of GDP by 2019. This is predicated on continuing the reform effort to cement the ongoing transformation of the economy.

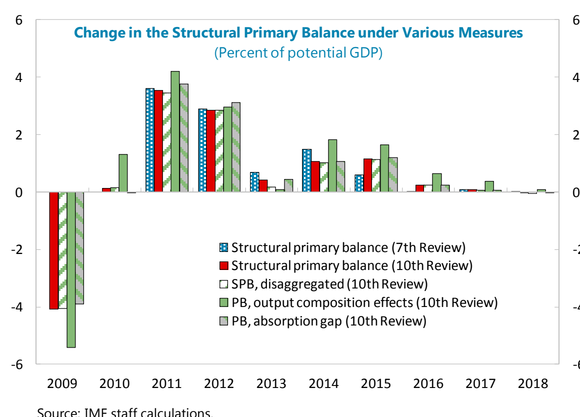
13. There nevertheless are significant risks to the baseline. An unanticipated increase in uncertainty or a dampening in consumer confidence could curtail consumption growth. Further Constitutional Court rulings against reforms could undermine confidence and growth prospects, in part because the government would have to increasingly resort to lower-quality and less growth-friendly fiscal measures to close the resulting budgetary gaps. Slower external demand could reduce the contribution of net exports and investment to the recovery. Turning to the medium term, the possibility that the drag on growth from the economy-wide deleveraging process could exceed expectations remains a persistent concern. Global financial conditions could also adversely affect prospects, particularly as the unwinding of extraordinary U.S. monetary stimulus now underway could push yields higher for a broad range of borrowers. Elevated deflationary risks in the euro area could also add significant headwinds to the regional recovery and impede the repair of the already-weak private and public balance sheets in Portugal. In addition, while markets tend to view the country favorably at this juncture, market conditions could quickly deteriorate if any of these uncertainties were to materialize, as evidenced by the volatile market sentiment towards Portugal throughout the program period.

ADVANCING FISCAL CONSOLIDATION

Continued fiscal discipline is critical to complete the necessary fiscal consolidation efforts and secure durable market access. The key challenges include monitoring budget implementation to ensure the fiscal targets are met, identifying reforms to underpin future adjustment, and sustaining fiscal structural efforts to limit risks and ensure a hard budget constraint across the general government.

A. Recent Fiscal Developments

14. Fiscal performance has been in line with the program, with the 2013 target expected to have been met with some margin.[1] Preliminary data suggest that budget execution in the last quarter of 2013 has remained in line with the program targets and that, accordingly, the program deficit objective of 5.5 percent of GDP is expected to have been comfortably met.[2] Tax collection through November exceeded the authorities' own projections by €336 million (0.2 percent of GDP). Moreover, additional measures to offset the budgetary slippages identified at the time of the eighth and ninth reviews were successfully implemented through the second supplementary budget that was



Source: IMF staff calculations.

[1] The end-September quantitative performance criteria on the general government cash balance and debt were met by a comfortable margin, in the context of a broad-based recovery in tax revenues.

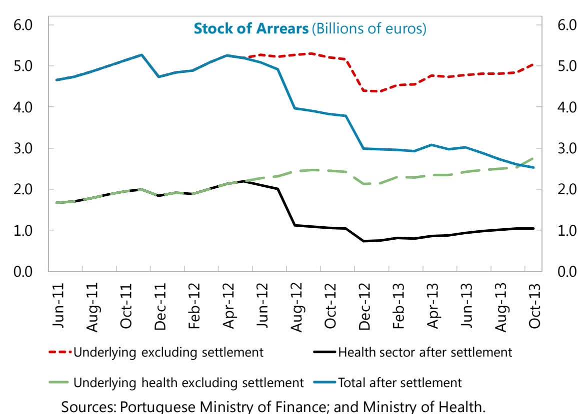
[2] The program definition of general government deficit excludes bank recapitalization costs (0.4 percent of GDP in 2013).

approved last November. In particular, preliminary evidence suggests that the one-off (tax and social security contributions) debt recovery scheme should have delivered about €1.25 billion, well above its initially targeted yield of €0.7 billion.

15. The 2014 budget law was ratified in line with staff's understandings and consistent with a deficit target of 4 percent of GDP. Most of the budgetary measures were drawn from the authorities' Public Expenditure Review (PER)—including a wage bill reform, a pension reform, and sector specific savings. Minor amendments to the wage bill and to the pension measures were introduced in the final budget law, aiming at protecting lower-income earners and reducing legal risks, with necessary compensating measures duly identified. The budget implies a structural primary adjustment of about 1 percent of GDP.

16. A new ruling by the Constitutional Court has complicated the authorities' efforts to effectively rebalance the fiscal consolidation effort toward expenditure-based measures. The 2014 budget contained, as part of pension reform measures, key provisions aligning the rules and benefits of the public sector pension fund, CGA, to those of the general pension regime, with a projected yield of about 0.2 percent of GDP in net terms. However, the measure was ruled unconstitutional in late December, forcing the authorities to approve offsetting measures to safeguard the 2014 deficit target (see Policy Discussions). The recent Constitutional Court decision is the fourth adverse ruling on fiscal measures since mid-2012, highlighting the substantial legal risks surrounding the economic reform agenda and the increasing hurdles faced by the authorities in advancing their reform of public administration, in the context of the high burden posed by social transfers and public wages on Portugal's fiscal accounts.

17. While there has been notable progress in fiscal structural reforms, important challenges remain in expenditure control and arrears. Since 2011, the government has taken a number of actions to deal with the accumulation of arrears. A Commitment Control Law (CCL) was passed in February 2012, accompanying IT systems have been rolled out, and existing stocks of arrears are being cleared. In spite of the visible progress, expenditure arrears continue to accumulate, albeit at a slower pace, breaching the related continuous indicative target. The problem is mostly concentrated in a few large state-owned hospitals in the health sector,[3] in which the underlying stock of arrears (i.e., excluding the reduction agreed under the arrears settlement program) has increased from €2.1 billion in December 2012 to €2.8 billion in October 2013. At the local government level, while the total



Sources: Portuguese Ministry of Finance; and Ministry of Health.

[3] A number of hospitals are facing structural financial imbalances. Arrears in 12 hospitals are increasing to the tune of 10 percent of their contracted current expenses. While full application of the Commitment Control Law (CCL) remains crucial, imbalances of this magnitude require a combination of policy measures.

underlying stock of arrears is declining, there still are municipalities that continue to accumulate arrears on an ongoing basis, suggesting that the CCL is not being fully implemented or enforced (see Policy Discussions).

18. PPPs renegotiations are ongoing, although with some delays. In the context of the ongoing measures to minimize fiscal risks from PPPs,the major renegotiation of road contract PPPs with all the concessionaires is being finalized and is expected to generate additional savings of more than €2.5 billion over the life cycle of the concessions. As part of the process, the authorities are completing the revision of the regulatory framework for the road and rail sectors in line with the EU standards and with the objective of minimizing fiscal risks. Moreover, the renegotiation of the PPP contract on National Security and Emergency (SIRESP) is proceeding as envisaged, with the objective of generating further permanent savings in 2014 via a reduction in its internal rate of return and rationalization of operating costs.

19. The financial performance of state-owned enterprises (SOEs) has improved, and the privatization program is on track. Cost-reduction efforts and voluntary separation programs have helped improve the consolidated operational balance of SOEs, although some of them have likely remained in deficit in 2013, also as a result of the reinstatement of the 13th and 14th salaries.[4] About half of the outstanding derivative contracts of SOEs (in mark-to-market terms) were settled by end-June 2013, while the unwinding of the remaining complex derivative contracts is pending judicial review. SOE governance has been strengthened with the entry into force of the new framework law in December 2013. At the same time, the postal company CTT was successfully privatized through an initial public offering for 70 percent of the shares.[5] Binding offers for the sale of the waste management company EGF are expected by mid-May 2014, while opening the water concessions to private capital and management is expected to take longer.

20. The debt outlook remains fragile. The debt peak has been revised upward and is now set to have peaked below 129½ percent of GDP in 2013, around 1 percentage point higher than projected at the time of the previous review. However, this has largely been due to the accumulation of cash buffers. Accordingly, net debt—excluding central government deposits—is projected to smoothly peak at around 120 percent of GDP in 2013 and 2014, slightly below the earlier projections. The decline in the general government gross debt-to-GDP ratio starting in 2014 is expected to be supported in part by further use of cash deposits as well as by the ongoing reallocation of the Social Security portfolio from foreign assets to government securities.[6] Most importantly, the sustainability of Portugal's debt trajectory continues to hinge on strong fiscal effort—including via its positive impact on credibility and market rates—as well as on further advances in the structural reform agenda to support competitiveness and anchor long-term growth. Accordingly, debt dynamics remain highly vulnerable to macro-fiscal as well as contingent liabilities shocks (see Annex II).

[4] Excluding this reinstatement, transport SOEs would have registered a small operational surplus in 2013.

[5] The privatizations of the flag carrier TAP and of the rail cargo firm CP Carga are still on hold, however.

[6] The planned introduction of the ESA2010 classification rules, as of September 2014, is expected to have a limited impact on debt, although discussions are still ongoing at European level with estimates not yet finalized.

B. Policy Discussions

21. The authorities have demonstrated their firm commitment to safeguarding the 2014 fiscal deficit target. There was agreement that if some of the measures in the budget were determined to be unconstitutional, the government would identify and implement compensatory measures of high quality to meet the agreed deficit targets. Accordingly, after the Constitutional Court struck down the CGA pension measure on December 19, the authorities announced offsetting measures to safeguard the 2014 deficit target. These include the frontloading of the planned increase in the beneficiaries' contributions to the special health insurance schemes (ADSE, SAD, and ADM), with corresponding savings for the State, and a recalibration of the parameters of the existing extraordinary solidarity contribution on pensions (CES). Submission to Parliament of the revised CES through a supplementary budget and approval by the Council of Ministers of the decree law on the change in contributions to the special health insurance schemes are *prior actions* for completion of this review. These measures will provide the authorities with the necessary time to develop a more comprehensive structural reform and expenditure rationalization of pensions—critical to addressing the still large gap between social transfers and social contributions and improve intergenerational equity—in line with the Court ruling, with preliminary discussions to take stock of this process to be held at the time of the eleventh review.

22. Efforts are now focused on budget implementation. Staff welcomed the authorities' plans to monitor closely the attainment of the defined budget objectives for each line ministry, including through monthly reporting to the Council of Ministers. In particular, to ensure the targeted reduction in the size of the public sector workforce, following the conclusion of a first voluntary separation scheme (with about 3,000 applicants), the authorities have already launched two new programs, with others in the pipeline, targeting different career categories and line ministries. In parallel, the authorities are finalizing the remaining legislation underpinning the budget law (MEFP ¶5).

23. However, the risk of further adverse legal rulings remains. While all the PER measures in the budget law and in the supporting legislation were designed with a view to ensure sustainability, effectiveness, and social equity of the state expenditure programs, further legal challenges have arisen. In January, the opposition submitted some articles of the 2014 budget law to the Constitutional Court, contesting four expenditure measures that were to yield around ½ percent of GDP in savings. There is no definitive timeline for a ruling by the Constitutional Court, but the authorities remain committed to meet the fiscal targets through the identification of alternative measures of equivalent size and quality. This, however, would be a challenging task, given the increasingly limited room for maneuver on the expenditure side and the need to avoid one-off and lower-quality measures.

24. Despite these persistent legal hurdles, the authorities are determined to advance the reform of public administration to anchor their medium-term fiscal consolidation path. To reach the targeted deficit of 2.5 percent of GDP and the corresponding exit from the EU Excessive Deficit Procedure in 2015, the authorities will need to identify additional permanent measures of about 1.2 percent of GDP. Moreover, further fiscal effort of about ½ percent of GDP beyond staff's

baseline projections will be needed in the outer years to comply with requirements of the Treaty on Stability, Coordination, and Governance in the EMU (Fiscal Compact). To meet these objectives, the authorities are advancing specific measures to rationalize public administration, including through a review of public sector remuneration and careers aiming at introducing single wage and supplement scales. Preliminary discussions will be held at the time of the eleventh review to assess progress on these measures, with detailed proposals underpinning the medium-term budgetary plans to be included by the authorities in the 2014 Fiscal Strategy Document, to be published in April.

25. There was agreement that the recently approved corporate income tax (CIT) reform should be implemented within the existing budgetary envelope. In parallel to the 2014 budget process, a comprehensive CIT reform was approved by Parliament last December with a broad-based political consensus. The reform aims at boosting investment and growth through a gradual reduction in the statutory rate (frontloaded for SMEs);[7] the creation of a participation exemption regime; the simplification of tax rules; as well as new incentives to invest. Nevertheless, given the limited fiscal space and remaining legal risks, it was agreed that the reform will be implemented within the existing budgetary envelope in 2015 and the outer years.

26. Staff agreed on additional measures to further advance the fiscal structural agenda.

- ***Expenditure control and arrears.*** Staff expressed concern over the accumulation of new domestic arrears and stressed that full compliance with the existing legislation and expenditure control mechanisms should be enforced. To address this issue, the authorities agreed to establish a dedicated unit reporting directly to the State Secretary for the Budget at the Ministry of Finance. This unit will (i) monitor the accumulation of expenditure arrears in all general government entities and all state-owned hospitals and (ii) provide recommendations to fix the remaining technical issues with the commiment control system. To underpin the financial sustainability of the public entities that continue to face structural financial imbalances—including some of the larger hospitals—targeted programs are being developed.

- ***Budget Framework.*** Staff and the authorities agreed that the revision of the Budget Framework Law (BFL) should follow a two-step approach. First, the transposition of the Fiscal Compact and of the EU law should be completed by end-March 2014. Second, the Reform Unit at the Ministry of Finance will develop a comprehensive analysis of all the reforms implied by the revision of BFL. The Reform Unit will also consult key stakeholders on the main elements of the legislation, with a view to completing the underlying technical work by end-April 2014. As part of these efforts, the authorities have also agreed to undertake an IMF Fiscal Transparency Evaluation by the end of the program.

- ***Revenue Administration***. Recent steps by the authorities to curb tax evasion and improve compliance included hiring 1,000 new tax auditors, making the Large Taxpayer Unit fully

[7] To address the risk that the reform could disproportionately favor the largest companies in the non-tradable sectors, profits exceeding €35 million will be subject to a new additional surcharge.

operational, and increasing sanctions for tax and social security criminal offenders. Going forward, staff underscored the importance of making the Compliance Risk Management Unit—created last November—fully operational.[8] Staff also discussed the authorities' plans to establish a dedicated Taxpayer Services Department in 2014, with the goal of unifying most taxpayer services and improving the taxpayers' relationship with the tax administration. Beyond that, authorities agreed that the 50-percent reduction in the number of local offices should move from the planning to the execution phase. In addition, they also concurred that further strengthening the exchange of information between the tax and the anti-money laundering authorities—in line with international best practices—is warranted.

- ***Regional and Local Governments.*** The program to support local governments' arrears settlement (PAEL) was finalized at the end of 2013, supporting 90 municipalities with disbursements for around €500 million. Moreover, with the Regional Finance Law and Local Finance Law approved last September, a budgetary coordination council between the central and subnational governments is becoming operational in February. Staff discussed the design of the forthcoming insolvency procedure for local governments, including a Municipality Resolution Fund introduced by the Local Financing Law. A group of experts is preparing the rules and procedures for this fund, which will be specified in a draft law expected to be submitted to Parliament in the first quarter of 2014.

SAFEGUARDING FINANCIAL STABILITY AND FACILITATING ORDERLY DELEVERAGING

The financial sector remains stable, thanks to the successful completion of the 2012–13 capital augmentation exercise, resilient customer deposits, as well as exceptional liquidity support from the Eurosystem. However, credit to the private sector remains depressed and, in the context of ongoing bank deleveraging and financial fragmentation, the economic recovery in the foreseeable future will need to rely less on bank credit than prior to the crisis. Therefore, it is essential to strengthen corporate sector balance sheets by facilitating an orderly deleveraging process and to explore alternative funding sources from private capital markets for viable firms, notably SMEs.

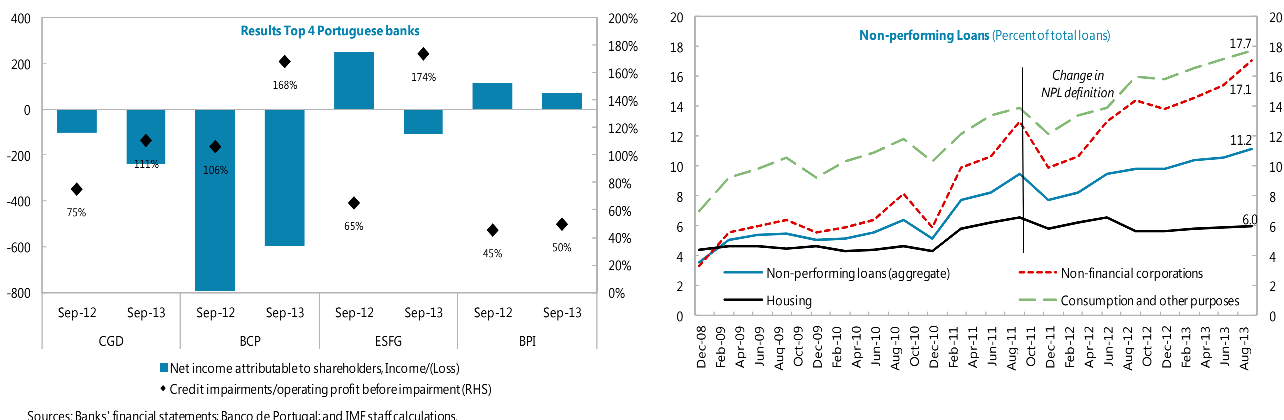
A. Recent Financial Developments

27. While capital buffers remain robust, the weak domestic environment continues to weigh on banks' performance. All banks continue to meet the minimum capital requirements set under the program, and remain resilient under adverse scenarios while adequate provisioning levels are being safeguarded through periodical impairment reviews.[9] However, banks' profitability is

[8] This unit aims at strengthening tax compliance by (i) phasing in a modern compliance risk model; (ii) strengthening PIT compliance management through the pilot projects on the high net wealth individuals and the self-employed professionals; and (iii) enhancing control (e.g., audits) and analysis of the monthly PIT withholding information.

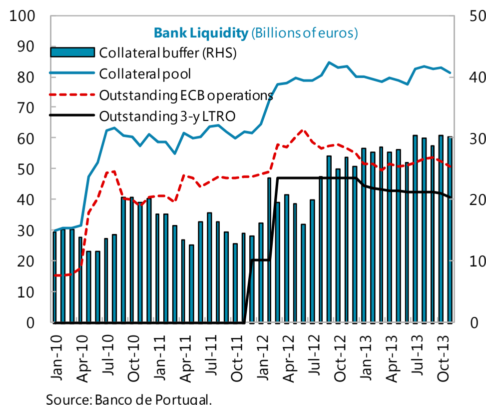
[9] To date, the authorities have conducted three impairment reviews, with the most recent one completed in August 2013. The impairment shortfalls that those exercises highlighted have immediately been addressed by the participating banks.

being negatively affected by reduced business volumes, elevated impairment charges, and high funding costs.[10] This development, in turn, weakens the banks' ability to generate new capital. Nonperforming loans (NPLs) continue to increase, amounting to 11.2 percent of total loans by end-September 2013, with the increase in NPLs during the past year being largely driven by developments in banks' corporate portfolios.[11] Although international activities continue to contribute to earnings, and banks are gradually reducing their cost base—in line with the restructuring plans that have been agreed with the European Commission's Directorate-General for Competition[12]—neither effect is sufficient to offset the reduced earnings capacity of domestic operations.



Sources: Banks' financial statements; Banco de Portugal; and IMF staff calculations.

28. Against this backdrop and despite adequate liquidity buffers, credit conditions remain challenging. In the context of stable deposits, banks' Eurosystem liquidity exposure declined gradually since its peak in June 2012 and stood at about €51 billion in November 2013, with a comfortable collateral buffer of about €30 billion covering over one year of banks' refinancing needs. Nevertheless, credit conditions remain challenging, especially among SMEs.

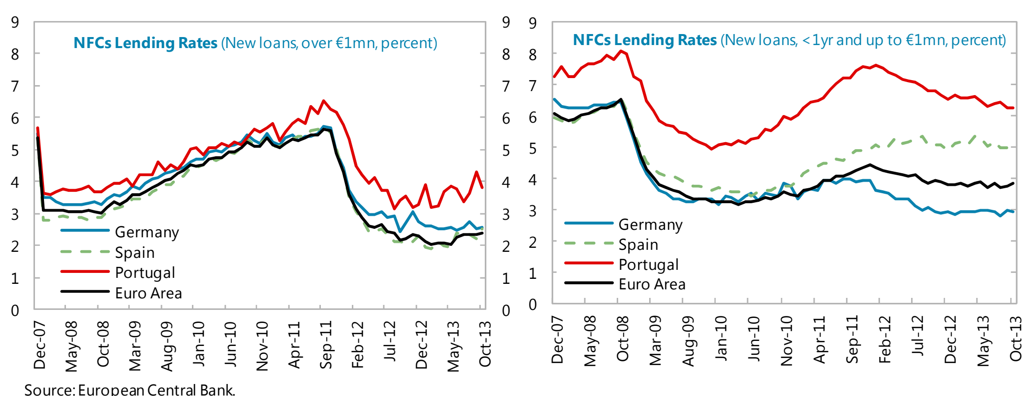


Source: Banco de Portugal.

[10] High funding costs are in particular due to the high cost of attracting retail deposits, notwithstanding the steps taken earlier by the Banco de Portugal to alleviate upward pressures on deposit rates.

[11] Further corporate deleveraging, if it proceeds in an orderly manner, is expected to benefit the banks by improving the stability of the banking system.

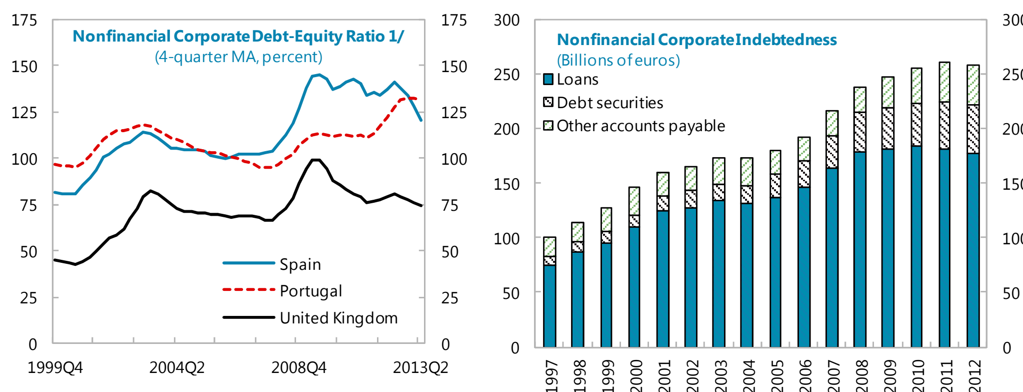
[12] The finalization of the restructuring plan of Banif, a smaller bank recapitalized in early 2013, was delayed. This delay has necessitated a rephasing of the second tranche of the recapitalization strategy, originally scheduled to be completed by end-June 2013.



Source: European Central Bank.

- Credit continues to contract in aggregate terms, reflecting the ongoing deleveraging by banks and still-weak credit demand, although the pace of decline has moderated somewhat in recent months. Nevertheless, credit developments remain consistent with the much-needed rebalancing towards the tradable sector. Loans to the nontradable sector—notably construction and domestic trade—have contracted significantly, while loans to exporting firms have grown (Figure 4).

- Reflecting banks' weak profitability and still difficult market conditions, lending rates to the corporate sector remain elevated. Notwithstanding some decline from their peaks in late 2011, rates on new business loans stay well above those in euro area peers.



Sources: Bank of Portugal; European Central Bank; and IMF staff estimates.
1/ Measured as debt-to-equity. Debt includes loans, debt securities, pension fund reserves, other accounts payables, and financial derivatives.

29. Despite the prolonged credit contraction, corporate sector deleveraging has yet to start in earnest. Notwithstanding ongoing efforts to cut labor costs and capital expenditure, the reduction in the nominal debt by Portuguese companies has been slower than the decline in nominal GDP. As a result, total debt remained above 155 percent of GDP, on a consolidated basis, as of December 2012. This persistently high indebtedness has resulted in companies' rising difficulty in servicing their debt—over 65 percent of the corporate debt is on the balance sheet of enterprises with an interest coverage ratio (ICR) of 2 or less (see Box 2)[13].

[13] It is worth noting that ICR may not always provide a complete picture of a company's capacity to repay its debt, if the company can rely on adequate cash (and liquid financial assets) to meet its debt obligations. As of 2012, Portuguese companies held about 24 percent of GDP in cash and bank deposits.

B. Policy Discussions

Safeguarding Financial Stability

30. Robust capital buffers provide the largest banks with a favorable starting position for the Comprehensive Assessment in the context of the Single Supervisory Mechanism. As agreed during the eighth and ninth reviews, starting from January 1 all banks are expected to maintain a common equity Tier 1 (CET1) capital ratio of at least 7 percent.[14] Moreover, the largest banks are expected to maintain a CET1 add-on of 1 percentage point in anticipation of the Comprehensive Assessment, to be conducted by the European Central Bank (ECB) in the context of the Single Supervisory Mechanism. Banks' projections indicate that the current levels of regulatory capital—although potentially subject to erosion through further credit impairments—allow banks to comply with the new minimum CET1 capital requirements. The Banco de Portugal (BdP) is taking further steps to ensure that the largest banks remain well positioned for the forthcoming Comprehensive Assessment.

- ***Credit Impairment***. To ensure timely and consistent recognition of losses, the BdP is developing guidelines on measuring credit portfolio impairment, incorporating best practices identified during the three impairment reviews that have been conducted since May 2011, expected to be published by mid-February. In addition, the guidelines require the institutions to promote greater disclosure of information on asset quality and credit risk management, with the aim to provide market participants with a better understanding of the institutions' risk profile. The guidelines are effective immediately, although the institutions are only expected to incorporate the additional disclosure requirements in their financial statements as of June 30, 2014.

- ***Restructured Loans***. Following the publication of draft implementing technical standards on nonperforming exposures and forbearance—developed by the European Banking Authority to enhance cross-border comparability of asset quality indicators—the BdP has amended its instruction on the identification and marking of restructured loans due to financial difficulties of the client. Among the changes are more conservative criteria that must be met before a restructured loan may cease to be marked as such, including a two-year probation period during which regular payments of principal have to be made. As a next step, the BdP intends to review its standards on nonperforming loans, in line with the timeframe set at the EU level for the implementation of relevant technical standards.

- ***Real Estate***. Real estate valuation requirements have been tightened for all institutions. As part of the implementation of the new standards, institutions have been requested to ensure that their collateral valuations remain sufficiently conservative. Banks have updated valuations of all

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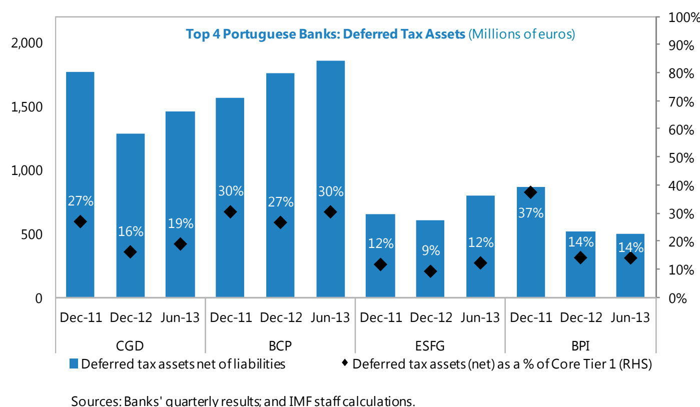
[14] This is consistent with the capital requirements prescribed by the CRD IV package, which transposes—via a Regulation and a Directive—the Basel III standards on bank capital into the EU legal framework. In computing regulatory capital, banks are expected to comply with all the transitional provisions related to the definition of capital, including the gradual phase-in of regulatory deductions.

real estate assets that have been obtained in lieu of payment and whose last valuation was done before July 31, 2012. The BdP will verify compliance with these requirements by the second quarter of 2014.



Sources: Banks' quarterly results; and IMF staff calculations.

31. In light of the recent initiatives in some other euro area member states, staff discussed with the authorities the possibility for a conversion of deferred tax assets (DTAs) to counteract mandatory deductions under CRD IV. DTAs are assets on banks' balance sheets that can be used to reduce future corporate income tax payments. As in other euro area member states, Portuguese banks have built up a significant position of DTAs, arising largely from temporary differences between the accounting treatment of loan loss provisioning and the tax deductibility thereof.[15] Under CRD IV, DTAs that rely on future profitability of the bank are to be gradually deducted in the calculation of CET1, recognizing that DTAs only create value if a bank can generate sufficient taxable income against which they can be offset. Such deductions can be averted by replacing the DTAs with tax credits that can be offset against the institution's tax liabilities and, under certain circumstances, constitute a direct claim on central government. Staff was of the view that while a conversion of DTAs to nondeductable tax credits would have a positive effect on the bank's forward-looking capital ratios, it would be important to guard against a materialization of fiscal liabilities. Moreover, it is advisable to ensure that any DTA conversions are contingent on actions that contribute to the strengthening of the bank's balance sheet. Such actions could include simultaneous equity issuances, additional provisioning, and disposals of distressed assets.

32. Staff welcomed the BdP's continued efforts to further strengthen the banks' quarterly stress tests (Box 3). The BdP further enhanced the quality assurance and review process of the bottom-up results and designed a top-down stress testing framework. As a next step, it was agreed that the top-down stress testing framework will be integrated into the quality assurance process in the next round of quarterly stress tests, to be finalized in February 2014 (MEFP ¶15). The BdP will also enhance the coverage of relevant risk factors, and align the framework as much as possible with the ECB's 2014 stress test. Resources from the Bank Solvency Support Facility (€6.4 billion) remain available to provide support to the banking system should further capital needs emerge, and such support will be subject to State-aid requirements, notably, the burden sharing rules envisaged therein.[16]

[15] At end-June 2013, DTAs (net of deferred tax liabilities) for the four largest banks were about €4.5 billion, amounting to approximately 19 percent of their aggregated Core Tier 1 capital.

[16] Amendments to Law 63-A/2008 of November 24, 2008, reflecting the new State-aid regime, entered into force on January 17, 2014.

Facilitating Orderly Corporate Sector Deleveraging and Promoting Access to Credit for Viable Firms

33. Staff stressed and the authorities agreed that stepped-up efforts from both banks and firms are needed to facilitate an orderly corporate sector deleveraging, which would in turn support financial stability. While the enhancement of the legal framework for both in-court and out-of-court procedures is complete, early utilization of the new restructuring tools remains unsatisfactory. It is therefore essential to reshape the incentives in order to promote greater utilization of the restructuring tools and improve firms' recovery prospects. More importantly, the corporate debt overhang poses significant risks to the banking system and, if left unaddressed, could weigh on medium-term growth prospects. In this regard, staff welcomed the authorities' ongoing efforts and urged continued exploration of further policy options.

- In an effort to ensure that banks engage with troubled debtors before their viability is in jeopardy, the BdP, supported by an external advisor, has finalized the Special Assessment Program (SAP) that sought to review the policies and procedures of the eight largest banks in the area of distressed loan management (DLM).[17] Recommendations have been issued to each participating bank, taking account of the banks' portfolios, size, and business model.

- In the context of an in-depth review of the national guarantee system (see below), a new guaranteed credit line has been designed for viable firms that have successfully completed a corporate debt restructuring process and effectively reduced nominal debt level. The general guidelines are being finalized and a pilot—within the existing budgetary envelope—will be initiated by end-March 2014.

34. At the same time, the authorities remain committed to promoting access to credit for viable firms, under a three-pronged strategy.

- ***Facilitating continued access to credit for viable firms***. While banks have been able to reduce gradually their exposure to the Eurosystem since its peak in mid-2012, the continued provision of exceptional liquidity at long maturities plays a critical role in preventing a supply-driven credit crunch. In parallel, the use of government guarantees continues to represent an important tool to support continued access to credit by viable firms, with €1.7 billion in guaranteed credit extended as of end-2013 (SME *Crescimento* line). In this context, staff welcomed the progress made by the authorities in improving the efficiency of the national guarantee system, in particular the competitiveness and transparency of the current pricing system. A development financial institution (DFI) is being established to channel EU structural funds more efficiently (MEFP ¶20). Staff stressed the need to avoid any additional burden on or risks to public finances. In particular, staff was of the view that (i) the sole purpose of the DFI should be to address

[17] The key aspects of effective DLM frameworks include organizational structure, processes and tools, talent and personnel, analytics, management information and reporting, infrastructure and technology, and customer resolution policies and strategies.

market failures in the financing of private nonfinancial corporations, notably SMEs; (ii) the DFI should not accept deposits or other repayable funds from the public, nor engage in direct lending; and (iii) its final design should be consistent with a consolidation within the general government, in line with national accounts rules.

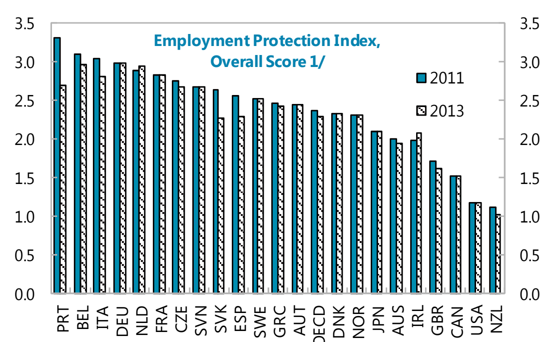
- ***Promoting alternative funding sources***. As part of the authorities' initiatives to promote access to capital markets, notably for SMEs, necessary changes have been made to the regulatory environment applicable to the commercial paper market, with a view to facilitating its expansion among a wider investor base. In parallel, the authorities continue to discuss with their European partners further initiatives to support funding conditions, including potential mechanisms to securitize SME credit as well as banks' high-quality mortgage portfolios (MEFP ¶20).
- ***Reducing information asymmetry***. Given the important role played by credit bureaus in providing the necessary information to access firms' credit standing, the BdP has proposed changes to the legislation governing the Central Credit Registry. Once passed, the new legislation will allow banks to have access to companies' historical credit background and to their financial situation, as recorded in the central balance sheet database (MEFP ¶21).

BOOSTING COMPETITIVENESS AND GROWTH

As the program draws to a close, a large number of structural reforms initially identified as priorities to improve the functioning of the labor and product markets, boost productivity, and improve the business environment have been legislated. Yet it remains unclear whether these steps will be sufficient to generate a strong supply response and to engender a sustainable export-led model. The key challenge is to translate Portugal's impressive roster of adopted measures into effective change, while sustaining efforts to identify and tackle remaining impediments to competitiveness and growth.

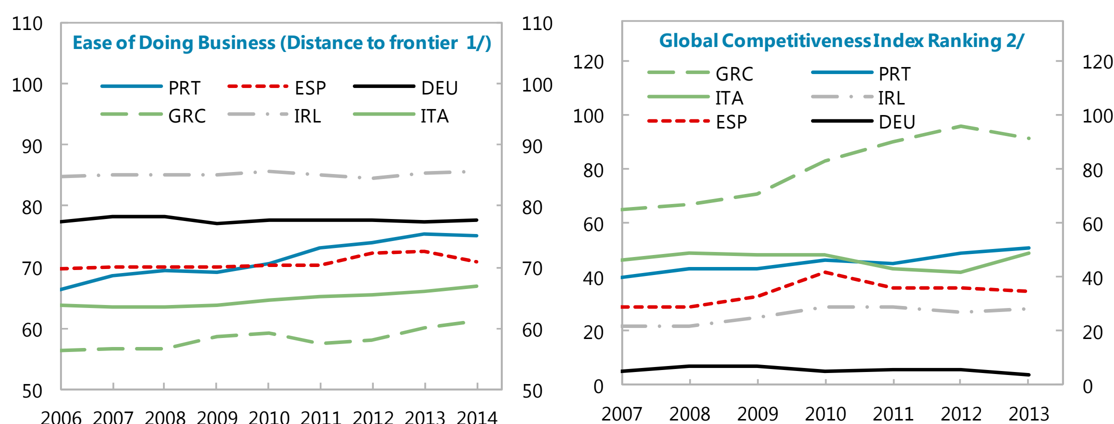
A. Background

35. Two and half years into the program, significant statutory reforms have been enacted, with visible impact on employment protection legislation (EPL) and business climate indicators (see Annex I).[18] Steps have been taken to enhance labor market micro- and macro-flexibility, and active labor market and education policies have been overhauled to reduce labor market mismatches (see Box 4). The competition framework, regulatory environment, and product markets (particularly in network industries, transport, and services) have been reformed to foster competition and reduce rents (see Box 5). Efforts have been made to improve the business environment,



Source: OECD.
1/ A higher value corresponds to a greater level of employment protection. The 2013 index includes the regulations in force on Jan 1, 2013, and as such do not take account of the most recent reduction in severance payments in Portugal. The cut in severance pay entered into force in October in Portugal should lead to a further improvement in the index.

[18] These indices, however, measure legislative changes, not effective change.



Sources: World Bank; and World Economic Forum.
1/ Distance to Frontier for Overall measure (without electricity): This measure shows the distance of each economy to the "frontier". The frontier represents the highest performance observed across all economies measured in *Doing Business* since the inclusion of the indicator. An economy's distance to frontier is reflected on a scale for 0 to 100, where 0 represents the lowest performance and 100 represents the frontier.
2/ A lower rank corresponds to a more advantageous competitive position.

including by cutting red tape and raising the efficiency of the judicial system. These reforms have already led to upgrades in indices of EPL restrictiveness, business environment and overall competitiveness (see charts). And further improvements are expected given the lagging nature of these indicators.

36. Other measures of the impact of reforms have been equivocal, amidst signs of still-significant nominal rigidities. Unit labor costs have decreased somewhat in the private sector—with a faster decline in the tradable sector than that in the nontradable sector. However, this has been driven in large part by the rapid recession-induced labor shedding—with the unemployment rate remaining uncomfortably high—and related productivity gains, putting the sustainability of these developments in question. In addition, there are still indications of significant nominal wage rigidity. In spite of the reforms implemented to date, there remain significant upward pressures on electricity prices; and the benefits of the reforms in the ports sector have yet to be fully passed through to the prices charged to end users (see below). While some measures of relative prices are moving in the right direction, relative mark-ups still point to a significant premium for the nontradable sector.

37. However, durable rebalancing of the economy from the nontradable sector to the tradable sector requires more flexibility and productivity gains. Nominal wage flexibility is important to ensure that wage costs adjust to productivity, including in the nontradable sector. Further efforts to tackle rents, increase productivity, and reduce nontradable prices are critical to reducing input costs for exporters and boosting competitiveness. This is also important to ensure that the burden of the required adjustment does not fall excessively on labor.

B. Policy Discussions

38. Staff expressed concerns that reforms implemented so far may not be sufficient to generate a strong supply response and engender a sustainable export-led model. While recognizing that reforms take time to bear fruit and can even hamper growth in the short term, staff highlighted the remaining significant nominal rigidities. Staff noted that with imports of investment goods and consumer durables likely to recover from unusually low levels, higher savings would be necessary to support a lasting turnaround of the current account, consistent with a gradual improvement in the large negative international investment position (-109 percent of GDP at end-2013). This will only be achievable with stronger and sustained export growth. Yet, the recent green shoots have been driven mainly by a normalization of domestic demand, amidst a reduction in the contribution of net exports to growth. Staff also stressed that more visible reductions in input costs for the tradable sector, including nonlabor costs, would be necessary to boost competitiveness. In addition, a lasting reduction in unemployment would also be critical to achieving higher sustainable growth over the medium term.

39. Against this backdrop, staff called for a more systematic evaluation of reform implementation and for efforts to sustain the reform momentum. One important challenge is to ensure that the adopted measures translate into effective change. Accordingly, the reforms must be continuously evaluated against outcomes to ensure that they deliver the desired results. At the same time, staff called on the authorities to sustain efforts to identify and tackle remaining impediments to competitiveness and growth. Staff stressed that continued structural reform efforts will have to be the centerpiece of a credible push for sustainable growth in the coming years, irrespective of the post-program financing strategy. In light of the constraints imposed by the monetary union, efforts should focus on further increasing competition and flexibility in product and labor markets with the aim of facilitating sustained rebalancing of the economy from the nontradable to the tradable sector.

40. The authorities had a more positive assessment of the impact of reforms. They stressed that most reforms identified under the program had already been implemented. They believed flexibility and rebalancing were at play, as demonstrated by the spectacular turnaround in the current account. In particular, they thought that the declines in unit labor costs had helped close the competitiveness gap and would lead to continued strong export growth. They also saw the recent positive output and employment data as encouraging signs that the reforms were already bearing fruit. The authorities were concerned by the lack of investment, including FDI. However, they thought that partly reflected misperceptions regarding the depth of the structural change the economy was undergoing. While they concurred that sustaining the reform effort was important, they thought priority should be given to making public administration more effective in supporting business activity and to refocusing institutions and policies toward investment promotion.

41. While discussions on new reform priorities will continue during the upcoming reviews, there was agreement on the steps to be taken in the near term. In addition to the ongoing actions to promote the proper functioning of the competition and regulatory authorities (MEFP

¶27), to increase competition in the services sector (MEFP ¶28), and to streamline licensing procedures (MEFP ¶29), the authorities' near-term agenda will focus on:

- Alleviating the economic consequences of the recent Constitutional Court decision to overturn labor code provisions intended to soften employment protection rules for individual dismissals. To this end, legislative amendments will be submitted to Parliament by end-January 2014 (MEFP ¶24).

- Assessing policy options to ensure more effective decentralization of wage bargaining, encourage wage flexibility, and reduce incentives to challenge individual dismissals in court.[19] Policy proposals will be discussed at the time of the eleventh review.

- Ensuring full transmission of the lower labor costs generated by the new Ports Work Law to end-users of port services. To this end, the government will launch negotiations with existing port concessionaires during the first quarter of 2014 (MEFP ¶26).

- Identifying further policy measures to limit future electricity price increases for end-users, including by tackling excess rents in the sector. These measures will be discussed with staff at the time of the eleventh review.[20]

- Implementing judicial reform measures targeted under the program, all of which have now been adopted and most are in force. Among priorities are the implementation of the Judicial Organization Act to enable a smooth roll out in 2014, and the setting up of the agency to enhance the supervision of enforcement agents and insolvency administrators (CAAJ) scheduled for the first half of 2014.

FINANCING, RISKS, AND PROGRAM MODALITIES

42. The near-term financing outlook has improved in recent months, but medium-term financing challenges remain. Government bond yields have declined rapidly in recent months, allowing for a debt swap that smoothed the 2014-15 amortization profile, and a sizeable new bond issue. The authorities have also launched successfully a new retail instrument.[21] In light of this and

[19] The latter incentives may indeed have been reinforced by the recent new reduction in severance pay for fair dismissals and the concurrent widening of the gap between severance pay for fair and unfair dismissals.

[20] With the electricity system costs determined independently of the level of demand—mainly through contracts with generators that hedge the sale price from the market price—and with the prices paid by the final users below these costs—the electricity system is generating a "tariff deficit." The related electricity system debt is owed by the final user. In the absence of new measures to better balance the burden of reducing the tariff deficit between the various stakeholders of the electricity sector, including by tackling producer rents more forcefully, large electricity price increases would be necessary to meet the authorities' objective to eliminate the electricity system's debt by 2020.

[21] On October 30, 2013, a new retail savings instrument (CTPM) was successfully launched, with close to €650 million raised by end-December 2013. The instrument has a step-up interest rate, starting at 2.75 percent in the first year and increasing by 100 basis points each year, up to a maximum of 5 percent. In addition, a growth premium will be

(continued)

the government's comfortable cash buffers (about €9 billion before the recent bond issue), under baseline assumptions financing assurances over the next 12 months are in place.[22] Nonetheless, medium-term financing needs are large. Even after the maturity extension for EFSF—and more recently EFSM—loans, refinancing needs will average about 7 percent of GDP per year in the next few years. With a sub-investment grade rating and sovereign yields still highly susceptible to global market developments, solid program performance and continued political stability will be critical to ensure durable market access of the magnitude needed to cover these funding needs.

43. Notwithstanding the recent improvement in financing conditions for the public and private sectors, exceptional access remains justified. Exceptional access under the program remains critical to addressing Portugal's funding needs (Criterion 1). While staff considers public debt to be sustainable over the medium term, this cannot be asserted with high probability. However, systemic risk from contagion to other vulnerable euro area countries, should the sovereign fail to service its debt, continues to justify exceptional access (Criterion 2). Barring a reversal in the recent improvements in market sentiment, prospects for sustaining market access within the period that Fund resources are outstanding remain good, although the potential scale of market access is still uncertain. Nevertheless, commitments by euro area leaders to support Portugal until full market access is regained—provided the authorities persevere with strict program implementation—give additional assurances that financing will be available to repay the Fund (Criterion 3). Despite political and legal risks, prospects for program success remain reasonably strong, given the authorities' solid implementation capacity and commitment to the program objectives (Criterion 4).

44. Capacity to repay the Fund remains adequate. The Fund's exposure to Portugal is projected to rise to 16 percent of GDP in 2014, with debt service expected to peak at 5.3 percent of exports of goods and services or 2.5 percent of GDP in 2018. Despite political tensions that surfaced in the summer of 2013 and legal risks surrounding public expenditure reforms, as demonstrated by the recent Constitutional Court decision that struck down a key pension reform measure, program implementation capacity remains strong. The observed turnaround of external imbalances provides additional assurance that adequate resources will be available to repay the Fund.

45. Despite recent gains, there are notable downside risks to the attainment of the program's objectives. While the government was quickly able to introduce offsetting measures after the Constitutional Court struck down a key pension reform provision, other parts of the budget were subsequently challenged. Should those challenges succeed or should downside risks to the macro-fiscal outlook materialize, prompt policy action to ensure that the fiscal objectives are not compromised will be essential for maintaining the hard-won market confidence. In addition,

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added in the 4th and 5th years, amounting to 80 percent of average real GDP growth observed in the last four quarters

[22] New long-term bond issues are expected in the coming months; even without such issuance, financing needs over the next 12 months can still be met through limited net issuance of retail products and bond purchases by the social security fund in the primary market as part of its ongoing portfolio reallocation.

Portugal—with its high debt and large refinancing needs—is uniquely susceptible to changes in market sentiment, which is in part driven by changes in global financial conditions.

46. The authorities request a waiver of applicability of end-December 2013 performance criteria. The controlling performance criteria for the tenth review are those set for end-December 2013. The authorities, however, request a waiver of applicability, since (i) the final data to assess performance for end-December is not yet available and (ii) there is no clear evidence suggesting that the performance criteria might not be observed.

STAFF APPRAISAL

47. Program implementation is on track despite recent legal setbacks. The end-September 2013 performance criteria were met comfortably, and fiscal measures were implemented to offset the budgetary slippages identified at the time of the eighth and ninth reviews. Preliminary estimates indicate that the 2013 budget deficit target was achieved comfortably. A 2014 budget consistent with understandings reached at the time of the previous review was promulgated in December. In response to the adverse ruling on December 19 by the Constitutional Court invalidating the CGA pension reform measure, the authorities have devised offsetting measures in order to reaffirm the fiscal deficit target of 4.0 percent of GDP contained in the 2014 budget, and are in the process of developing new measures as part of the ongoing pension reforms, in line with the Court ruling. Submission to Parliament of the revised CES through a supplementary budget and approval by the Council of Ministers of the decree law on the change in contributions to the special health insurance schemes are prior actions for completion of this review.

48. Risks to attaining the objectives of the program, however, continue to remain high. In the short term, successful legal challenges to the 2014 budget could undermine the quality of fiscal adjustment, with attendant negative consequences for the recovery of output and employment. In addition, with its high debt ratios and large refinancing needs, Portugal remains susceptible to any abrupt changes in market sentiment—notwithstanding recent improvements. In the medium term, the large turnaround in external balances seen in recent years may partially reverse if the compression of imports and rise in fuel exports reverse too abruptly; both the drag on growth and impact on bank balance sheets from the required private sector deleveraging may exceed expectations; and the implemented statutory structural reforms may not be sufficient to generate the needed strong supply response. It will be important to ensure that a sense of complacency about structural reforms does not take hold.

49. Broad political consensus is needed to ensure that the fiscal consolidation efforts undertaken over the past three years are sustained and taken to conclusion. In order to ensure that public debt is firmly on a declining trajectory, pressures to increase public expenditures will have to be firmly resisted for at least several political cycles, while any tax reform measures will need to be accommodated within the overall budgetary envelope. Efforts at rationalizing public administration need to continue, given Portugal's relatively high level of primary expenditures, of which a large share is for wages and pensions. Moreover, significant expenditure rationalization will

be needed to address the still large gap between social transfers and social contributions, the narrowing of which would also improve intergenerational equity. While some of these efforts have encountered legal challenges, the authorities will need to continue to find alternatives as they have again done in regard to the now-overturned CGA pension reform. While such alternatives are second best from the point of view of growth and employment, there is no alternative to continued consolidation efforts given Portugal's very high debt levels.

50. Continued fiscal structural reforms will be critical to maintaining sustainable public finances and ensuring hard budget constraints across the general government. The refinements to the budget framework law and the review of the underlying PFM processes are an important step forward. Addressing the significant problem of arrears will require more forceful implementation and enforcement of the Commitment Control Law. The progress made in renegotiation of PPPs, SOE restructuring, and the steps to strengthen revenue administration need to be sustained in order to generate further permanent savings and limit budgetary risks.

51. Preserving financial stability while promoting access to credit is necessary to facilitate a durable recovery. While robust capital buffers provide the largest banks a favorable starting position for the EU-wide Comprehensive Assessment, the challenging economic environment requires sustained vigilance with regard to the health of banks' balance sheets. In this context, the BdP's ongoing efforts to further strengthen quarterly stress tests will provide an additional degree of confidence in the soundness of the financial system and its ability to withstand shocks. Despite the uncertainties surrounding the outcomes of the Comprehensive Assessment, the remaining buffer in the BSSF provides reasonable assurance that any additional funding need can be covered under the current envelope. Given the high levels of corporate debt which are tying up bank credit, stepped up efforts are needed to reduce the overhang of private debt and free up credit for lending under better terms, paving the way for a more robust pick-up in private investment and improved external competitiveness. In addition, other measures to provide access to funding for viable firms in the case of a clear market failure would be helpful.

52. Portugal's efforts at debt and external sustainability rely crucially on raising the economy's underlying growth potential through structural reforms and more progress is needed in several areas. Current levels of net investment will erode the economy's capital stock and therefore need to be raised. Much of this new investment will need to be in the tradable sector in order to generate the sustained external surpluses necessary to unwind decades of deficits. Reducing the overhang of corporate debt would help free up resources for investment in these new areas and reduce the drag on overall investment. The persistence of rents in the nontradable sector needs to be addressed decisively to improve the economy's growth potential and underlying competitiveness. Priorities in this regard should include areas crucial to external competitiveness such as energy and transport infrastructure. In the absence of such reforms, the burden of adjustment would fall excessively on the labor force. Continued reforms to strengthen flexibility in the labor market are also important in order to address the challenges from very high unemployment. Structural reforms to address distortions need to be a continuous and longer-term

process and need to integrate a rigorous evaluation of the efficacy of past reforms for their effectiveness.

53. Continued external support and effective crisis management at the euro-area level are important for the success of the program. While strong implementation of the program is a necessary condition to regain durable market access, institutional reforms and strong crisis management policies at the euro area level are also essential to help Portugal remain resilient to shocks. In view of still substantial medium-term financing challenges, the commitment by European leaders to support Portugal until full market access is restored, provided that program implementation is on track, continues to provide valuable financing assurances.

54. Staff recommends completion of the tenth review and the granting of waivers of applicability of end-December 2013 performance criteria.

Box 1. Portugal: External Adjustment and Competitiveness

External adjustment is taking place at a faster pace than envisaged under the program. Having peaked at about 12¾ percent of GDP in January 2009, the current account deficit rapidly narrowed and turned into a small surplus in September 2013. About three quarters of this adjustment took place since May 2011, when the program started. At that time, the cumulative adjustment over 2009-13 was projected at less than 7 percent of GDP, just over a half of the adjustment that has actually taken place.

The external adjustment has in large part been driven compression of nonfuel imports and—lately—growth of fuel exports. While export growth accounts for close to 60 percent of the improvement in the current account since January 2009, this has largely been driven by fuel exports that more than doubled during the same period (fuel accounted for about a quarter of the cumulative increase in exports). The share of export growth attributed to fuel products is now close to 60 percent, up from less than 10 percent in 2009. At the same time, with an increase of 15 percent between January 2009 and October 2013, fuel imports have been the largest contributor to import growth, masking the underlying compression of non-oil imports. In nominal terms, just under half of the adjustment in the trade balance is due to the compression of non-oil imports, one third due to non-oil export growth, and one sixth due to the improvement in the services balance (in turn largely driven by buoyant tourism receipts). This reliance on compression of nonfuel imports and on fuel exports risks undermining the gains to date when imports recover from the unusually low levels and oil refining facilities eventually exhaust their spare capacity,[1] while the improvement in the services balance is vulnerable to shocks to tourism demand. For instance, the increase in service exports to France (2½ percent) may reflect a diversion of French tourists from countries in the Maghreb to Portugal that may reverse.[2]

The pace and composition of Portugal's external adjustment is comparable to that of its peers. Portugal's cumulative current account adjustment in percent of GDP is roughly at par with Ireland's and only marginally smaller than those achieved by Greece and Cyprus. While Portugal's adjustment was initially the slowest among the periphery countries, it has caught up rapidly. Relative to a broader sample of euro area countries that are correcting external imbalances in the wake of the European debt crisis, the composition of adjustment is in line with the average.

Adjustment in relative prices has lagged behind. Labor shedding and wage cuts have lowered unit labor costs, which are now 5½ percent below its peak in the first quarter of 2009. Portugal's real effective exchange rate (REER) deflated by ULC has depreciated by some 8 percent since then, while the reduction in the CPI-based REER has been more limited (2½ percent). Relative to other euro area countries that are correcting external imbalances, the improvement in Portugal's price competitiveness indicators has been somewhat below average. In view of the already limited improvement, it is concerning that some of the gains in these indicators have been reversed recently.

Coupled with the need to reduce Portugal's sizeable stock of external liabilities, further gains in competitiveness may be needed to ensure the sustainability of the external adjustment. With a negative IIP estimated at 109 percent of GDP in 2013, sustained surpluses will be needed to bring external liabilities to more healthy levels. Although the current account surplus is projected to gradually increase over the medium term, Portugal's net external liabilities are still projected to be in excess of 70 percent of GDP by 2019, underscoring the need to achieve further gains in competitiveness to strengthen the sustainability of the external adjustment.

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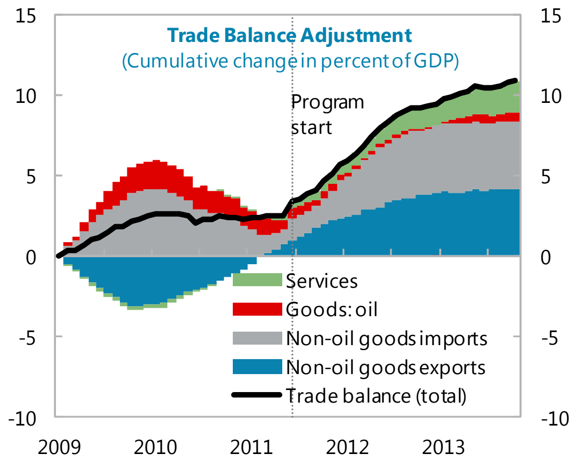
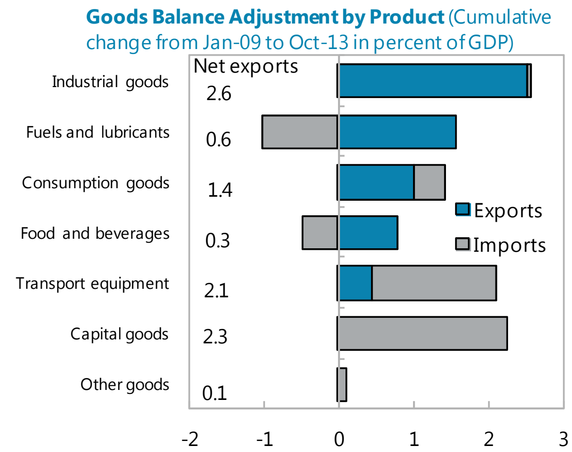
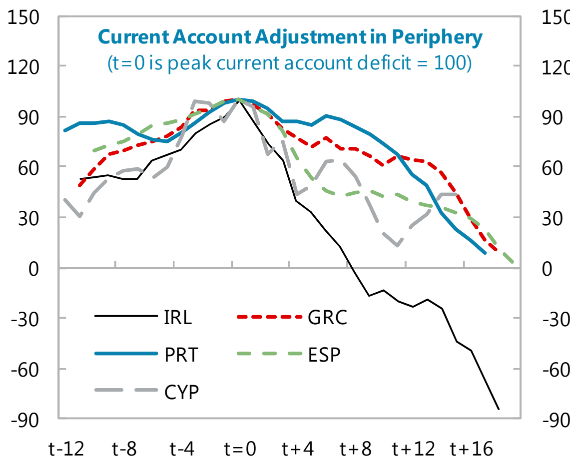
[1] In view of the recent expansion in refining capacity, this is not likely to happen in the short term.

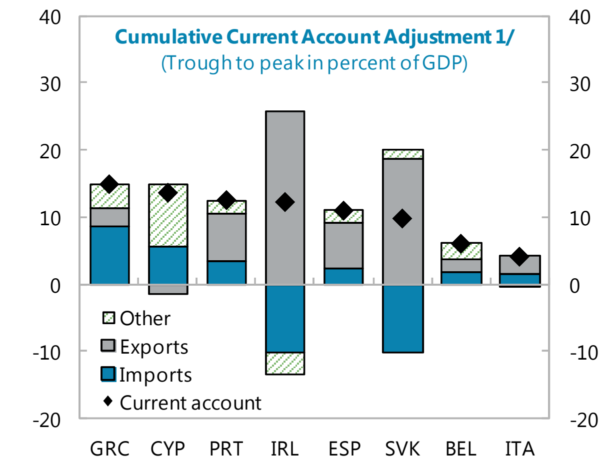
[2] While France accounts for some 20 percent of the increase services exports in the first ten months of 2013 (in nominal terms), it contributed 15 percent to the increase in hotel nights spent in Portugal by nonresidents. As travelers from the UK and Germany account for 30 and 20 percent of this increase, respectively, buoyant tourism demand does not only reflect this substitution effect.

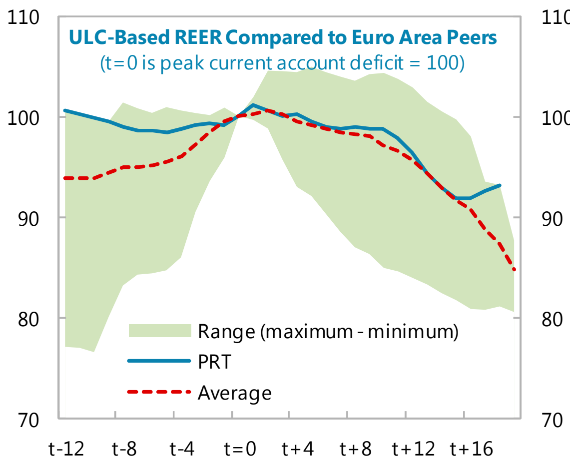
Box 1. Portugal: External Adjustment and Competitiveness (concluded)

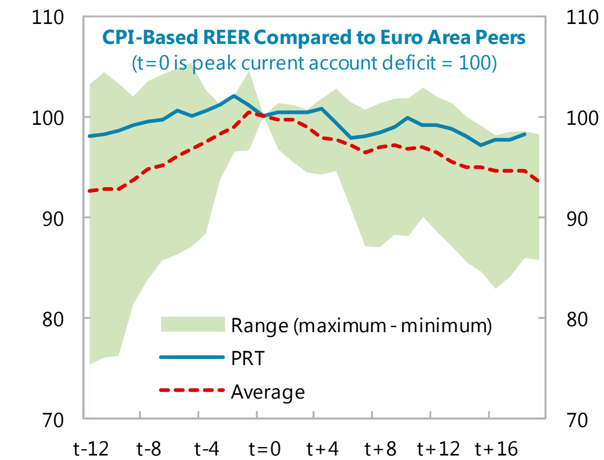










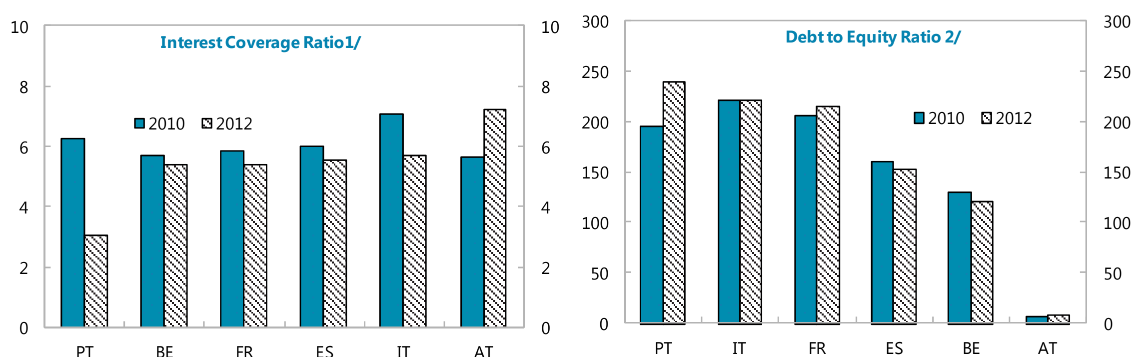


Sources: Bank of Portugal; IMF, *International Financial Statistics*; IMF, *World Economic Outlook*; and IMF staff estimates.
1/ The sample includes countries that turned a current account deficit of at least 3 percent of GDP into a surplus or narrowed the deficit by at least 10 percent of GDP. The date at which the current account deficit peaked varies between countries.

Box 2. Portugal: Corporate Debt Restructuring

Debt restructuring tools have been an essential part of a multifaceted strategy to help the corporate sector deleverage. Insolvency and debt restructuring tools were revamped, in line with best international practices. A few tax policy measures were advanced, such as making it possible for positive variation in assets following a debt restructuring and capital gains originating from mergers or acquisitions to be tax-exempt. The government is also trying to stimulate equity investment. For instance, public resources are being channeled through private equity funds aiming at enterprises with growth potential.

However, statistics are pointing to a slow pace of corporate debt restructuring. With debt on an upward trend since before the crisis, surpassing 150 percent of GDP at the end of 2012 and debt-to-EBITDA close to 14 at 2013Q2, the Portuguese corporate sector remains amongst the most leveraged in the Euro Area (EA). Despite companies' deep cuts into labor costs and capital investment, key metrics of corporate leverage have continued to deteriorate. For example, the average interest coverage ratio has declined substantially between 2010 and 2012, compared to other EA countries.



Source: BACH database.
1/ Defined as EBITDA/interest on financial debt.
2/ Defined as total liabilities over total equity.

Portugal is missing a catalyst that can trigger debt restructurings. Companies are delaying debt restructurings often beyond the point where they can still be recovered. Data on the use of the two most recently introduced restructuring mechanisms, PER and SIREVE, show not very high numbers of companies using these toolkits, i.e., a little over 1500 companies have gone or are going through PER and-about more than 300 through SIREVE, as of September 2013, mostly Micro and SMEs.[1] At the same time, some companies try to initiate debt restructurings to delay inevitable insolvencies, consuming scarce judicial resources. Furthermore, with companies sometimes exposed to a large number of banks, it can also prove difficult and lengthy to find an agreement among creditors.

But having the corporate sector deleveraging is of paramount importance to help improve external competitiveness and sustain durable growth. When struggling to service their debt, companies often shift to a survival mode in detriment of the management of their businesses. And there is plenty of evidence on how overleveraged corporate sectors can be a drag on growth (see "Portugal's Corporate (De)Leveraging" in *IMF Country Report 13/19*). It is also important to bear in mind that overleveraged corporate balance sheets will remain a challenge to the proper functioning of the monetary transmission mechanism—with Portuguese firms likely continuing to face tighter credit conditions than their EA peers—and will remain an important source of risk to banks' balance sheets as well.

[1] PER was introduced in May 2012 as a special, fast-track in-court procedure by which pre-arranged restructuring plans can be approved rapidly by court. SIREVE was introduced in September 2012 to provide a new formal out-of-court restructuring toolkit in addition to the existing, voluntary out-of-court corporate debt restructuring mechanism.

Box 3. The Stress Testing Framework for the Portuguese Banking System

The quarterly solvency stress testing exercises under the program have come a long way. These tests have been performed, on a quarterly basis, by the largest Portuguese banks, and were based on common macroeconomic scenarios and key assumptions, but different asset classification methods, risk parameter definitions, and deleveraging assumptions. For the tests under the tenth review, banks applied the new capital framework. This included the new CRD IV / CRR common equity tier 1 (CET1) definition that is replacing the BdP's Core Tier 1 definition in 2014, considering the CRD IV / CRR transitional provisions. No consideration has been given to the potential conversion of the deferred tax assets into tax credits that would, as per Article 39(2) of the CRR, not be subject to deductions from banks' CET1 capital (also see ¶31).

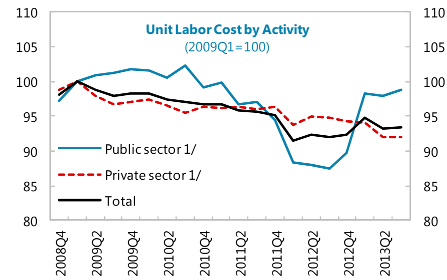
During the course of 2013, the BdP has successfully increased the rigor of the stress tests, resulting in a conservative framework that facilitates the identification of strengths and weaknesses in banks. Cross-sectional comparability of inputs (including data and parameters) and outputs has improved. The work on BdP's top-down stress testing methodology profited from a workshop with experts from other European supervisors as well as from continuous collaboration with the EC/ECB/IMF staff, clearly improving the BdP's stress testing infrastructure as a whole, and further stimulating the systematic use and strict enforcement of minimum requirements. Moreover, the benchmark default probabilities generated by the BdP's improved credit risk model now better reflect the characteristics of the adverse scenario, while remaining justifiable from risk modeling perspectives. Most banks continue to make use of the BdP's benchmark parameters, mainly due to a lack of internal credit risk models, resulting in highly constrained settings for banks that cannot base the tests on own models.

However, the framework does not yet cover all relevant risk factors. By design, the stress tests under the program have been focusing on credit and (some) market risks. Market liquidity risks have not been fully taken into account, and funding from sources that could no longer tapped into (including wholesale funding) were in many cases assumed to be replaced by ECB facilities, dampening the shocks. Sovereign risk has been stressed according to existing accounting standards, including the applicability of the prudential filter on available-for-sale sovereign exposures, and the pricing of held-to-maturity portfolios at book values. Market risks covered in the tests are equity price risk, house price risk, securitization risk (according to the EBA's methodology), general direct interest rate risk, and direct foreign exchange rate risk

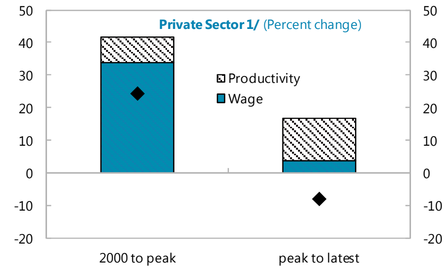
The BdP continues to improve the stress testing framework, and is preparing for the ECB's forthcoming Comprehensive Assessment, which includes an Asset Quality Review (AQR) and EU-wide stress test. Thanks to the regular reviews of banks' portfolios that BdP has been conducting in the recent years, the impact from the AQR may be less pronounced than in other countries, but this will ultimately depend on the concrete specifications of the analyses (which are unknown today). The BdP is anticipating the developments on the EU level, aligning the BdP's stress tests approach and scenarios as much as possible to European developments, including the coverage of risk factors that have not yet entered the BdP's stress testing framework.

Box 4. Portugal: Labor Market Reforms and Outcomes

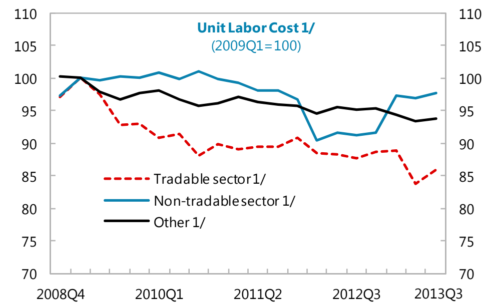
At the onset of the program, the Portuguese labor market was characterized by extreme rigidity. The key structural problems were: (i) an extreme level of employment protection, (ii) wage-setting mechanisms governed by multi-year increases in the minimum wage and sectoral collective agreements that were extended without regard to the competitive position of nonaffiliated firms, and (iii) one of the most generous unemployment benefit system in Europe.



The main objectives of labor market reforms were to foster micro- and macro-flexibility and improve the job matching process. To increase *micro-flexibility*, the severance pay was reduced to make it more in line with the EU average. The Labor Code was changed to facilitate individual dismissals. The unemployment benefit system was reformed to reduce the replacement rate, shorten duration and reduce minimum benefits. At the same time, the eligibility coverage was extended to certain groups. Steps were also taken to increase the effectiveness of active labor market policies, improve the quality of secondary/tertiary education and vocational training. To enhance *macro-flexibility*, the minimum wage was frozen for the duration of the program; the labor code was revised to facilitate working time flexibility. There was also steps taken to facilitate firm-level agreements, and a higher degree of representation was required before extension of collective agreements. *Active labor market and education policies* have also been overhauled to train the unemployed and reduce labor market mismatches.



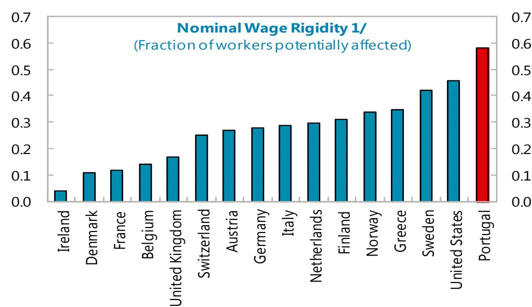
Sources: INE; DGAEP; Eurostat; and IMF staff calculations.
1/ Public sector refers to public administration, education, and social work. Private sector refers to the rest of the economy. Productivity for public sector and private sector is gross value added divided by employment.



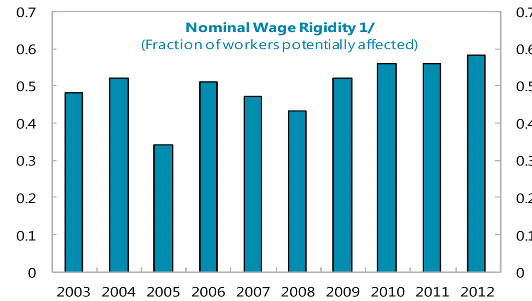
Sources: Eurostat; and IMF staff calculations.
1/ Tradable sector refers to Industry excluding Construction (includes Manufacturing). Non-tradable sector refers to Agriculture, Forestry & Fishing; Professional, Science & Tech.; Trade, Travel, Accomodation & Food. Other refers to the rest of the economy. Productivity is gross value added divided by employment.

Labor market outcomes have been mixed thus far.

- Notwithstanding the rapid fall in unemployment in recent months, the unemployment rate remains uncomfortably high at 15.6 percent, highlighting hysteresis risks.
- ULCs have decreased somewhat in the private sector, but this has been driven in large part by the rapid labor shedding experienced in the past three years and related productivity gains. However, ULCs in the tradable sector seem to have declined faster than those in the nontradable sector.
- Downward wage rigidity, measured as ratio of unchanged wages vis-à-vis wage reductions and unchanged wages, is still extremely high compared to other countries and has not changed much in recent years. This could for instance reflect the minimum wage constraint or the lack of effective decentralized wage bargaining—in spite of the economic crisis, the number of firm-level agreements has been on a declining trend since 2009 (with a slight uptick last year).



Source: Dickens et al. (2007). How Wages Change: Micro Evidence from the International Wage Flexibility Project. *Journal of Economic Perspectives*, Vol. 21, No. 2.



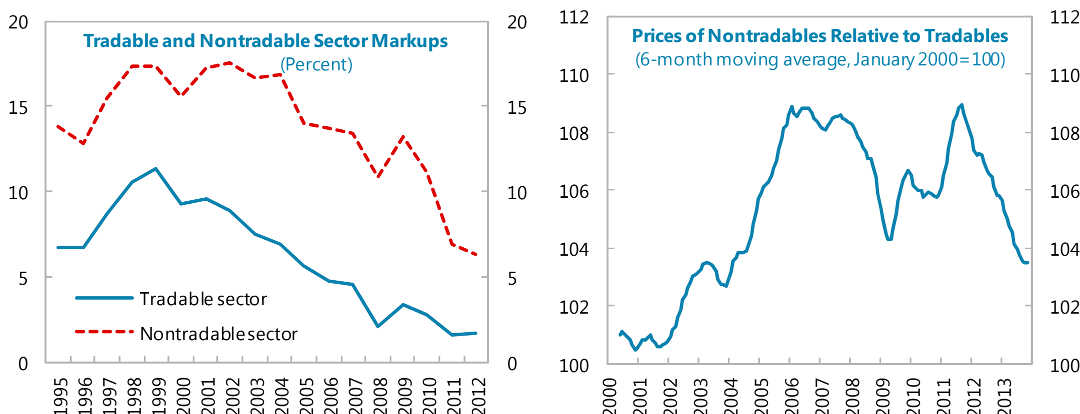
Source: Banco de Portugal; and IMF staff estimates.
1/ The index measures the number of workers with nominal wage freezes as a share of the number of workers with nominal wage freezes and the number of workers with nominal wage cuts. A higher number indicates more nominal wage rigidity.

Box 5. Portugal: Product Market Reforms

Product markets in Portugal were at the onset of the program characterized by deep-rooted structural deficiencies that had inhibited the development of the tradable sector. Impediments to competition and heavy protection in the nontradable sector had pushed up costs, encouraged rent-seeking activities in the sector, and, importantly, impeded the development of the tradable sector. Consequently, the mark-ups and the relative prices in the nontradable sector were significantly higher than in the tradable sector, which favored investment in the former at the expense of the latter.

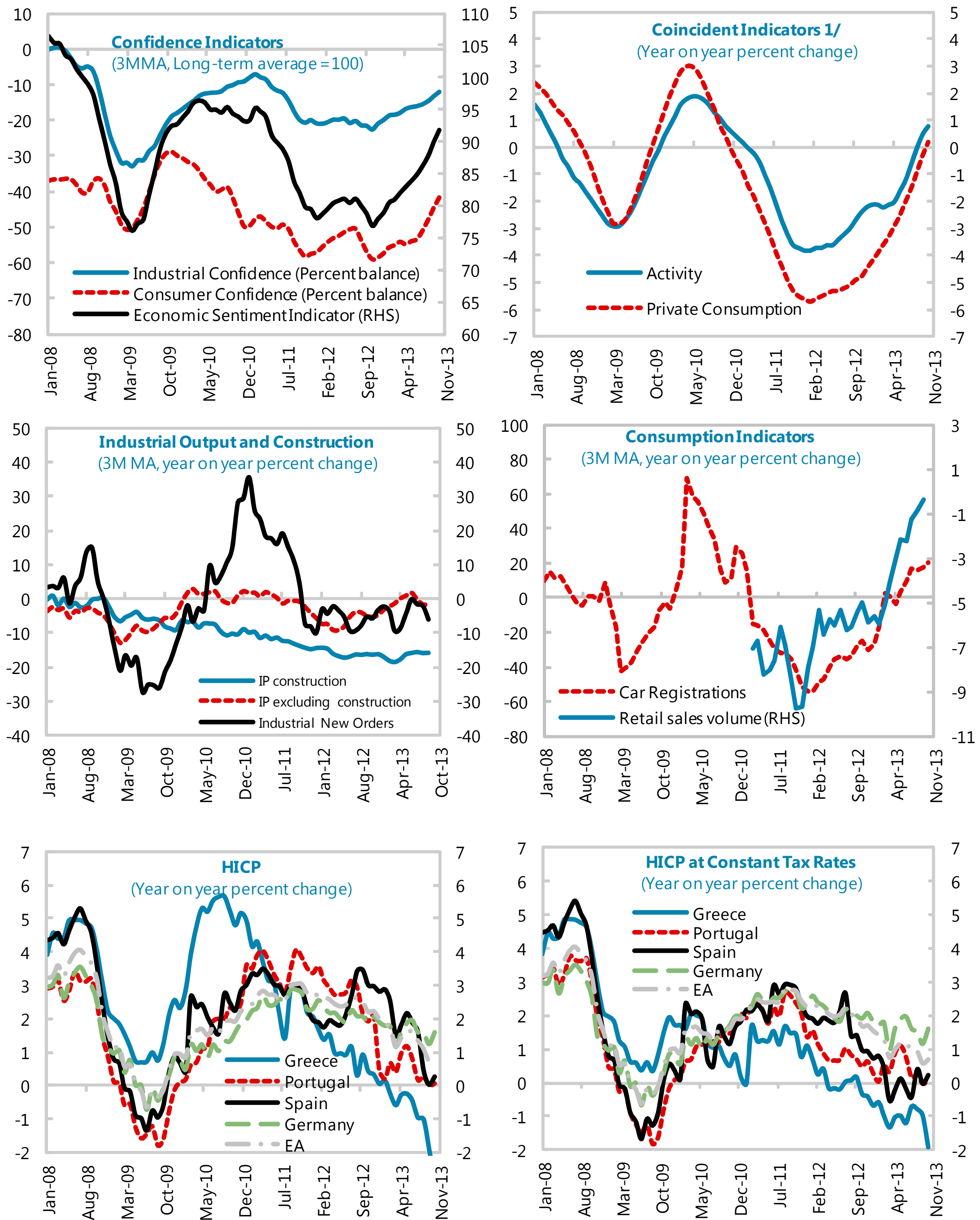
The main objectives of product market reforms have been (i) to remove policy-induced distortions constraining internal and external competitiveness and (ii) to encourage rebalancing of economic activity towards the tradable sector, thereby fostering higher sustained growth. The key reforms implemented thus far include the adoption of a new competition framework and a framework law for the functioning of regulatory bodies, both aimed at promoting market efficiency and a sound regulatory environment. Procurement rules have been strengthened. Significant steps have been taken to open up professional services and to comply with the requirements of the EU services directive regarding rules for establishment and provision of cross-border services. Sectoral reforms have been enacted in order to reduce rents in the energy sector. Steps have been taken to liberalize the gas and electricity markets, to foster competition in the telecommunication sector, and to reduce costs for exporters through targeted reforms in the transportation sector.

Outcomes in the product market have been mixed thus far. The reforms have been designed to engineer a reduction in production costs, particularly for exporters. But there are significant price rigidities at play in some areas. For example, there are significant upward pressures on electricity prices, reflecting the structure of purchasing contracts with generators. The benefits of the reforms in the ports sector have yet to be fully passed through to end-users and renegotiation of contracts with existing concessionaires will be necessary to ensure tangible results in this area. Reforms also aim at an adjustment in relative prices and profitability to underpin a durable reallocation of resources. Relative prices (expressed as the ratio of nontradable to tradable prices) have decreased markedly, currently 7.3 percent below its peak in August 2011. However, relative prices remain high compared to the levels observed in the early 2000s, indicating that further reduction is required to restore competitiveness. In addition, relative mark-ups still point to a significant premium for the nontradable sector.



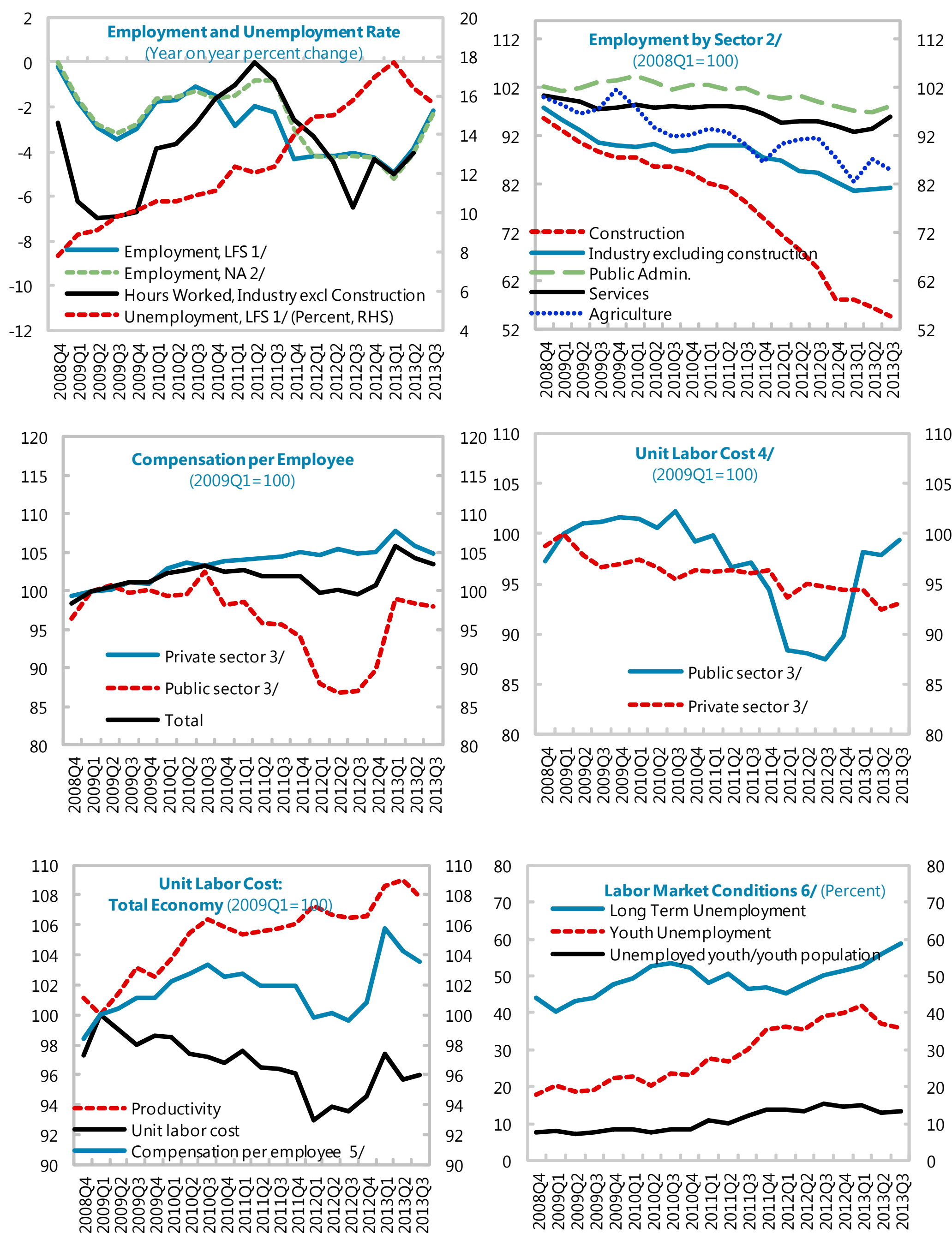
Sources: INE; Eurostat; and IMF staff estimates.

Figure 1. Portugal: High Frequency Indicators



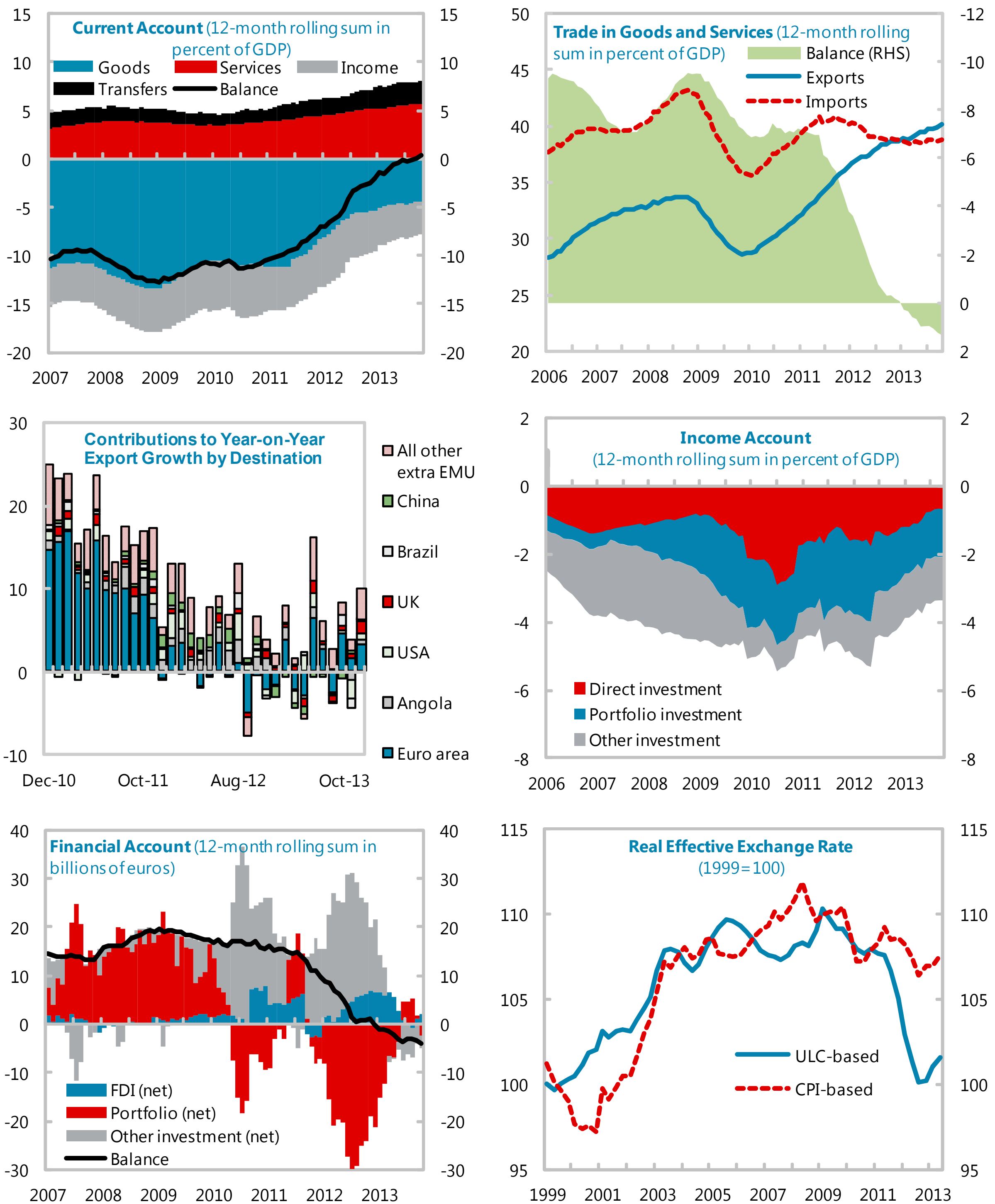
Source: Statistical Office of the European Communities; European Commission; Bank of Portugal; and Fund staff calculations.
1/ Calculated by the Bank of Portugal.

Figure 2. Portugal: Labor Market Indicators



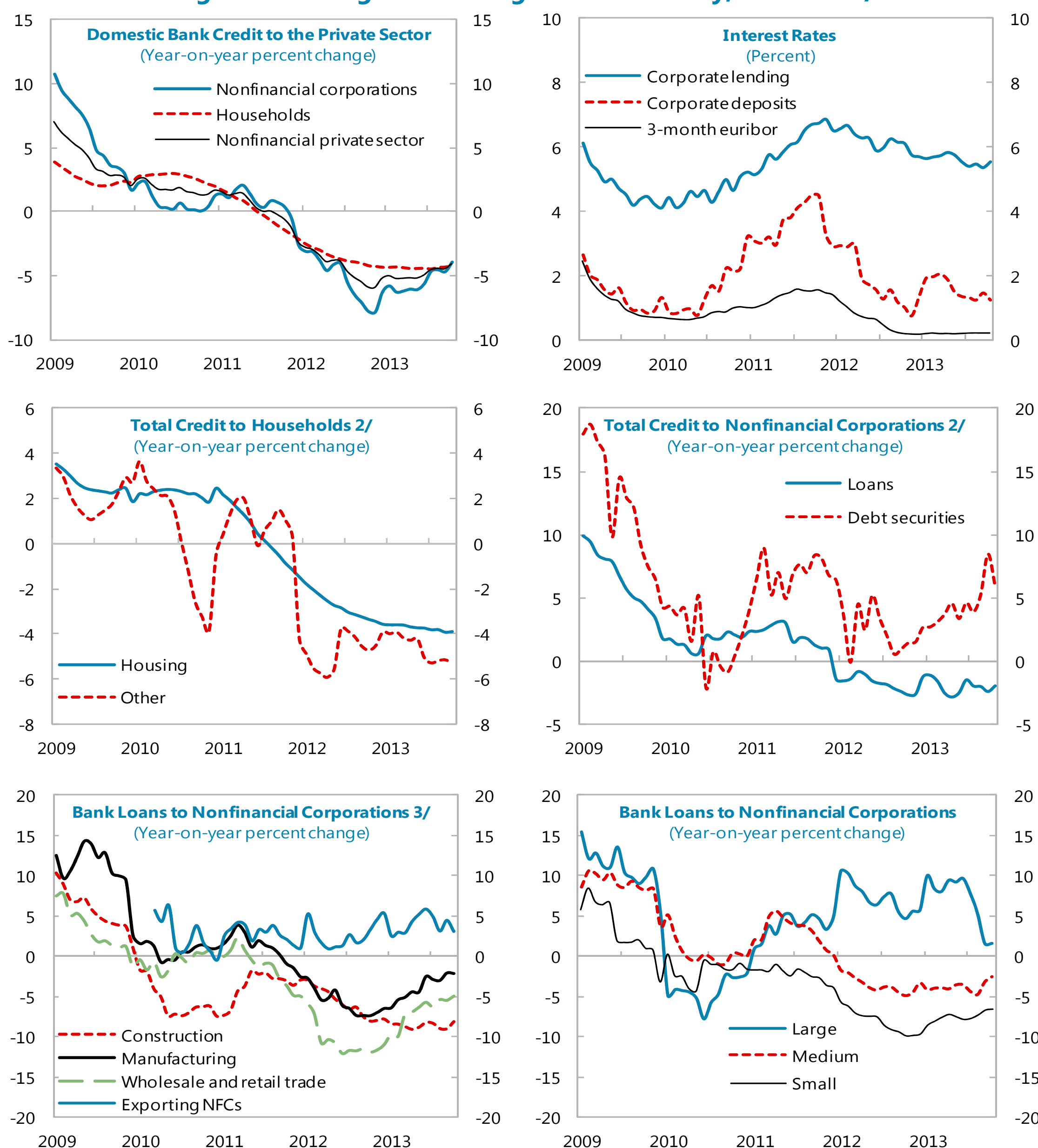
Source: Statistical Office of the European Communities; European Commission; Bank of Portugal; and Fund staff calculations and estimates.
1/ Labor Force Survey.
2/ National Accounts.
3/ Public sector refers to public administration, education, and social work. Private sector refers to the rest of the economy.
4/ Staff estimates. Productivity is gross value added divided by employment.
5/ Effective from 2013, private sector employees can choose to receive Christmas bonus monthly instead of once in Q4.
6/ Long term unemployment rate as percent of total unemployed; youth unemployment rate as percent of youth labor force.

Figure 3. Portugal: Balance of Payments Developments, 2006–13



Sources: INE; Bank of Portugal; Eurostat; and IMF staff calculations.

Figure 4. Portugal: Financing of the Economy, 2009–13 1/



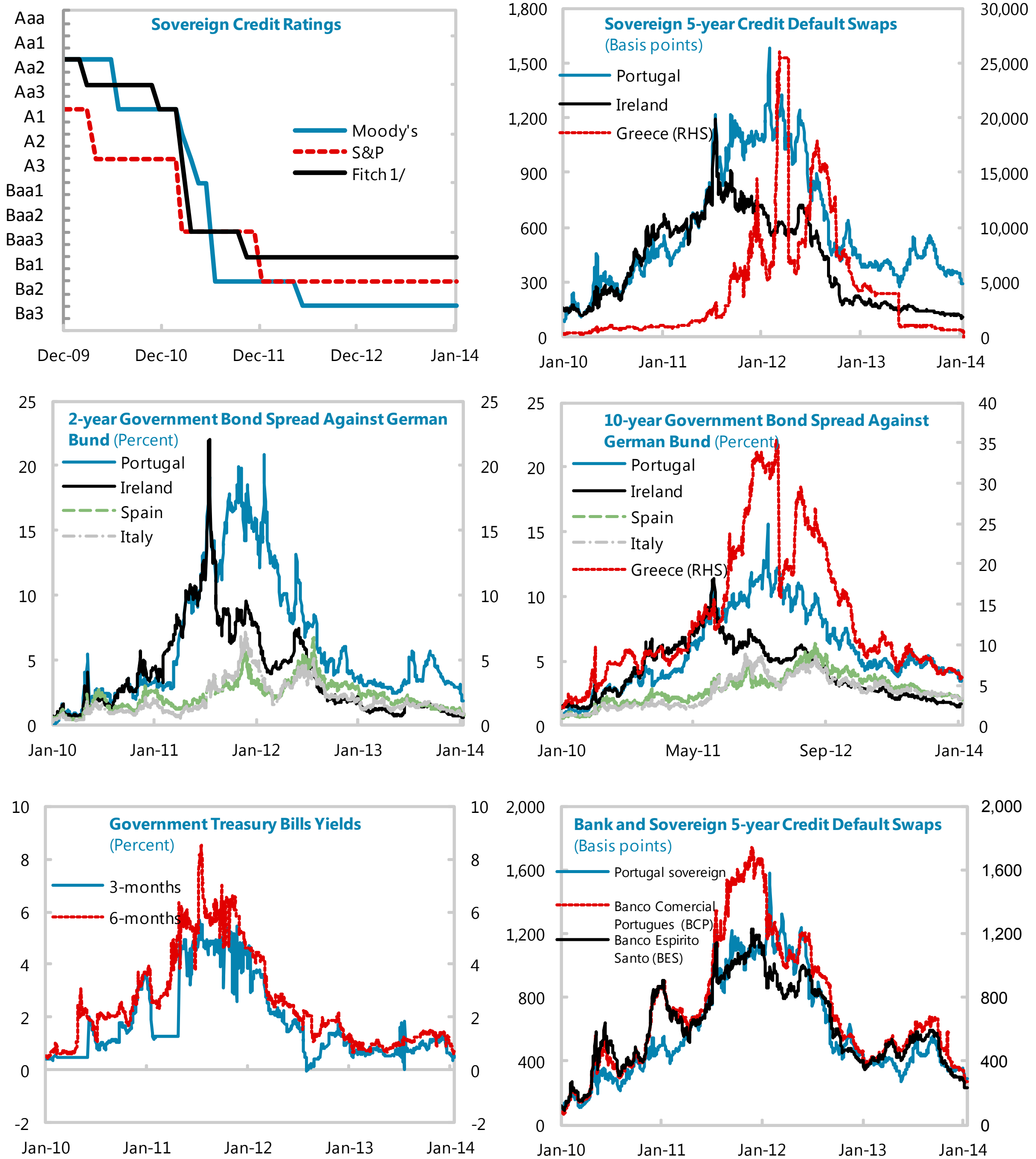
Source: Bank of Portugal.

1/ Credit and loan figures are adjusted for securitisation operations and monthly transactions (calculated using the outstanding amounts corrected of reclassifications, write-offs/write-downs, exchange rate changes and price revaluations). Whenever relevant, figures are additionally adjusted for credit portfolio sales, as well as for other operations with no impact on non-financial corporations' effective financing.

2/ Total credit granted to residents by resident and non-resident entities is reported on a consolidated basis and includes loans, debt securities and trade credits.

3/ Private-owned exporting companies, defined as: a) companies that export more than 50% of the turnover; or b) companies that export more than 10% of the turnover and the total amount exceeds 150 thousand euro (with both criteria met in the last 3 years).

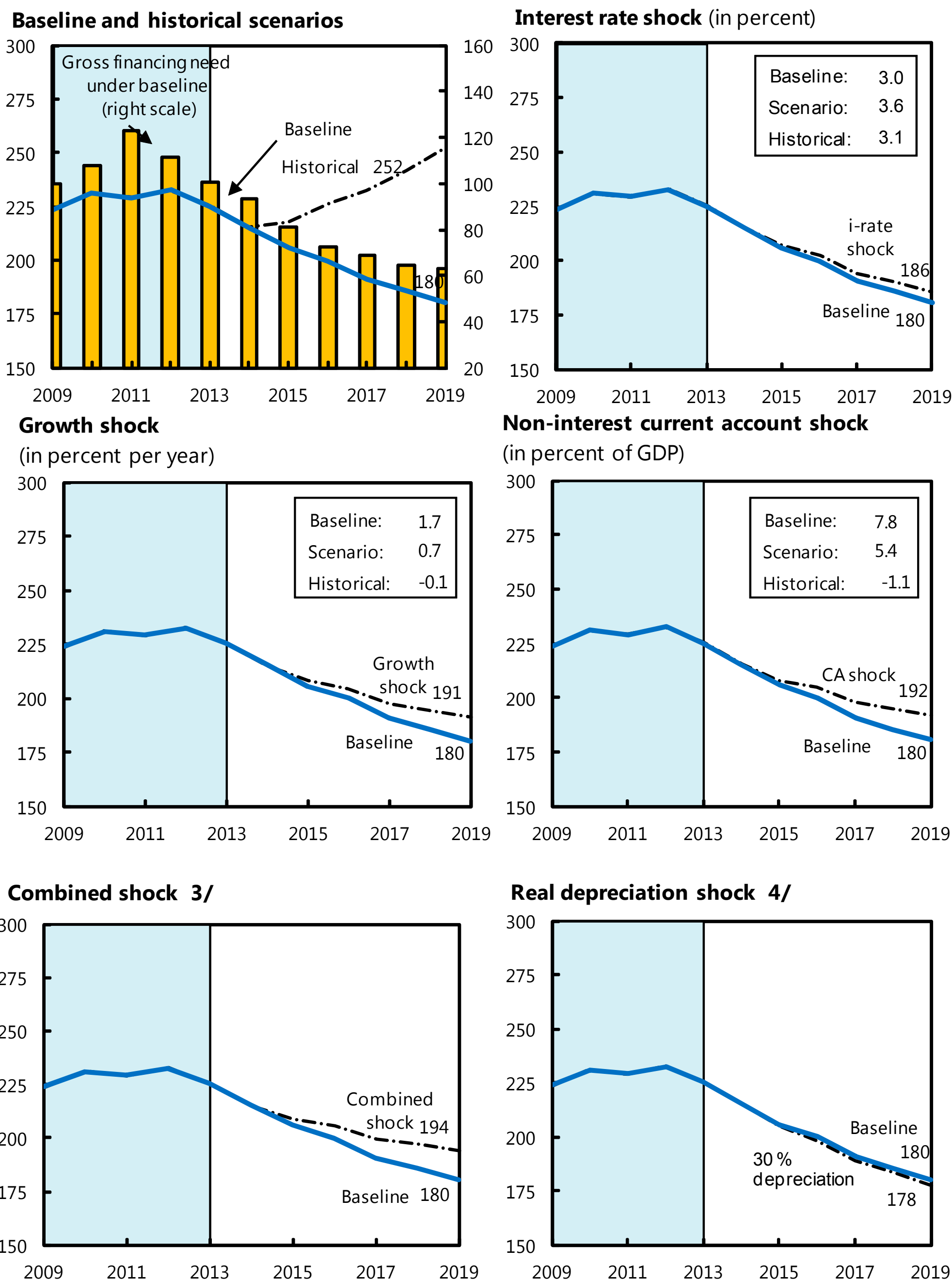
Figure 5. Portugal: Financial Panel



Sources: Bloomberg; and IMF staff calculations.
1/ Rating used is the LT Foreign Currency Issuer Default

Figure 6. Portugal: External Debt Sustainability: Bound Tests 1/ 2/

(External Debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks, except the interest rate shock which is a permanent one standard deviation shock. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to growth rate, and current account balance, and 1/2 standard deviation shock to the real interest rate.

4/ One-time real depreciation of 30 percent occurs in 2013.

Table 1. Portugal: Selected Economic Indicators

(Year-on-year percent change, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
				Projections						
Real GDP	1.9	-1.3	-3.2	-1.6	0.8	1.5	1.7	1.8	1.8	1.8
Total domestic demand	1.8	-5.1	-6.6	-2.7	0.0	0.7	1.1	1.3	1.4	1.3
Private consumption	2.5	-3.3	-5.4	-1.8	0.1	0.8	0.7	0.8	0.8	0.8
Public consumption	0.1	-5.0	-4.7	-2.0	-2.5	-2.2	0.5	0.9	1.3	1.0
Gross fixed investment	-3.1	-10.5	-14.3	-8.0	1.2	3.7	3.7	4.3	3.8	3.8
Private	-8.3	-5.2	-11.4	-9.7	2.6	4.8	4.1	4.8	4.3	4.3
Government	27.1	-32.9	-31.4	4.6	-7.6	-4.2	0.5	0.2	-0.6	-0.4
Exports	10.2	6.9	3.2	5.8	5.0	5.3	5.7	5.6	5.5	5.6
Imports	8.0	-5.3	-6.6	2.6	3.0	3.7	4.4	4.6	4.7	4.7
Contribution to Growth										
Total domestic demand	2.0	-5.5	-6.9	-2.7	0.0	0.7	1.0	1.3	1.3	1.2
Private consumption	1.7	-2.2	-3.5	-1.1	0.1	0.5	0.4	0.5	0.5	0.5
Public consumption	0.0	-1.1	-1.0	-0.4	-0.5	-0.4	0.1	0.2	0.2	0.2
Gross fixed investment	-0.7	-2.1	-2.6	-1.3	0.2	0.6	0.6	0.7	0.6	0.6
Foreign balance	-0.1	4.4	3.7	1.2	0.8	0.7	0.6	0.5	0.5	0.6
Savings-investment balance (percent of GDP)										
Gross national savings	9.8	11.3	14.8	15.9	16.5	17.5	18.3	19.3	20.5	21.7
Private	16.8	16.2	19.8	19.9	18.8	18.4	18.6	19.3	20.2	21.3
Public	-7.0	-4.9	-5.1	-4.0	-2.3	-0.9	-0.3	0.0	0.3	0.4
Gross domestic investment	20.2	18.4	16.7	15.4	15.7	16.3	16.8	17.3	18.1	18.8
Private	16.3	15.8	14.8	13.5	13.8	14.5	15.0	15.6	16.3	17.0
Public	3.9	2.7	1.9	2.0	1.9	1.8	1.8	1.8	1.8	1.8
Resource utilization										
Potential GDP	0.7	-0.2	-0.8	-0.9	-0.4	0.4	0.9	1.1	1.1	1.8
Output Gap (% of potential)	-0.3	-1.3	-3.7	-4.3	-3.2	-2.2	-1.4	-0.7	0.0	0.0
Employment	-1.5	-1.5	-4.2	-3.2	-0.4	0.4	0.6	0.6	0.6	0.6
Unemployment rate (%) 1/	10.8	12.7	15.7	16.5	16.8	16.5	16.0	15.4	14.8	14.2
Prices										
GDP deflator	0.6	0.3	-0.3	1.7	0.9	1.0	1.7	1.8	1.8	1.8
Consumer prices (harmonized index)	1.4	3.6	2.8	0.4	0.8	1.2	1.4	1.5	1.5	1.5
Compensation per worker (whole economy)	2.0	-0.6	-2.0	2.7	-0.9	1.0	1.2	1.2	1.2	1.2
Labor productivity	3.5	0.3	1.1	1.6	1.1	1.1	1.1	1.2	1.2	1.2
Unit labor costs (whole economy)	-1.4	-0.9	-3.1	1.1	-1.9	0.0	0.1	0.0	0.0	0.0
Money and credit (end of period, percent change)										
Private sector credit	-0.3	-1.5	-6.5	-4.4	-3.0	-0.5	1.0	1.5	1.8	1.8
Broad money	-1.3	-1.3	-6.2	0.0	1.7	2.5	3.4	3.7	3.7	3.7
Interest rates (percent)										
Short-term deposit rate	1.7	3.5	3.0	2.3	2.7	3.0	3.5	3.8	3.8	3.8
Government bond rate, 10-year	5.3	10.2	10.6	6.5	6.1	5.6	5.2	5.3	5.5	5.5
Fiscal indicators (percent of GDP)										
General government balance 2/	-9.9	-4.3	-6.5	-5.9	-4.0	-2.5	-2.0	-1.7	-1.4	-1.3
Primary government balance	-7.0	-0.3	-2.1	-1.6	0.3	1.9	2.5	2.9	3.1	3.2
Structural balance	-9.0	-6.6	-4.1	-3.7	-2.6	-1.5	-1.3	-1.4	-1.4	-1.3
Structural primary balance (percent of potential GDP)	-6.2	-2.7	0.1	0.5	1.6	2.8	3.0	3.1	3.1	3.2
General government debt	94.0	108.2	124.1	129.4	126.6	125.8	123.4	119.9	117.3	114.7
External sector (percent of GDP)										
Trade balance (goods)	-11.1	-8.3	-5.4	-4.4	-3.6	-3.1	-2.6	-2.3	-2.1	-1.8
Trade balance (G&S)	-7.2	-3.8	-0.1	1.7	3.0	3.9	4.6	5.1	5.5	5.9
Current account balance	-10.6	-7.0	-2.0	0.4	0.8	1.2	1.6	2.0	2.4	2.8
Net international investment position	-107.2	-104.8	-116.1	-113.4	-108.7	-102.9	-96.0	-88.8	-81.5	-74.1
REER based on ULC (1999=100)	108.0	106.7	101.1	102.7	100.4	100.7	100.6	100.2	99.9	99.6
(rate of growth)	-1.4	-1.2	-5.3	1.5	-2.2	0.3	-0.1	-0.4	-0.3	-0.3
REER based on CPI (1999=100)	107.8	108.7	107.3	106.6	106.0	106.0	106.1	106.1	106.3	106.4
(rate of growth)	-2.1	0.9	-1.3	-0.6	-0.5	0.0	0.1	0.1	0.1	0.1
Nominal GDP (billions of euro)	172.9	171.1	165.1	165.3	168.2	172.4	178.2	184.8	191.6	198.7

Sources: Bank of Portugal; Ministry of Finance; National Statistics Office (INE); Eurostat; and IMF staff projections.

1/ The unemployment rate series contains a structural break in 2011.

2/ EDP notification concept.

Table 2a. Portugal: General Government Accounts 1/

(Billions of euros)

	2011	2012	2013	2014	2015	2016	2017	2018	2019
			Projections 2/						
Revenue	77.0	67.6	71.5	71.9	73.6	75.8	77.8	79.7	81.7
Taxes	40.4	38.1	40.4	41.2	42.4	43.8	45.0	46.3	47.5
Taxes on production and imports	23.5	22.5	21.9	22.6	23.3	24.1	24.7	25.2	25.8
Current taxes on income, wealth, etc. and capital taxes	16.9	15.5	18.5	18.7	19.1	19.7	20.3	21.0	21.7
Current taxes on income, wealth, etc.	16.9	15.3	18.5	18.7	19.1	19.7	20.3	21.0	21.7
Capital taxes	0.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	21.0	19.1	19.9	19.6	19.5	19.8	20.2	20.4	20.7
Grants and other revenue	15.6	10.4	11.2	11.1	11.7	12.1	12.6	13.0	13.5
Property income	1.2	1.2	1.4	1.4	1.5	1.5	1.6	1.6	1.7
Sales of goods and services	4.3	4.6	4.8	4.6	4.7	4.9	5.0	5.2	5.4
Other current revenue	2.3	2.3	3.1	3.3	3.6	3.7	3.9	4.0	4.2
Capital transfers and investment grants	7.8	2.2	1.9	1.8	2.0	2.0	2.1	2.2	2.3
Expenditure 3/	84.4	78.2	81.2	78.7	78.0	79.2	80.8	82.4	84.3
Expense	83.9	79.7	82.2	79.8	79.3	80.6	82.3	83.8	85.8
Compensation of employees	19.4	16.5	17.5	15.8	15.2	15.2	15.4	15.6	16.0
Use of goods and services	7.9	7.4	7.9	7.8	7.6	7.7	7.8	7.9	8.1
Consumption of fixed capital	3.9	3.9	4.1	4.1	4.2	4.4	4.5	4.7	4.8
Interest (ESA95)	6.9	7.2	7.2	7.3	7.6	7.9	8.3	8.6	8.9
Subsidies	1.2	1.0	1.2	1.3	1.3	1.3	1.3	1.4	1.4
Social benefits	37.8	37.1	38.4	38.3	38.3	38.9	39.5	40.2	41.0
Grants and other expense	6.9	6.6	6.0	5.3	5.2	5.3	5.3	5.4	5.5
Other current expense	4.4	4.2	4.5	4.8	4.4	4.5	4.5	4.6	4.7
Capital transfers	2.4	2.3	1.5	0.5	0.8	0.8	0.8	0.8	0.9
Net acquisition of nonfinancial assets	0.5	-1.4	-1.0	-1.1	-1.3	-1.4	-1.4	-1.4	-1.5
Gross fixed capital formation	4.5	2.5	3.1	3.0	2.9	3.0	3.1	3.2	3.3
(-) Consumption of fixed capital	-3.9	-3.9	-4.1	-4.1	-4.2	-4.4	-4.5	-4.7	-4.8
Acquisitions less disposals of other nonfinancial assets	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-3.0	-8.2	-6.7	-3.8	-1.5	-0.5	0.0	0.6	0.8
Net lending (+)/borrowing (–) (ESA95)	-7.4	-10.7	-9.8	-6.8	-4.4	-3.5	-3.1	-2.6	-2.5
Net lending (+)/borrowing (–) (EDP notification)	-7.4	-10.6	-9.8	-6.8	-4.4	-3.5	-3.1	-2.6	-2.5
Net lending (+)/borrowing (–) (program) 4/	-6.8	-7.8	-9.1	-6.8	-4.4	-3.5	-3.1	-2.6	-2.5
Net acquisition of financial assets	14.2	4.8	...	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	...	...	...	...	...	...	...
Currency and deposits	10.2	1.2	...	...	...	...	...	...	...
Debt securities	0.4	6.4	...	...	...	...	...	...	...
Loans	0.4	1.2	...	...	...	...	...	...	...
Equity and investment fund shares	-0.3	-1.1	...	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	...	...	...	...	...	...	...
Financial derivatives and employee stock options	-0.2	-0.2	...	...	...	...	...	...	...
Other accounts receivable	3.7	-2.6	...	...	...	...	...	...	...
Net incurrence of liabilities	21.8	15.5	...	...	...	...	...	...	...
SDRs	0.0	0.0	...	...	...	...	...	...	...
Currency and deposits	-3.1	-1.4	...	...	...	...	...	...	...
Debt securities	-11.2	-6.8	...	...	...	...	...	...	...
Loans	35.5	27.1	...	...	...	...	...	...	...
Equity and investment fund shares	0.0	0.0	...	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	...	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	...	...	...	...	...	...	...
Other accounts payable	0.5	-3.5	...	...	...	...	...	...	...
Memorandum items:									
Primary balance	-0.5	-3.5	-2.6	0.5	3.2	4.4	5.3	6.0	6.4
Interest (EDP notification)	6.9	7.1	7.2	7.3	7.6	7.9	8.3	8.6	8.9
Debt at face value (EDP notification)	185.2	204.8	213.9	212.9	216.8	220.0	221.6	224.7	227.8
Nominal GDP	171.1	165.1	165.3	168.2	172.4	178.2	184.8	191.6	198.7

Sources: Portuguese statistical authorities; and IMF staff projections.

1/ GFSM 2001 presentation.

2/ Projections assume no structural fiscal effort after 2015. In contrast, the authorities assume additional effort in order to achieve the European "fiscal compact" objective (structural deficit of less than 0.5 percent of GDP). Compared with the baseline, adherence to the "fiscal compact" would lower the debt-to-GDP ratio by three percentage points by 2020.

3/ Historical data include expenditure commitments that have given rise to arrears of the general government.

4/ Excludes the impact of several large transactions that were booked differently at the time the original deficit targets were set. In 2011, those were €600 million in bank restructuring costs (IMF Country Report 12/77). In 2012, those were ANA concession (€1,200 million), increase in the share capital of CGD (€750 million), reclassfied operations of Sagestamo (€750 million), and valuation changes of BPN (€100 million). In 2013, they include the increase in the share capital of Banif (€700 million).

Table 2b. Portugal: General Government Accounts 1/

(Percent of GDP)

	2011	2012	Projections 2/ 2013	2014	2015	2016	2017	2018	2019
Revenue	45.0	40.9	43.2	42.8	42.7	42.5	42.1	41.6	41.1
Taxes	23.6	23.1	24.5	24.5	24.6	24.6	24.4	24.1	23.9
Taxes on production and imports	13.7	13.7	13.3	13.4	13.5	13.5	13.3	13.2	13.0
Current taxes on income, wealth, etc. and capital taxes	9.9	9.4	11.2	11.1	11.1	11.0	11.0	11.0	10.9
Current taxes on income, wealth, etc.	9.9	9.3	11.2	11.1	11.1	11.0	11.0	11.0	10.9
Capital taxes	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	12.3	11.6	12.0	11.6	11.3	11.1	10.9	10.7	10.4
Grants and other revenue	9.1	6.3	6.8	6.6	6.8	6.8	6.8	6.8	6.8
Property income	0.7	0.7	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Sales of goods and services	2.5	2.8	2.9	2.7	2.7	2.7	2.7	2.7	2.7
Other current revenue	1.3	1.4	1.9	2.0	2.1	2.1	2.1	2.1	2.1
Capital transfers and investment grants	4.6	1.4	1.2	1.1	1.1	1.1	1.1	1.1	1.1
Expenditure 3/	49.3	47.4	49.1	46.8	45.3	44.5	43.8	43.0	42.4
Expense	49.0	48.3	49.7	47.5	46.0	45.2	44.5	43.7	43.2
Compensation of employees	11.3	10.0	10.6	9.4	8.8	8.5	8.3	8.1	8.0
Use of goods and services	4.6	4.5	4.8	4.6	4.4	4.3	4.2	4.1	4.1
Consumption of fixed capital	2.3	2.4	2.5	2.4	2.4	2.4	2.4	2.4	2.4
Interest (ESA95)	4.0	4.3	4.3	4.4	4.4	4.4	4.5	4.5	4.5
Subsidies	0.7	0.6	0.7	0.8	0.8	0.7	0.7	0.7	0.7
Social benefits	22.1	22.5	23.2	22.8	22.2	21.8	21.4	21.0	20.7
Grants and other expense	4.0	4.0	3.6	3.2	3.0	2.9	2.9	2.8	2.8
Other current expense	2.6	2.6	2.7	2.8	2.6	2.5	2.5	2.4	2.4
Capital transfers	1.4	1.4	0.9	0.3	0.4	0.4	0.4	0.4	0.4
Net acquisition of nonfinancial assets	0.3	-0.9	-0.6	-0.6	-0.8	-0.8	-0.8	-0.8	-0.7
Gross fixed capital formation	2.6	1.5	1.9	1.8	1.7	1.7	1.7	1.7	1.7
(-) Consumption of fixed capital	-2.3	-2.4	-2.5	-2.4	-2.4	-2.4	-2.4	-2.4	-2.4
Acquisitions less disposals of other nonfinancial assets	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-1.8	-5.0	-4.0	-2.3	-0.8	-0.3	0.0	0.3	0.4
Net lending (+)/borrowing (–) (ESA95)	-4.3	-6.5	-5.9	-4.0	-2.5	-2.0	-1.7	-1.4	-1.3
Net lending (+)/borrowing (–) (EDP notification)	-4.3	-6.4	-5.9	-4.0	-2.5	-2.0	-1.7	-1.4	-1.3
Net lending (+)/borrowing (–) (program) 4/	-4.0	-4.7	-5.5	-4.0	-2.5	-2.0	-1.7	-1.4	-1.3
Net acquisition of financial assets	8.3	2.9	...	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	...	...	...	...	...	...	...
Currency and deposits	6.0	0.7	...	...	...	...	...	...	...
Debt securities	0.2	3.9	...	...	...	...	...	...	...
Loans	0.3	0.7	...	...	...	...	...	...	...
Equity and investment fund shares	-0.2	-0.7	...	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	...	...	...	...	...	...	...
Financial derivatives and employee stock options	-0.1	-0.1	...	...	...	...	...	...	...
Other accounts receivable	2.2	-1.6	...	...	...	...	...	...	...
Net incurrence of liabilities	12.7	9.4	...	...	...	...	...	...	...
SDRs	0.0	0.0	...	...	...	...	...	...	...
Currency and deposits	-1.8	-0.9	...	...	...	...	...	...	...
Debt securities	-6.5	-4.1	...	...	...	...	...	...	...
Loans	20.7	16.4	...	...	...	...	...	...	...
Equity and investment fund shares	0.0	0.0	...	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	...	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	...	...	...	...	...	...	...
Other accounts payable	0.3	-2.1	...	...	...	...	...	...	...
Memorandum items:									
Primary balance	-0.3	-2.1	-1.6	0.3	1.9	2.5	2.9	3.1	3.2
Structural balance (Percent of potential GDP)	-6.6	-4.1	-3.7	-2.6	-1.5	-1.3	-1.3	-1.4	-1.3
Structural primary balance (Percent of potential GDP)	-2.7	0.1	0.5	1.6	2.8	3.0	3.1	3.1	3.2
Interest (EDP notification)	4.0	4.3	4.3	4.4	4.4	4.4	4.5	4.5	4.5
Debt at face value (EDP notification)	108.2	124.1	129.4	126.6	125.8	123.4	119.9	117.3	114.7

Sources: Portuguese statistical authorities; and IMF staff projections.

1/ GFSM 2001 presentation.

2/ Projections assume no structural fiscal effort after 2015. In contrast, the authorities assume additional effort in order to achieve the European "fiscal compact" objective (structural deficit of of less than 0.5 percent of GDP). Compared with the baseline, adherence to the "fiscal compact" would lower the debt-to-GDP ratio by about three percentage points by 2020.

3/ Historical data include expenditure commitments that have given rise to arrears of the general government.

4/ Excludes the impact of several large transactions that were booked differently at the time the original deficit targets were set. In 2011, those were €600 million in bank restructuring costs (IMF Country Report 12/77). In 2012, those were ANA concession (€1,200 million), increase in the share capital of CGD (€750 million), reclassified operations of Sagestamo (€750 million), and valuation changes of BPN (€100 million). In 2013, they include the increase in the share capital of Banif (€700 million).

Table 3. Portugal: General Government Stock Positions
(Billions of euros)

	2008	2009	2010	2011	2012
Net financial worth	-93.1	-108.7	-111.2	-93.5	-129.0
Financial assets	45.7	48.6	58.5	73.7	83.1
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0
Currency and deposits	7.3	6.8	7.7	18.0	19.2
Debt securities	1.5	1.9	1.8	2.2	8.6
Loans	3.0	2.8	4.1	4.6	5.8
Equity and investment fund shares	25.8	28.7	34.4	34.7	38.0
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	0.0
Financial derivatives and employee stock options	-0.1	0.0	0.1	0.4	0.4
Other accounts receivable	8.1	8.5	10.3	13.8	11.2
Liabilities	138.8	157.2	169.7	167.2	212.2
Special Drawing Rights (SDRs)	0.0	0.0	0.0	0.0	0.0
Currency and deposits	19.5	18.9	18.1	15.0	13.6
Debt securities	98.1	114.3	120.5	85.2	105.4
Loans	15.7	17.4	22.5	58.6	85.3
Equity and investment fund shares	0.0	0.0	0.0	0.0	0.0
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	0.0
Financial derivatives and employee stock options	0.0	0.0	0.0	0.9	1.2
Other accounts payable	5.6	6.5	8.5	7.6	6.7
Memorandum items:					
Gross debt (at market value)	138.8	157.2	169.6	166.3	211.0
Gross debt at face value	128.9	147.6	171.0	192.8	211.6
Gross debt at face value (EDP notification)	123.3	141.1	162.5	185.2	204.8
Other economic flows - financial assets	...	1.8	5.0	1.1	4.6
Other economic flows - liabilities	...	0.3	-9.5	-24.2	29.5

Sources: Portuguese statistical authorities; and IMF staff calculations.

Table 4. Portugal: General Government Financing Requirements and Sources 1/

(Billions of euros)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Gross borrowing need	58.4	59.2	67.2	45.6	46.5	40.2	40.2	41.4	44.7	48.0
Overall balance	17.0	7.4	10.7	9.8	6.8	4.4	3.5	3.1	2.6	2.5
Amortization	31.0	40.7	39.5	31.4	43.1	36.2	37.1	39.8	41.6	45.0
M<	7.7	12.8	18.7	12.2	23.2	13.7	12.4	14.1	15.2	18.3
Residents	0.7	3.9	11.5	4.8	12.1	5.7	6.1	7.9	10.7	11.7
Of which within general government	0.0	0.4	3.2	0.9	1.7	1.7	0.7	0.7	0.7	0.7
Non-residents	7.1	8.9	7.2	7.4	11.1	8.0	6.3	6.2	4.5	6.6
ST 2/	23.3	27.9	19.8	19.2	16.9	22.0	22.0	22.0	22.0	22.0
Residents	6.4	16.9	18.0	18.3	14.9	18.5	16.9	16.9	16.9	16.9
Of which within general government	1.1	3.3	4.7	7.5	...	...	...	...	...	...
Non-residents	16.9	11.0	1.8	0.9	2.0	3.5	5.1	5.1	5.1	5.1
EU and IMF 3/	0.0	0.0	1.0	0.0	3.0	0.5	2.7	3.7	4.4	4.6
Other (net) 4/	10.4	11.0	17.0	4.4	-3.3	-0.4	-0.4	-1.5	0.5	0.5
Of which within general government	4.6	3.9	5.0	...	...	...	...	...	...	...
Gross financing sources	58.4	23.9	38.6	35.5	38.7	40.2	40.2	41.4	44.7	48.0
Privatization receipts	0.7	0.6	2.2	0.5	0.1	0.0	0.0	0.0	0.0	0.0
Market access	59.0	36.8	36.3	34.5	34.2	40.2	40.2	41.4	44.7	48.0
M<	31.0	18.0	17.1	17.6	12.2	18.2	18.2	19.4	22.7	26.0
Residents	15.9	13.7	15.2	10.6	7.7	10.0	8.6	9.3	10.9	12.7
Of which from general government	3.0	6.1	6.2	...	...	...	...	...	...	...
Non-residents	15.1	4.3	1.9	7.0	4.5	8.2	9.6	10.2	11.8	13.3
ST 2/	27.9	18.8	19.2	16.9	22.0	22.0	22.0	22.0	22.0	22.0
Residents	16.9	17.0	18.3	14.9	18.5	16.9	16.9	16.9	16.9	16.9
Of which from general government	3.3	4.7	5.6	...	...	...	...	...	...	...
Non-residents	11.0	1.8	0.9	2.0	3.5	5.1	5.1	5.1	5.1	5.1
Other	0.9	6.3	14.0	9.0	0.0	0.0	0.0	0.0	0.0	0
Of which from general government	1.7	6.8	7.9	...	...	...	...	...	...	...
Use of deposits 5/	-1.3	-13.5	0.0	0.6	4.4	0.0	0.0	0.0	0.0	0.0
Of which intra-government	-0.6	-3.2	1.2	...	...	...	...	...	...	...
Financing under the program 3/	0.0	35.3	28.5	10.0	7.9	0.0	0.0	0.0	0.0	0.0
European Union	...	22.2	20.4	6.6	5.1	...	...	...	...	...
IMF	...	13.1	8.2	3.4	2.7	...	...	...	...	...
Net placement (market access-amortization)	28.0	-3.9	-3.1	3.1	-8.9	3.9	3.1	1.6	3.1	3.0
Residents	25.8	9.9	4.0	2.4	-0.8	2.4	1.2	-0.5	-2.0	-0.1
M<	15.3	9.8	3.7	5.8	-4.4	4.0	1.2	-0.5	-2.0	-0.1
ST (net increase)	10.5	0.1	0.3	-3.4	3.6	-1.6	0.0	0.0	0.0	0.0
Non-residents	2.2	-13.8	-6.1	0.7	-5.1	1.5	2.0	2.1	5.1	3.2
M<	8.0	-4.6	-5.3	-0.4	-6.6	-0.1	2.0	2.1	5.1	3.2
ST (net increase)	-5.9	-9.2	-0.9	1.1	1.4	1.6	0.0	0.0	0.0	0.0

Source: Portuguese authorities and Fund staff estimates.

1/ The coverage of this table has been expanded to fully reflect all general government (including local and regional governments and SOES) financing operations. However, data are on a non-consolidated basis (with intra-government flows presented where available). On a consolidated basis, they are smaller, by the amount of intra-government transactions.

2/ For projection years, all t-bills issuance is assumed to be short term (i.e. at maturities of 12 months or below).

3/ Changes to IMF disbursements compared to initial programmed amounts reflect EUR/SDR exchange rate variations. Program financing from the EU includes the EUR 1.1 billion EFSF prepaid margin and EUR 0.1 billion in issuance costs (2011) and the roll-over of a EUR 1 billion short-term loan (2012). On June 21st 2013, ECOFIN has decided to extend the average maturity of EFSM loans by 7 years, which will bring the average maturity from 12.5 to 19.5 years. Pending the definition of the final maturity date of each individual loan, the table still reflects the original maturities.

4/ Includes use of Bank Solvency Support Facility and other net financial transactions, net financing from retail government securities programs, as well as adjustments for cash-accrual differences and consistency between annual projections and preliminary quarterly accounts.

5/ Changes in government deposits (including deposits in BSSF).

Table 5. Portugal: Balance of Payments, 2010–19

	2010	2011	2012	Est. 2013	Projections 2014	2015	2016	2017	2018	2019
				(Billions of euro)						
Current account	-18.3	-12.0	-3.3	0.7	1.3	2.1	2.8	3.7	4.4	5.5
Balance of goods and services	-12.5	-6.5	-0.1	2.8	5.0	6.7	8.2	9.5	10.5	11.6
Trade balance	-19.2	-14.2	-8.8	-7.3	-6.1	-5.4	-4.7	-4.2	-4.0	-3.6
Exports fob	37.4	43.1	45.4	47.3	49.7	52.8	55.6	59.0	62.4	66.5
Imports fob	56.6	57.3	54.3	54.6	55.8	58.1	60.3	63.2	66.4	70.1
Services, net	6.7	7.7	8.7	10.1	11.1	12.0	12.9	13.7	14.5	15.2
Exports	17.6	19.2	19.1	20.7	22.0	23.5	25.0	26.6	28.3	29.6
Imports	10.9	11.5	10.4	10.6	10.9	11.5	12.2	12.9	13.8	14.4
Of which:										
Tourism	4.6	5.2	5.7	6.5	7.0	7.5	8.0	8.5	9.1	9.5
Exports	7.6	8.1	8.6	9.5	10.1	10.8	11.5	12.2	13.0	13.6
Imports	3.0	3.0	2.9	3.0	3.1	3.2	3.4	3.7	3.9	4.1
Income, net	-7.9	-8.5	-6.9	-6.0	-7.7	-8.5	-9.3	-9.6	-9.8	-9.8
Current transfers, net	2.2	3.0	3.8	3.9	4.0	4.0	4.0	3.8	3.8	3.7
Private remittances, net	2.2	2.4	2.8	3.1	3.2	3.2	3.2	3.2	3.3	3.4
Official transfers, net	-0.1	0.6	1.0	0.8	0.8	0.8	0.8	0.6	0.4	0.3
Capital account	1.9	2.1	3.9	3.5	3.4	3.4	3.4	3.4	3.4	3.4
Financial account	15.6	-24.2	-27.7	-14.2	-12.5	-5.5	-6.2	-7.1	-7.8	-8.9
Direct investment	7.7	-2.7	6.6	0.4	1.9	1.9	1.9	1.0	1.0	0.9
Portuguese investment abroad	5.7	-10.7	-0.5	-1.4	-1.4	-1.5	-1.5	-2.5	-2.6	-2.7
Foreign investment in Portugal	2.0	8.0	7.0	1.8	3.4	3.4	3.5	3.5	3.6	3.7
Portfolio investment, net	-9.7	-4.6	-21.5	-3.2	-3.6	4.5	6.7	6.3	9.5	9.1
Financial derivatives	0.4	0.5	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other investment, net	18.2	-18.6	-12.6	-11.4	-10.9	-12.0	-14.8	-14.4	-18.4	-18.9
Reserve assets	-1.0	1.2	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	0.8	0.1	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	...	33.9	27.7	9.9	7.8	...	...	...	...	...
European Union	...	20.9	19.4	6.6	5.1	...	...	...	...	...
IMF	...	13.1	8.2	3.4	2.7	...	...	...	...	...
Memorandum items:										
Net international investment position 1/	-185.2	-179.4	-191.7	-187.5	-182.8	-177.3	-171.2	-164.1	-156.3	-147.4
Direct investment, net	-33.6	-30.6	-33.1	-33.5	-35.5	-37.4	-39.3	-40.3	-41.3	-42.2
Portfolio investment, net	-52.1	-31.7	-24.6	-21.4	-17.8	-22.3	-29.0	-35.3	-44.8	-53.9
Financial derivatives	-1.1	-2.4	-3.6	-3.7	-3.8	-3.8	-3.9	-4.0	-4.0	-4.1
Other investment, net	-114.1	-131.2	-147.5	-146.1	-142.9	-130.9	-116.1	-101.7	-83.3	-64.4
Reserve assets	15.7	16.5	17.2	17.2	17.2	17.2	17.2	17.2	17.2	17.2
Nominal GDP	172.9	171.1	165.1	165.3	168.2	172.4	178.2	184.8	191.6	198.7
				(Percentage of GDP)						
Current account	-10.6	-7.0	-2.0	0.4	0.8	1.2	1.6	2.0	2.3	2.8
Current account (including capital transfers)	-9.5	-5.8	0.3	2.5	2.8	3.2	3.5	3.8	4.1	4.5
Of which: Balance of goods and services	-7.2	-3.8	-0.1	1.7	3.0	3.9	4.6	5.1	5.5	5.9
Net international investment position 1/	-107.2	-104.8	-116.1	-113.4	-108.7	-102.9	-96.0	-88.8	-81.6	-74.2
Direct investment, net	-19.5	-17.9	-20.1	-20.3	-21.1	-21.7	-22.1	-21.8	-21.6	-21.3
Portfolio investment, net	-30.1	-18.5	-14.9	-12.9	-10.6	-13.0	-16.3	-19.1	-23.4	-27.1
Financial derivatives	-0.7	-1.4	-2.2	-2.2	-2.2	-2.2	-2.2	-2.1	-2.1	-2.1
Other investment, net	-66.0	-76.7	-89.4	-88.4	-85.0	-76.0	-65.1	-55.0	-43.5	-32.4
Reserve assets	9.1	9.6	10.4	10.4	10.2	10.0	9.6	9.3	9.0	8.6

Sources: Bank of Portugal; and IMF staff calculations.

1/ End-of-period data.

Table 6. Portugal: External Financing Requirements and Sources, 2010–19

(Billions of euros)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
GROSS FINANCING REQUIREMENTS	186.4	210.4	183.9	166.9	156.9	140.2	129.1	126.7	124.2	122.9
Current account deficit	18.3	12.0	3.3	-0.7	-1.3	-2.1	-2.8	-3.7	-4.4	-5.5
Medium- and long-term debt amortization	28.9	29.6	32.8	34.3	35.6	27.4	24.8	25.3	29.0	31.3
Public sector	7.1	8.9	7.2	7.4	11.1	8.0	6.3	6.2	4.5	6.6
Banks	18.5	16.7	18.6	18.6	19.1	13.9	13.3	14.9	19.8	20.2
Other private	3.3	4.1	7.0	8.3	5.4	5.5	5.2	4.2	4.7	4.4
Short-term debt amortization	139.3	168.8	147.8	133.3	122.7	114.4	104.5	101.7	95.5	92.9
Public sector	40.6	71.1	63.8	67.0	67.2	60.7	46.1	35.0	29.7	27.7
Central Bank	23.4	59.9	61.0	66.1	65.2	57.3	41.1	29.9	24.7	22.6
General government and SOEs	17.1	11.2	2.9	0.9	2.0	3.5	5.1	5.1	5.1	5.1
Banks	79.5	76.6	57.4	47.7	38.7	37.7	39.3	40.9	42.6	44.3
Other private	19.2	21.1	26.6	18.6	16.8	15.9	19.1	25.8	23.2	20.9
EU and IMF 1/	0.0	0.0	0.0	0.0	0.0	0.5	2.5	3.5	4.1	4.3
SOURCES OF FINANCING	186.4	176.5	156.3	156.9	149.1	140.2	129.1	126.7	124.2	122.9
Capital account (net)	1.9	2.1	3.9	3.5	3.4	3.4	3.4	3.4	3.4	3.4
Foreign direct investment (net)	7.7	-2.7	6.6	0.4	1.9	1.9	1.9	1.0	1.0	0.9
Inward	2.0	8.0	7.0	1.8	3.4	3.4	3.5	3.5	3.6	3.7
New borrowing and debt rollover	193.2	157.7	143.0	145.6	140.3	135.0	133.2	127.2	131.6	131.1
Medium and long-term borrowing	24.6	10.9	9.7	22.9	25.9	30.5	31.6	31.6	38.7	40.5
General Government	15.1	4.3	1.9	7.0	4.5	8.2	9.6	10.2	11.9	13.3
Banks	2.8	1.2	2.2	9.3	16.6	15.6	14.9	16.4	21.3	21.8
Other private	6.7	5.4	5.6	6.7	4.9	6.6	7.0	5.0	5.6	5.3
Short-term borrowing	168.6	146.7	133.3	122.7	114.4	104.5	101.7	95.5	92.9	90.7
Public sector	71.0	62.8	67.0	67.2	60.7	46.1	35.0	29.7	27.7	25.8
Central Bank	59.9	61.0	66.1	65.2	57.3	41.1	29.9	24.7	22.6	20.8
General government	11.0	1.8	0.9	2.0	3.5	5.1	5.1	5.1	5.1	5.1
Banks	76.6	57.4	47.7	38.7	37.7	39.3	40.9	42.6	44.3	46.0
Other private	21.1	26.6	18.6	16.8	15.9	19.1	25.8	23.2	20.9	18.8
Other (includes asset operations)	-16.4	19.4	2.9	7.4	3.5	-0.1	-9.5	-4.8	-11.7	-12.5
Of which: Net errors and omissions	0.8	0.1	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
FINANCING GAP	0.0	33.9	27.7	9.9	7.8	0.0	0.0	0.0	0.0	0.0
European Union (2/3 of total) 1/	...	20.9	19.4	6.6	5.1	...	...	...	...	...
IMF (1/3 of total) 2/	...	13.1	8.2	3.4	2.7	...	...	...	...	...
ROLLOVER RATES										
General government	108.1	30.4	28.4	108.3	60.7	115.8	129.0	135.4	177.3	157.2
Private	88.9	76.5	67.6	76.7	94.0	110.4	115.3	101.7	101.9	102.4
Banks	80.9	62.8	65.7	72.5	94.0	106.3	106.1	105.8	105.0	105.3
Other private	123.5	127.0	72.1	86.9	93.8	120.0	135.0	94.2	95.0	95.2

Source: Bank of Portugal and staff estimates.

1/ Net of intra-year EFSF treasury bill issuance and amortization and EFSF pre-paid margin. On June 21st 2013, ECOFIN has decided to extend the average maturity of EFSM loans by 7 years, which will bring the average maturity from 12.5 to 19.5 years. Pending the definition of the final maturity date of each individual loan, the table still reflects the original maturities.

2/ Changes to IMF disbursements compared to initial programmed amounts reflect EUR/SDR exchange rate variations.

Table 7. Portugal: Selected Financial Indicators of the Banking System, 2008–13Q2

(Percent)

	2008	2009	2010	2011	2012				2013	
					Mar.	Jun.	Sep.	Dec.	Mar.	Jun.
Capital adequacy										
Regulatory capital to risk-weighted assets	9.4	10.5	10.3	9.8	10.7	12.3	12.3	12.6	13.0	13.1
Regulatory tier 1 capital to risk-weighted assets	6.6	7.9	8.3	8.6	9.5	11.0	11.1	11.3	11.7	11.7
Capital to assets 1/	5.8	6.5	6.7	5.3	5.8	6.2	6.6	6.7	6.9	6.7
Asset composition and quality										
Nonperforming loans to total gross loans 2/	3.6	4.8	5.2	7.5	8.0	9.2	9.8	9.8	10.4	10.6
Sectoral distribution of loans										
Residents	83.7	83.6	83.3	84.0	83.2	82.4	82.5	83.3	83.2	83.9
Deposit-takers	6.2	5.8	5.3	6.5	6.8	7.3	6.3	7.7	7.2	6.2
Central bank	1.3	1.2	0.5	0.9	0.4	0.4	0.7	1.1	0.8	0.5
Other financial corporations	3.6	3.7	3.9	2.9	2.7	2.7	2.7	2.4	2.3	2.3
General government	1.6	1.7	2.9	2.6	3.2	2.7	2.7	2.2	2.2	2.3
Nonfinancial corporations	31.6	31.5	30.7	31.0	30.6	30.0	30.3	30.2	30.5	31.5
Other domestic sectors	39.5	39.6	39.9	40.1	39.6	39.2	39.8	39.8	40.1	41.1
Nonresidents	16.3	16.4	16.7	16.0	16.8	17.6	17.5	16.7	16.8	16.1
Earnings and profitability										
Return on assets	0.3	0.4	0.5	-0.3	0.5	0.1	0.0	-0.3	-0.3	-0.5
Return on equity	5.6	7.3	7.5	-5.5	8.2	2.5	0.3	-5.4	-3.7	-8.0
Interest margin to gross income	59.5	53.8	52.3	57.5	51.3	47.9	46.6	46.7	41.7	43.4
Noninterest expenses to gross income	58.0	58.3	58.9	63.9	58.2	55.0	57.0	59.6	66.2	66.7
Liquidity										
Liquid assets to total assets 3/	12.8	13.2	19.0	13.8	11.2	12.7	13.7	14.8	14.8	16.0
Liquid assets to short-term liabilities 3/	67.7	84.5	86.2	85.4	90.5	101.5	123.2	140.0	149.5	150.7
Loans to deposits 4/	160.3	161.5	157.8	140.2	136.9	136.3	133.3	127.9	124.0	122.6
Foreign-currency-denominated liabilities to total liabilities 5/	5.8	5.1	5.1	4.1	3.9	3.9	4.0	4.2	4.5	4.4

Source: Bank of Portugal.

1/ On accounting basis; consolidated.
2/ New NPL ratio in line with international practices. On a consolidated basis.
3/ Three-month residual maturity.
4/ Loans to customers (net of impairments) and securitized non-derecognized credit to customers divided by resources from customers and other loans.
5/ Includes foreign currency deposits and deposit-like instruments of resident nonmonetary sector and claims of nonresident vis-à-vis resident monetary financial institutions (excluding Bank of Portugal).

Table 8. Portugal: Monetary Survey, 2011–19

(Millions of euros, unless otherwise indicated; end of period)

			Projections						
	Dec-11	Dec-12	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18	Dec-19
Aggregated Balance Sheet of Monetary Financial Institutions (MFIs) 1/									
Assets	472,496	457,423	429,716	417,101	415,809	421,452	423,955	428,057	431,900
Cash	1,606	1,605	925	880	875	870	865	860	854
Claims on Bank of Portugal	5,692	8,136	2,100	1,658	867	453	237	124	65
Claims on other FIs	53,526	46,870	47,615	41,646	40,074	41,646	40,074	40,446	40,315
Claims on non MFIs	307,347	296,034	286,663	279,006	278,089	280,709	284,270	288,588	292,986
General government	32,309	38,759	40,603	40,242	40,431	40,674	40,635	40,568	40,501
Central government (excluding SOEs)	19,115	27,109	29,372	28,650	28,650	29,098	29,371	29,302	29,233
loans	38	464	326	324	319	315	310	287	263
securities	19,078	26,645	29,046	28,326	28,331	28,783	29,060	29,015	28,970
Bonds	10,307	16,078	22,934	20,541	21,345	21,798	22,075	22,030	21,985
Tbills	8,770	10,567	6,112	7,785	6,985	6,985	6,985	6,985	6,985
Regional and local government (excl SOEs)	6,405	5,592	5,762	5,762	5,762	5,762	5,762	5,823	5,883
SOEs	6,797	6,067	5,469	5,830	6,020	5,814	5,502	5,443	5,384
Private sector	275,038	257,275	246,060	238,764	237,658	240,035	243,635	248,020	252,485
Claims on non-residents	96,585	88,380	75,992	77,211	78,786	80,071	80,157	79,681	78,654
Other assets	7,740	16,398	16,420	16,700	17,117	17,703	18,353	18,359	19,027
Liabilities	472,496	457,423	429,716	417,101	415,809	421,452	423,955	428,057	431,900
Liabilities to Bank of Portugal	46,928	53,724	52,881	44,929	28,723	17,576	12,342	10,302	8,434
Liabilities to other FIs	57,477	42,436	38,117	39,098	38,752	40,191	38,674	39,061	39,842
Deposits of non MFIs	179,701	175,061	172,260	172,198	178,208	184,462	188,605	192,180	195,177
General government	12,279	13,218	8,929	4,498	4,498	4,498	4,498	4,498	4,498
Private sector	167,422	161,843	163,331	167,700	173,710	179,964	184,108	187,682	190,680
Securities other than capital	53,345	46,342	41,139	36,710	37,555	37,933	37,937	37,503	36,665
Liabilities to non-residents	105,130	89,474	74,337	72,479	75,450	78,544	81,764	85,034	88,436
Other	-10,690	326	288	277	271	280	291	301	312
Capital and reserves	40,606	50,061	50,693	51,410	56,850	62,466	64,342	63,676	63,032
Money and Credit									
Broad Money (M3)	172,547	161,855	161,894	164,654	168,767	174,543	180,945	187,645	194,537
Intermediate money (M2)	169,872	156,877	157,091	159,769	163,760	169,364	175,576	182,077	188,765
Narrow money (M1)	67,504	65,785	64,795	65,899	67,546	69,857	72,420	75,101	77,860
Private sector credit	275,038	257,275	246,060	238,764	237,658	240,035	243,635	248,020	252,485
Public sector credit	32,309	38,759	40,603	40,242	40,431	40,674	40,635	40,568	40,501
				(Percent of GDP)					
Broad Money	100.8	98.0	97.9	97.9	97.9	97.9	97.9	97.9	97.9
Private sector credit	160.7	155.8	148.8	142.0	137.9	134.7	131.8	129.4	127.1
Public sector credit	18.9	23.5	24.6	23.9	23.5	22.8	22.0	21.2	20.4
				(Percentage change)					
Broad Money	-1.3	-6.2	0.0	1.7	2.5	3.4	3.7	3.7	3.7
Private sector credit	-1.5	-6.5	-4.4	-3.0	-0.5	1.0	1.5	1.8	1.8
Public sector credit	-4.5	20.0	4.8	-0.9	0.5	0.6	-0.1	-0.2	-0.2
Memo items:									
ECB access (% assets)	9.9	11.7	12.3	10.8	6.9	4.2	2.9	2.4	2.0
Credit to deposits (%) 2/	146.1	148.9	145.8	135.6	130.7	127.9	127.3	127.2	127.0
Loan to deposits (%) 2/	140.6	145.0	140.6	137.1	133.5	130.2	130.1	129.4	128.7
Wholesale market funding (% assets) 3/	29.5	26.0	23.5	22.8	23.6	24.0	24.5	24.8	25.0

Sources: Bank of Portugal and staff estimates.

1/ Excludes Bank of Portugal.

2/ Credit to deposit ratio for banking system as a whole based on monetary statistics.

3/ Includes foreign interbank borrowing and securities issued.

Table 9. Portugal: External Debt Sustainability Framework, 2009–19

(Percent of GDP, unless otherwise indicated)

	Actual				Est.	Projections						
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Debt-stabilizing non-interest current account 6/
Baseline: External debt	223.8	231.0	229.2	232.7	225.2	215.4	205.9	199.8	191.0	185.7	180.5	-2.1
Change in external debt	22.9	7.3	-1.8	3.5	-7.6	-9.8	-9.5	-6.1	-8.8	-5.3	-5.2	
Identified external debt-creating flows (4+8+9)	13.3	0.4	13.5	10.1	-0.9	-4.2	-6.5	-7.1	-7.1	-7.5	-7.8	
Current account deficit, excluding interest payments	4.8	5.3	0.6	-4.9	-5.9	-6.4	-6.8	-7.1	-7.7	-8.3	-9.0	
Deficit in balance of goods and services	7.0	7.2	3.8	0.1	-1.7	-3.0	-3.9	-4.6	-5.1	-5.5	-5.9	
Exports	28.7	31.8	36.4	39.1	41.1	42.7	44.3	45.2	46.3	47.4	48.4	
Imports	35.7	39.0	40.2	39.2	39.4	39.7	40.4	40.7	41.2	41.8	42.5	
Net non-debt creating capital inflows (negative)	-1.8	-4.6	4.2	-0.3	-0.2	-1.7	-2.3	-2.2	-1.7	-1.6	-1.6	
Automatic debt dynamics 1/	10.2	-0.3	8.8	15.2	5.2	3.9	2.6	2.2	2.2	2.5	2.8	
Contribution from nominal interest rate	6.1	5.3	6.4	6.9	5.5	5.6	5.6	5.5	5.7	5.8	6.1	
Contribution from real GDP growth	6.0	-4.2	2.9	7.7	3.6	-1.7	-3.0	-3.3	-3.5	-3.4	-3.3	
Contribution from price and exchange rate changes 2/	-1.8	-1.4	-0.6	0.7	-3.9	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	9.7	6.8	-15.3	-6.6	-6.6	-5.6	-3.0	1.1	-1.7	2.2	2.6	
External debt-to-exports ratio (in percent)	780.1	726.3	630.3	595.4	547.7	504.5	465.0	441.6	412.2	392.0	372.5	
Gross external financing need (in billions of Euros) 4/				183.9	166.9	156.9	140.2	129.1	126.7	123.9	125.3	
in percent of GDP				111.4	100.9	93.3	81.4	72.4	68.6	64.7	63.1	
Scenario with key variables at their historical averages 5/						215.4	218.1	226.4	232.2	242.0	252.5	3.0
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	-2.9	1.9	-1.3	-3.2	-1.6	0.8	1.5	1.7	1.8	1.8	1.8	
GDP deflator in Euros (change in percent)	0.9	0.6	0.3	-0.3	1.7	0.9	1.0	1.7	1.8	1.8	1.8	
Nominal external interest rate (in percent)	3.0	2.4	2.8	2.9	2.4	2.5	2.7	2.8	2.9	3.2	3.4	
Growth of exports (Euros, in percent)	-15.3	13.7	13.2	3.7	5.3	5.6	6.3	5.7	6.2	6.0	6.0	
Growth of imports (Euros, in percent)	-18.1	12.2	1.8	-5.9	0.8	2.4	4.3	4.1	5.0	5.3	5.4	
Current account balance, excluding interest payments	-4.8	-5.3	-0.6	4.9	5.9	6.4	6.8	7.1	7.7	8.3	9.0	
Net non-debt creating capital inflows	1.8	4.6	-4.2	0.3	0.2	1.7	2.3	2.2	1.7	1.6	1.6	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator,
g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency--not used here), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an
appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, deflator growth, and non-debt inflows in percent of GDP) remain at their levels
of the last projection year.

Table 10. Portugal: Access and Phasing Under the Extended Arrangement, 2011–14

Review	Review date[1/]	Action	Purchase	
			In millions of SDRs	In percent of quota
	May 20, 2011	Board approval of Extended Arrangement	5,611	544.9
First review	September 12, 2011	Observation of end-June 2011 performance criteria; completion of first review	3,467	336.7
Second review	December 19, 2011	Observation of end-September 2011 performance criteria; completion of second review	2,425	235.5
Third review	April 4, 2012	Observation of end-December 2011 performance criteria; completion of third review	4,443	431.5
Fourth review	July 16, 2012	Observation of end-March 2012 performance criteria; completion of fourth review	1,197	116.2
Fifth review	October 24, 2012	Observation of end-June 2012 performance criteria; completion of fifth review	1,259	122.3
Sixth review	January 16, 2013	Observation of end-September 2012 performance criteria; completion of sixth review	724	70.3
Seventh review	June 12, 2013	Observation of end-March 2013 performance criteria; completion of seventh review	574	55.7
Eighth and Ninth reviews	November 8, 2013	Observation of end-June 2013 performance criteria; completion of eighth and ninth reviews	1679	163.1
Tenth review	December 15, 2013	Observation of end-September 2013 performance criteria; completion of tenth review	803	78.0
Eleventh review	March 15, 2014	Observation of end-December 2013 performance criteria; completion of eleventh review	760	73.8
Twelfth review	May 15, 2014	Observation of end-March 2014 performance criteria; completion of twelfth review	800	77.7
Total			23,742	2,305.7

Source: Fund staff projections.

1/ For completed reviews the dates refer to Board dates and for future reviews the dates refer to expected availability dates.

Table 11. Portugal: Indicators of Fund Credit

(Millions of euros, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Disbursements	13,052	8,216	3,391	2,650	…	…	…	…	…
(in percent of quota)	1,117	670	289	229	…	…	…	…	…
(Projected debt service to the Fund, based on existing and prospective drawings)									
Total	14	152	170	842	1,505	3,463	4,304	4,769	4,810
Interest and charges	14	152	170	842	985	935	811	657	483
Repayments	0	0	0	0	520	2,528	3,493	4,112	4,327
Total debt service, in percent of									
Exports of goods and services	0.0	0.2	0.3	1.2	2.0	4.3	5.0	5.3	5.0
GDP	0.0	0.1	0.1	0.5	0.9	1.9	2.3	2.5	2.4
(Projected level of credit outstanding based on existing and prospective drawings)									
Outstanding stock	13,052	22,777	24,352	26,629	25,882	23,194	19,593	15,367	11,040
in percent of quota	1,117.1	1,857.4	2,076.2	2,305.7	2,260.3	2,038.2	1,729.8	1,364.6	980.4
in percent of GDP	7.6	13.8	14.7	15.8	15.0	13.0	10.6	8.0	5.6
Memorandum Items (in billions of euros)									
Exports of goods and services	62	65	68	72	76	81	86	91	96
GDP	171	165	165	168	172	178	185	192	199

Source: Fund staff projections. Exchange rate forecasts against the SDR as per WEO assumptions.

Annex I. Summary of Key Structural Reforms, Portugal (2011–present)

Labor Market Reforms	
Enhancing Microflexibility	
Employment protection	Significantly reduce severance pay to make it more in line with the EU average. Labor code changes to facilitate individual dismissals.
Unemployment benefits	Unemployment benefit reform reduced the replacement rate, shortened duration, and reduced minimum benefits. At the same time, the eligibility coverage was extended to certain groups.
Active labor market policies	Reorientation of ALMP toward training programs and/or practical insertion courses. Improving the quality of secondary education and strengthening vocational training.
Enhancing Macroflexibility	
Minimum wage / public sector salaries	Multi-year tripartite agreement on minimum wage increases halted; minimum wage frozen (duration of program). Cuts in civil servant wages expected to reduce private sector reservation wages.
Working time and work arrangements	Labor Code revisions facilitating working time flexibility; reductions in holidays and annual leave days.
Collective bargaining / wage setting mechanism	Introducing a higher degree of representation before allowing extension of collective agreements. Steps to facilitate firm-level agreements.
Product Market Reforms and Liberalization of Services Market	
Competition	New competition framework, including the reinforcement of the powers of the existing Competition Authority. A framework law for the functioning of regulators was also recently enacted, aimed at: 1) protecting the public interest and promoting market efficiency, 2) guaranteeing the independence and financial, administrative and management autonomy of the National Regulatory Authorities, and 3) improving the role of the Competition Authority in enforcing competition rules. Public Procurement Code has been revised.
De-regulation/Business Environment	Efforts have been made to improve the business environment, including by cutting red tape, liberalizing the rental market, streamlining licensing requirements, accelerating judicial processes and improving court management, and reducing the backlog of cases. Removal of certain special rights of the state ("golden shares") in publicly held companies. Privatization program further advanced.
Services	Comprehensive approach to eliminating barriers to entry so as to foster competition in the services sector (legislative changes apply both to sector-specific legislations as well as the framework and bylaws for services self-regulated by professional bodies or by law).
Sectoral reforms	Telecoms: Transposition into national legislation of the EU Regulatory Framework for Electronic Communications. Mobile termination rates lowered. Measures for increased competition in fixed market by improving the mobility of consumers. New 4G spectrum license. Energy: Legislation phased out remaining regulated tariffs for electricity and natural gas. Transposition of the EU's Third Energy Package completed. Rent-reducing measures to alleviate some of the still substantial pressures on end-user prices. Early stages of work towards establishment of a pan-Iberian gas market. Transports: Landmark Port Work reform completed--with substantial effects exected on labor costs and efficiency in ports---and ambitious reform proposals for the port governance model are in train.

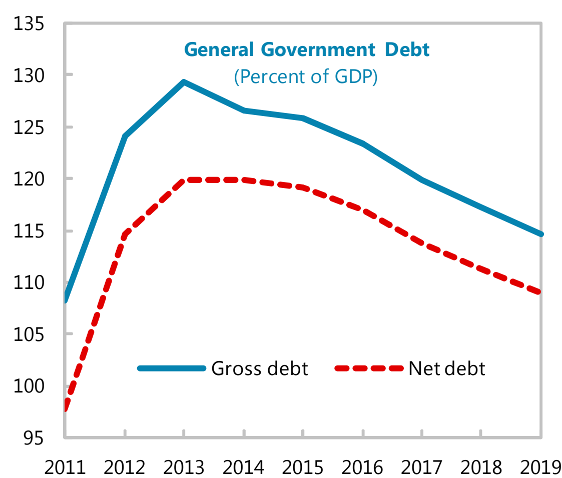
Source: Portugal's 2011 EFF program.

Annex II. Public Debt Sustainability Analysis (DSA)

Staff's analysis, applying the new Public DSA framework for Market-Access Countries, suggests that Portugal's gross debt trajectory remains sustainable under the program's baseline assumptions, subject to sustained fiscal consolidation and structural reform efforts. Nevertheless, given the country's sizable debt burden and gross financing needs, debt dynamics remain highly vulnerable to macro-fiscal and contingent liabilities shocks.

1. Baseline Scenario

Under the baseline, debt is projected to peak below 129½ percent of GDP in 2013 and gradually decline below 115 percent of GDP by 2019 (Figure AII.3 and AII.4). The recent increase in the debt peak (by around 1 percentage point compared to the previous review) is largely explained by the higher Treasury cash balance at end-2013. The decline in the debt-to-GDP ratio starting already in 2014 is expected to be partly supported by use of the government's cash reserves as well as the ongoing reallocation of the Social Security portfolio from foreign assets to government securities—initially expected to be front-loaded in 2013.[1] Portugal's debt net of government deposits—which is a better approximation of the net worth of the public sector given the increasing Treasury cash buffers—is projected to smoothly peak at around 120 percent of GDP in 2013–14 and then decline. The authorities agreed with this assessment (MEFP ¶7).



Sources: Portugal authorities; and IMF staff estimates.

2. Risk Assessment

Portugal's sizable debt burden and gross financing needs continue to pose significant risks to debt sustainability. As presented in Figure AII.1, Portugal's debt ratio exceeds the debt burden benchmark for advanced economies of 85 percent of GDP, suggesting that the country's debt level is highly vulnerable already under the baseline scenario. Moreover, Portugal's public and total external financing needs are both significantly higher than the relevant baseline benchmark.[2] Nevertheless, the debt profile is subject to medium to low risks in terms of market perception,

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[1] Please refer to the DSA Annex to the Eighth and Ninth Reviews Staff Report (Country Report No. 13/324) for further details.

[2] In the case of Portugal, however, the external financing requirements figure includes non-residents bank deposits, accounting for about 45 percent of GDP.

projected change in short-term debt, and the share of public debt held by nonresidents. Moreover, in the case of Portugal, the standard template indicates that the contingent liabilities shock is not relevant, due to limited bank vulnerabilities. Indeed, BSSF resources for €6.4 billion remain available under the program to support the banking sector and are already built into in the debt baseline projections. Nevertheless, the materialization of contingent liabilities from SOEs, including due to possible reclassifications, and PPPs may pose additional risks.

3. Realism of Baseline Assumptions and Alternative Scenarios

The attainment of potential growth assumed under the program has important implications for the debt adjustment path. Although Portugal's forecast track record is comparable to that of other countries with Fund-supported programs during the crisis period 2009–12, the growth forecast error tended to be significantly higher in earlier years (Figure AII.2). Nevertheless, staff's analysis suggests that achieving a 2-percent growth rate over the long-term is a realistic objective for Portugal, consistent with moderate growth convergence, as structural reforms start bearing fruit and the economy successfully rebalances from the nontradable to the tradable sectors.[3] That said, if growth were to turn out lower than currently projected, the rate of debt decline would significantly slow down, as also shown in Figure AII.4 and AII.5. Similarly, if the elevated deflationary risks in the euro area were to materialize, this could further impede the repair of the already-weak private and public balance sheets in Portugal.

Portugal's primary balance exceeds its debt-stabilizing threshold over the projection period, largely reflecting the sizable fiscal effort already achieved under the program. Under the baseline scenario, the fiscal primary balance is expected to reach about 3¼ percent of GDP by 2019. As estimated in Figure AII.2, the 3-year change in the cyclically-adjusted primary balance indentified for Portugal is in the top quartile of the fiscal adjustments observed in other countries with debt greater than 60 percent of GDP. While, due to the 3-year rolling nature of the estimate, this largely reflects the country's fiscal efforts already achieved over 2011–13 and not just the consolidation plans in the outer years, Portugal's debt profile remains vulnerable to a primary balance shock (Figure AII.4 and AII.5). This is also highlighted by the asymmetric fan chart analysis in Figure AII.1, which shows the risks to the debt outlook if only negative shocks to the primary balance were to materialize. Moreover, the authorities' medium-term fiscal strategy targets an even more ambitious adjustment path than staff's baseline,[4] consistent with the Fiscal Compact framework which establishes a minimum structural adjustment effort of ½ percent of GDP per year, until the medium term objective is achieved.

[3] Staff's potential growth estimates under the baseline scenario are based on an augmented growth-accounting framework, as discussed in Country Report No. 13/18.

[4] In line with the WEO guidelines and past practice under the program, medium-term assumptions that are not backed up by well-defined fiscal measures or go well beyond the program period are not incorporated by the team under the baseline scenario.

4. Stress Tests

The baseline remains highly sensitive to macro-fiscal and contingent liabilities shocks (Figure A.5)**:**

- Under a *growth shock* that lowers output by over 4 percentage points in 2015–16 (and in turn inflation by a cumulative 1 percentage point), debt would peak at 133 percent of GDP in 2016, around 9 percentage points higher compared with the 2015 baseline.

- A sustained interest rate shock of 200 bps on all debt throughout the projection period (consistent with the effective interest rate levels recorded at the peak of the crisis) is not expected to have a large immediate effect, but it would slow down the rate of debt decline in the medium term, so that by 2018 the debt-to-GDP ratio is almost 3 points higher compared with the baseline.

- A sizable realization of contingent liabilities would also have important implications for Portugal's debt dynamics. Banking sector vulnerabilities, as assessed by the MAC DSA tools, are limited and the additional resources available in the BSSF to backstop potential banking sector costs are already built into the baseline projections. Nevertheless, staff's updated assessment of fiscal risks suggests that, under a severe scenario, contingent liabilities could potentially materialize for about 7 percent of GDP, due to SOEs, PPPs, state guarantees, as well as broader reclassification issues.[5] A contingent liabilities shock of this magnitude would immediately push the 2015 debt ratio to nearly 133 percent of GDP, with debt reaching 122 percent of GDP only by 2019.

- A severe combined shock that incorporates all of the adverse scenarios mentioned above would significantly compromise the country's debt dynamics, with debt peaking at almost 139 percent of GDP in 2014 and declining only slowly to 134 percent of GDP by 2019.

[5] Staff's assumptions for the adverse contingent liabilities scenario include (i) 20 percent of the entire outstanding stock of PPPs claims being disputed by concessionaires; (ii) 20 percent of the SOE debt directly guaranteed by the State; (iii) 20 percent of the total amount of direct credit guarantees from the state; (iv) the full impact of the planned SOE debt reclassification due to the introduction of the ESA2010 rules, applying preliminary estimates as of end-2012; and (v) treatment of the entire stock of debt, included SOE debt subject to reclassification, at market value.

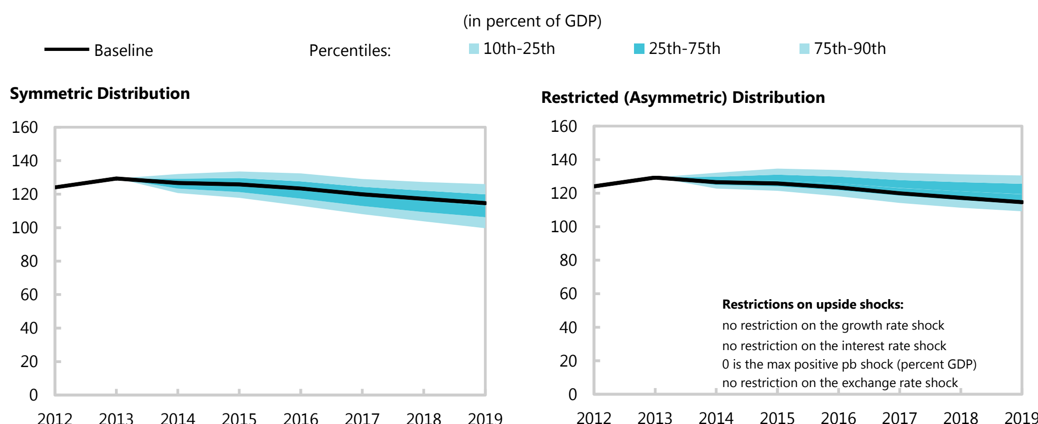
Figure AII.1. Portugal: Public DSA – Risk Assessment, 2012–19

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

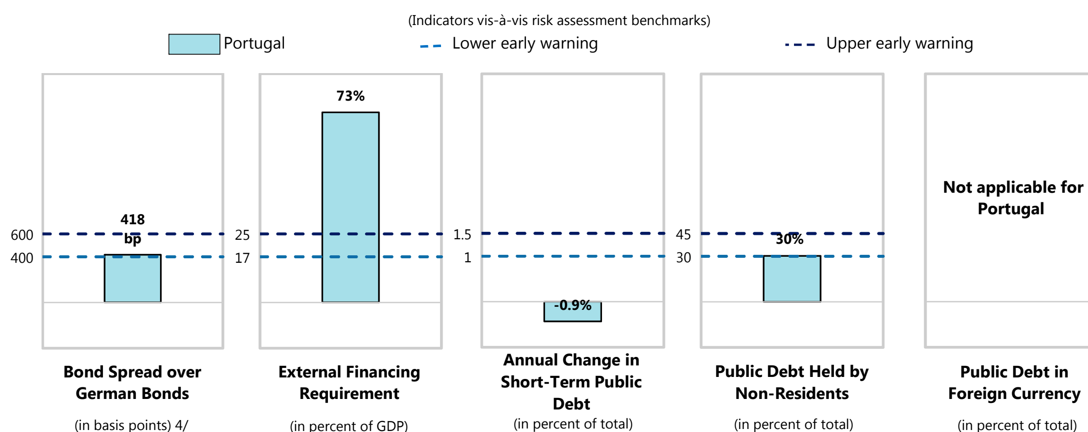
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant. In the case of Portugal, while the MAC DSA template indicates that the contingent liabilities shock is not relevant, due to limited bank vulnerabilities, the relevant cell is nonetheless highlighted in yellow given contingent liabilities risks from SOEs and PPPs.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

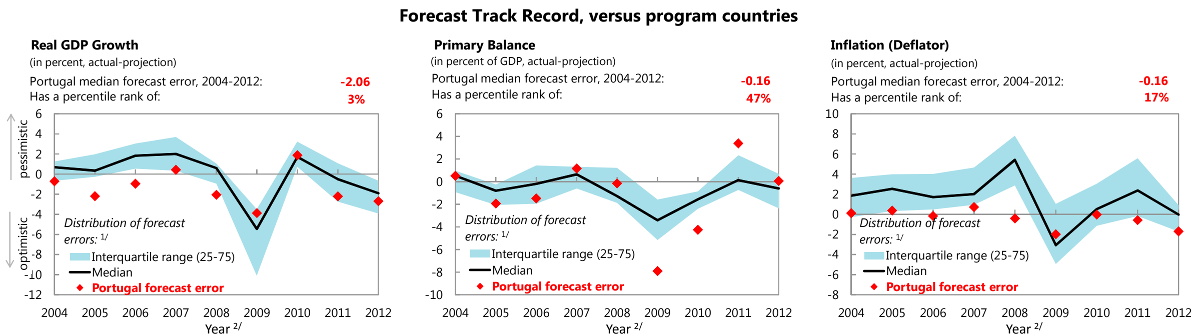
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents. In the case of Portugal, the external financing requirements figure includes bank deposits by non-residents (accounting for about 45 percent of GDP).

4/ An average over the last 3 months, 20-Sep-13 through 19-Dec-13.

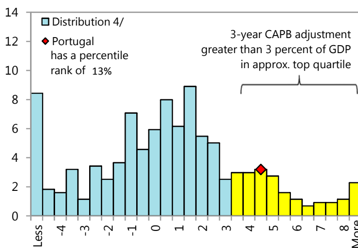
Figure AII.2. Portugal: Public DSA – Realism of Baseline Assumptions

Forecast Track Record, versus program countries

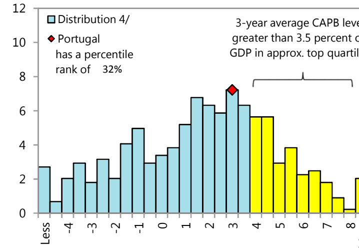


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Source : IMF Staff.
1/ Plotted distribution includes program countries, percentile rank refers to all countries. For the primary balance, Portugal forecast error for 2004-2009 was constructed using comparable WEO series.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Portugal.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure AII.3. Portugal: Public DSA – Baseline Scenario, 2003–19

(Percent of GDP, unless otherwise indicated)

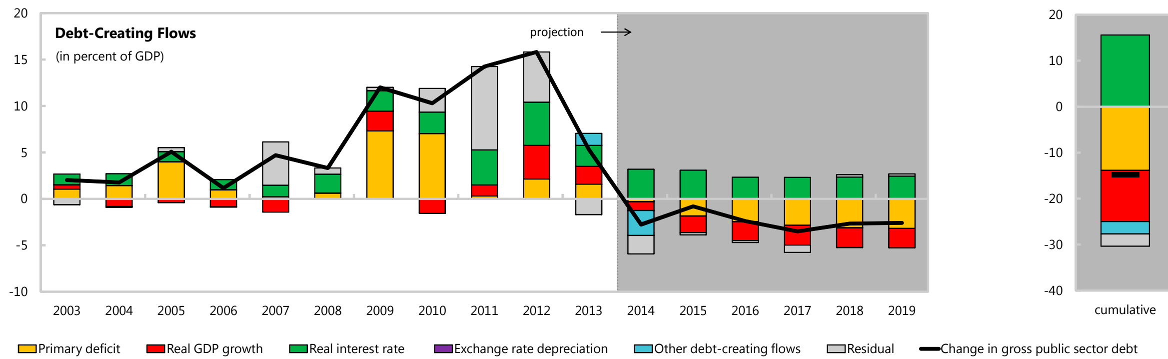
Debt, Economic and Market Indicators [1/]

	Actual		Prel.	Projections					
	2003-2011 [2/]	2012	2013	2014	2015	2016	2017	2018	2019
Nominal gross public debt	73.9	124.1	129.4	126.6	125.8	123.4	119.9	117.3	114.7
Public gross financing needs	...	29.1	21.0	19.9	20.9	19.7	20.5	20.0	17.4
Real GDP growth (in percent)	0.3	-3.2	-1.6	0.8	1.5	1.7	1.8	1.8	1.8
Inflation (GDP deflator, in percent)	1.9	-0.3	1.7	0.9	1.0	1.7	1.8	1.8	1.8
Nominal GDP growth (in percent)	2.2	-3.5	0.1	1.7	2.5	3.4	3.7	3.7	3.7
Effective interest rate (in percent) [4/]	4.5	3.9	3.5	3.4	3.5	3.6	3.8	3.9	4.0

As of December 19, 2013		
Sovereign Spreads		
Spread (bp) 3/		418
CDS (bp)		355
Ratings	Foreign	Local
Moody's	Ba3	Ba3
S&Ps	BB	BB
Fitch	BB+	BB+

Contribution to Changes in Public Debt

	Actual		Prel.	Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	6.1	15.8	5.3	-2.8	-0.8	-2.4	-3.5	-2.7	-2.6	-14.7	
Identified debt-creating flows	4.2	10.4	7.0	-0.8	-0.6	-2.2	-2.7	-2.9	-2.9	-12.1	
Primary deficit	2.5	2.1	1.6	-0.3	-1.9	-2.5	-2.9	-3.1	-3.2	-13.8	0.4
Primary (noninterest) revenue and grants	41.3	40.9	43.2	42.8	42.7	42.5	42.1	41.6	41.1	252.9	
Primary (noninterest) expenditure	43.8	43.1	44.8	42.5	40.9	40.0	39.2	38.5	37.9	239.0	
Automatic debt dynamics [5/]	1.6	8.3	4.2	2.2	1.3	0.3	0.1	0.2	0.4	4.5	
Interest rate/growth differential [6/]	1.6	8.3	4.2	2.2	1.3	0.3	0.1	0.2	0.4	4.5	
Of which: real interest rate	1.8	4.7	2.3	3.2	3.1	2.3	2.3	2.3	2.4	15.6	
Of which: real GDP growth	-0.1	3.6	1.9	-1.0	-1.8	-2.0	-2.1	-2.1	-2.1	-11.1	
Exchange rate depreciation [7/]	0.0	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	1.3	-2.7	0.0	0.0	0.0	0.0	0.0	-2.7	
Privatization Revenue (negative)	0.0	0.0	0.3	-0.1	0.0	0.0	0.0	0.0	0.0	-0.1	
Increase in deposits and other (- means drawn down of deposits)	0.0	0.0	1.0	-2.6	0.0	0.0	0.0	0.0	0.0	-2.6	
Residual, including asset changes [8/]	1.9	5.4	-1.7	-2.0	-0.2	-0.2	-0.8	0.3	0.3	-2.7	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Bond Spread over German Bonds.

4/ Defined as interest payments divided by debt stock at the end of previous year.

5/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the denominator in footnote 4 as r - π (1+g) and the real growth contribution as -g.

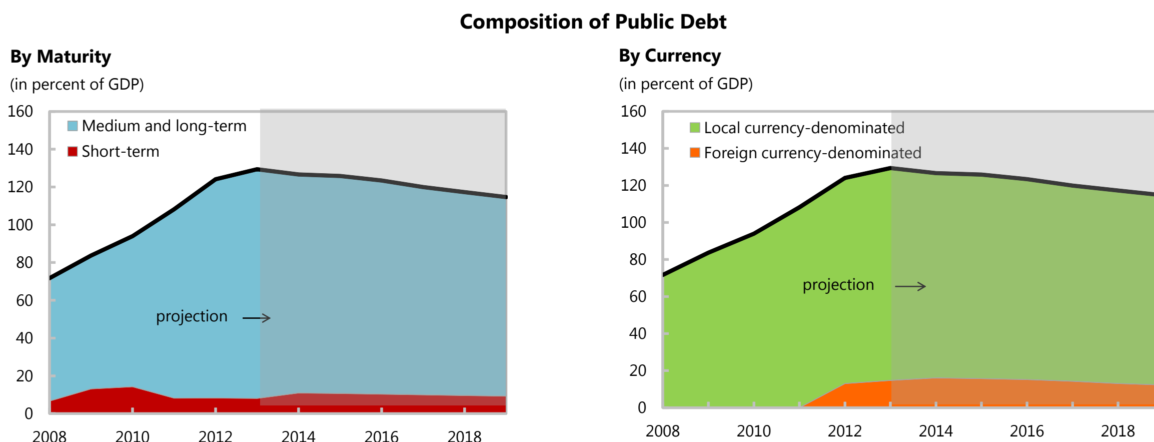
7/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

8/ For projections, this line includes exchange rate changes during the projection period.

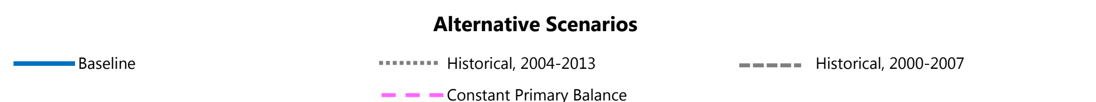
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

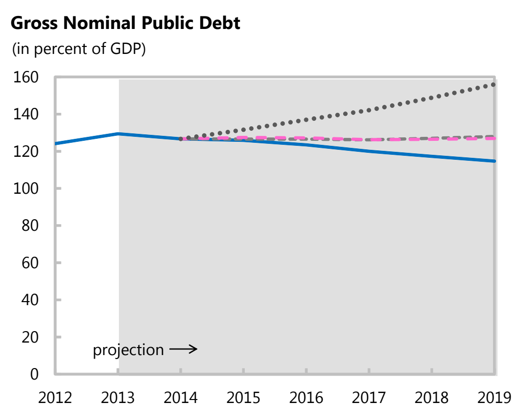
Figure AII.4. Portugal: Public DSA – Composition of Public Debt and Alternative Scenarios, 2008–19

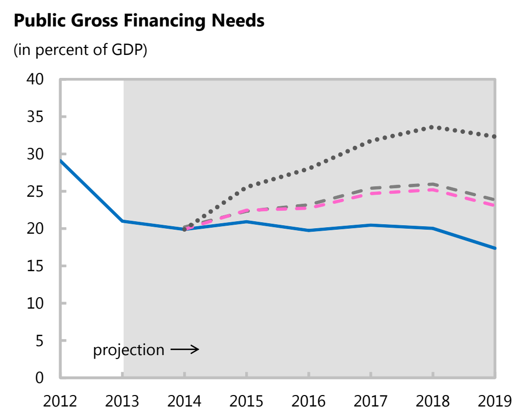
Composition of Public Debt



Alternative Scenarios







Underlying Assumptions

(in percent)

Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	0.8	1.5	1.7	1.8	1.8	1.8
Inflation	0.9	1.0	1.7	1.8	1.8	1.8
Primary Balance	0.3	1.9	2.5	2.9	3.1	3.2
Effective interest rate	3.4	3.5	3.6	3.8	3.9	4.0
Constant Primary Balance Scenario						
Real GDP growth	0.8	1.5	1.7	1.8	1.8	1.8
Inflation	0.9	1.0	1.7	1.8	1.8	1.8
Primary Balance	0.3	0.3	0.3	0.3	0.3	0.3
Effective interest rate	3.4	3.5	3.7	3.8	3.9	4.1

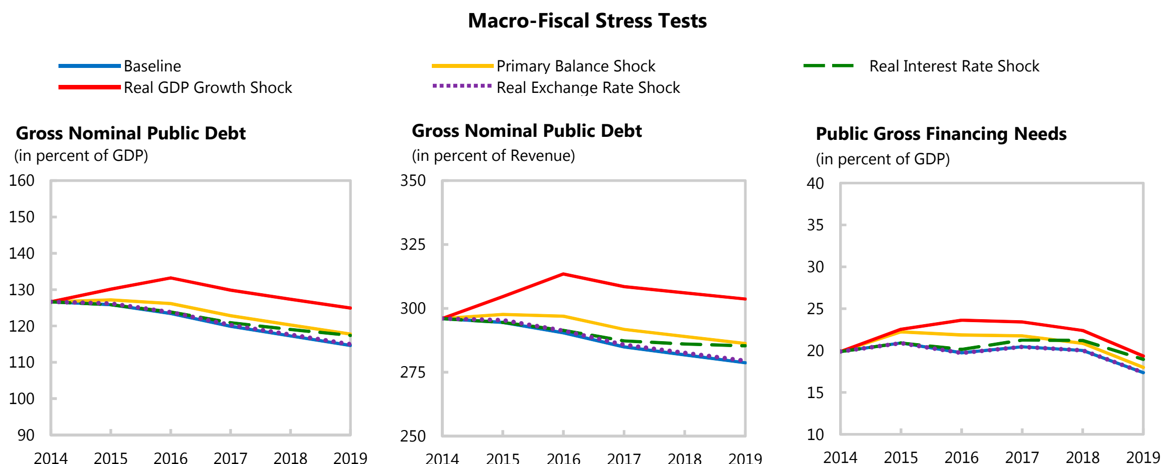
Historical, 2004-13	2014	2015	2016	2017	2018	2019
Real GDP growth	0.8	-0.1	-0.1	-0.1	-0.1	-0.1
Inflation	0.9	1.5	1.5	1.5	1.5	1.5
Primary Balance	0.3	-2.6	-2.6	-2.6	-2.6	-2.6
Effective interest rate	3.4	3.5	3.8	4.0	4.2	4.4

Historical, 2000-07	2014	2015	2016	2017	2018	2019
Real GDP growth	0.8	1.5	1.5	1.5	1.5	1.5
Inflation	0.9	3.0	3.0	3.0	3.0	3.0
Primary Balance	0.3	-1.3	-1.3	-1.3	-1.3	-1.3
Effective interest rate	3.4	3.5	3.6	3.8	3.9	4.1

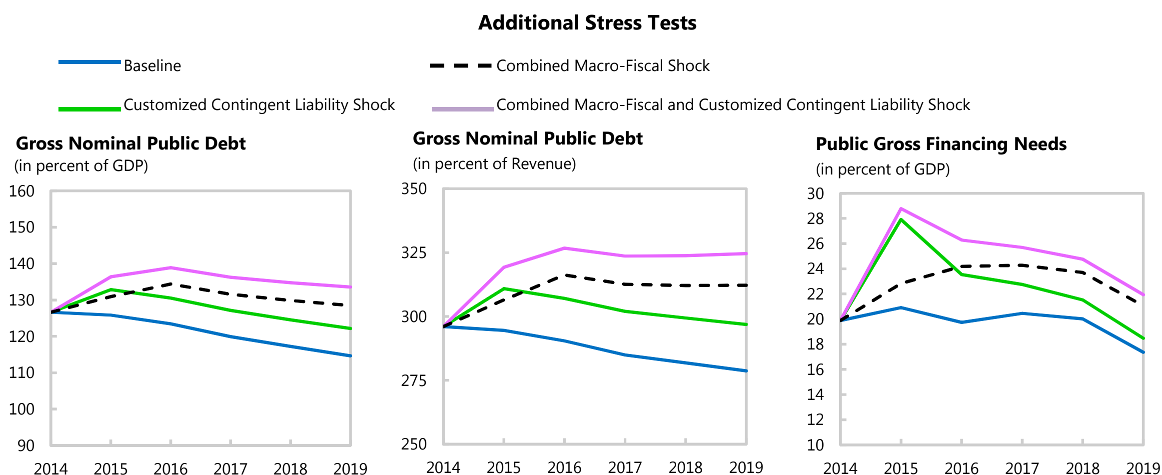
Source: IMF staff.

Figure AII.5. Portugal: Public DSA – Stress Tests, 2014–19

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2014	2015	2016	2017	2018	2019
Real GDP growth	0.8	1.5	1.7	1.8	1.8	1.8
Inflation	0.9	1.0	1.7	1.8	1.8	1.8
Primary balance	0.3	0.5	1.1	2.9	3.1	3.2
Effective interest rate	3.4	3.5	3.7	3.9	4.0	4.1
Real Interest Rate Shock						
Real GDP growth	0.8	1.5	1.7	1.8	1.8	1.8
Inflation	0.9	1.0	1.7	1.8	1.8	1.8
Primary balance	0.3	1.9	2.5	2.9	3.1	3.2
Effective interest rate	3.4	3.5	4.0	4.3	4.5	4.8
Combined Shock						
Real GDP growth	0.8	-0.6	-0.4	1.8	1.8	1.8
Inflation	0.9	0.5	1.2	1.8	1.8	1.8
Primary balance	0.3	0.5	0.4	2.9	3.1	3.2
Effective interest rate	3.4	3.5	4.0	4.3	4.6	4.9
Customized Contingent Liability Shock						
Real GDP growth	0.8	1.5	1.7	1.8	1.8	1.8
Inflation	0.9	1.0	1.7	1.8	1.8	1.8
Primary balance	0.3	-5.1	2.5	2.9	3.1	3.2
Effective interest rate	3.4	3.5	3.7	3.9	4.0	4.1

Real GDP Growth Shock	2014	2015	2016	2017	2018	2019
Real GDP growth	0.8	-0.6	-0.4	1.8	1.8	1.8
Inflation	0.9	0.5	1.2	1.8	1.8	1.8
Primary balance	0.3	0.8	0.4	2.9	3.1	3.2
Effective interest rate	3.4	3.5	3.7	3.9	4.0	4.1
Real Exchange Rate Shock						
Real GDP growth	0.8	1.5	1.7	1.8	1.8	1.8
Inflation	0.9	1.1	1.7	1.8	1.8	1.8
Primary balance	0.3	1.9	2.5	2.9	3.1	3.2
Effective interest rate	3.4	3.5	3.6	3.8	3.9	4.0
Combined Macro-Fiscal and Customized Contingent Liability Shock						
Real GDP growth	0.8	-0.6	-0.4	1.8	1.8	1.8
Inflation	0.9	0.5	1.2	1.8	1.8	1.8
Primary balance	0.3	-5.4	1.7	2.9	3.1	3.2
Effective interest rate	3.4	3.5	4.1	4.5	4.7	5.0

Source: IMF staff.

Portugal: Letter of Intent

Lisbon, January 27, 2014

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Ms. Lagarde:

1. The attached Memorandum of Economic and Financial Policies (MEFP) describes the progress made in recent months toward the objectives laid out in our program supported by the Extended Arrangement. It also updates previous MEFPs and highlights the policy steps to be taken in the months ahead.

2. We have made further progress towards the program objectives. The end-September deficit and debt performance criteria were met, and preliminary information suggests that we are also on track to comfortably meet the end-year targets, reflecting our firm commitment to fiscal discipline. We continue to take steps to fight tax evasion and mitigate fiscal risks, including through the recent creation of the Compliance Risk Management Unit. As part of our structural efforts, we have recently made further progress in the services sector, with steps aiming at eliminating entry barriers and increasing competition. Moreover, to secure the resilience of the banking sector amidst a still challenging operating environment, Banco de Portugal has proactively stepped up its supervisory activity.

3. Nevertheless, further efforts are still needed to anchor growth on a sustainable basis, complete our ambitious fiscal consolidation plan in line with our European commitments, and vigilantly monitor the resilience of the financial system in the context of the ongoing deleveraging and rebalancing of the economy. In particular,

- Many of the structural reforms originally envisaged in the program are now in place, and are beginning to have an impact, as evidenced by the gradual improvement in the macroeconomic outlook, underpinned by a solid export performance and improved market conditions. Yet, despite recent signs of economic stabilization, unemployment remains high, calling for renewed efforts to promote an adjustment more favorable to growth and employment. To this purpose, we are assessing necessary policy actions to further promote the dynamism and efficiency of the labor market, while continuing to reduce excessive rents in product markets and supporting a business-friendly environment.

- The 2014 budget law was approved by Parliament, with measures largely drawn from our ambitious Public Expenditure Review, targeting a general government deficit of 4 percent of GDP and ensuring a consolidation strongly tilted towards permanent spending measures.

Moreover, in response to a recent adverse Constitutional ruling on a key provision of the pension reform, we have identified offsetting measures of comparable size and quality. These include the frontloading of the planned increase in the beneficiaries' contributions to the special health insurance schemes (ADSE, SAD and ADM) and a recalibration of the parameters of the existing extraordinary solidarity contribution on pensions (CES). Submission to Parliament of the revised CES through a supplementary budget and approval by the Council of Ministers of the decree law on the change in contributions to the special health insurance schemes are *prior actions* for completion of this review. We are now in the process of developing new comprehensive measures as part of the ongoing structural reform of pensions, in line with the Court ruling. Stocktaking of this process will be made during the next review. More generally, we are determined to advance further our comprehensive reform of Public Administration, underpinning our commitment to the fiscal sustainability rules in the European Treaty on Stability, Coordination, and Governance.

- To support our medium-term fiscal objectives and ensure a more equitable adjustment, we remain determined to make further progress in streamlining the public sector, curbing tax evasion, and strengthening our budget control. In particular, we are determined to halt any new accumulation of arrears through targeted programs and full enforcement of the Commitment Control Law.

- We are committed to preserving financial stability and supporting an orderly deleveraging of balance sheets. Efforts to promote adequate funding conditions for the dynamic segments of the economy continue. In anticipation of the European Central Bank's comprehensive assessment, to be conducted this year in the context of the Single Supervisory Mechanism, Banco de Portugal will continue to vigilantly monitor the banking system, ensuring its supervisory standards remain in line with international best practice.

We trust that our continued commitment to fiscal discipline and structural reforms will further support investors' confidence in the Portuguese economy and secure our successful return to capital markets on a durable basis.

4. On the basis of the strength of the policies outlined in this letter, and in light of our performance under the program, we request the completion of the tenth review under the Extended Arrangement, as well as a waiver of applicability for the end-December deficit and debt performance criteria.

5. We remain confident that the policies described in the current and previous MEFPs are adequate to achieve the objectives under the program. We stand ready to take additional measures should they be needed to meet the objectives of the economic program and will consult with the IMF, the European Commission, and the ECB, in advance of any necessary revisions to the policies contained in this letter and attached Memorandum.

6. This letter is copied to Messrs. Dijsselbloem, Rehn, and Draghi.

Sincerely yours,

/s/	/s/	/s/
Paulo Portas	Maria Luís Albuquerque	Carlos da Silva Costa
Deputy Prime Minister	Minister of State and Finance	Governor of the Banco de Portugal

Attachments: 1. Memorandum of Economic and Financial Policies (MEFP)
2. Technical Memorandum of Understanding (TMU)

Attachment I. Portugal: Memorandum of Economic and Financial Policies

January 27, 2014

Macroeconomic Outlook

1. **Recent Macroeconomic Developments.** Economic activity is recovering. In the third quarter of 2013, output grew by 0.2 percent, thereby registering, for the first time in three years, two consecutive quarters of growth. This growth is underpinned by a modest recovery in domestic demand and robust exports, with the latter growing 6.6 percent year-on-year. The unemployment rate has fallen further to 15.6 percent in the third quarter, from 16.4 percent in the second quarter and 15.8 in the third quarter of 2012, driven by the expansion of employment, in particular in tourism-related activities, while the labor force remained broadly stable following previous declines.

2. **Outlook.** High-frequency indicators point to a continued moderate expansion in activity, and sentiment is gradually approaching its long-term average. Accordingly, we expect output to contract by 1.6 percent, compared with a contraction of 1.8 percent projected at the time of the last review. Growth in 2014 is still expected to pick up to 0.8 percent, supported by an increase in investment, a continued strong export performance, offset in part by higher imports, recovery in domestic consumption, and with unemployment projected to peak at 16.8 percent. Headline inflation averaged 0.3 percent in 2013, reflecting still weak domestic demand. Despite recent improvements, uncertainty remains elevated, as the negative impact of private sector deleveraging and of fiscal consolidation on growth may turn out to be stronger than expected, particularly if the competitiveness adjustment achieved to date is not sustained.

3. **External adjustment.** The current account adjustment continues, albeit at a slower pace, and is estimated to have registered a small surplus of about ½ percent of GDP in 2013, to be followed by a surplus of about 1 percent this year. This is lower than projected at the time of the last review, mainly due to an upward revision in domestic demand and imports. Nevertheless, strong export growth continues to underpin the external adjustment, supported by robust demand from non-EU trading partners with export market share gains in most markets. In addition, exports within the EU appear to have troughed, with exports to Spain—Portugal's main trading partner—growing by 10 percent in the first eleven months of 2013. In the short term, however, weaker demand from trading partners remains the main downside risk to external adjustment. Most importantly, while the structural reforms envisaged in the program have largely been implemented and are starting to bear fruit, maintaining robust export growth over the medium term will require continued improvement in external competitiveness.

Fiscal Policy

4. **2013 Budget.** The end-September quantitative performance criteria on the general government cash balance and debt were met by a comfortable margin, in the context of solid revenue performance. Moreover, the budgetary overruns and revenue shortfalls identified at the time of the previous review were addressed through additional measures –including use of the provisional budget allocation, reduction of funds available to line ministries, and recourse to a one-off (tax and social security contribution) debt recovery scheme—approved in a second supplementary budget of November 2013. While final figures are not yet available, preliminary data indicate that we are on track to achieve our general government deficit objective of 5.5 percent of GDP (excluding the BANIF recapitalization costs of 0.4 percent of GDP). This is consistent with an underlying structural primary adjustment of around 0.5 percent of GDP in 2013.

5. **2014 Budget.** We remain committed to achieving our 2014 deficit target of 4 percent of GDP in 2014—consistent with a structural primary adjustment of 1 percent of GDP. To achieve these objectives while arresting the accumulation of domestic arrears, the 2014 budget law, approved by Parliament last November, and its supporting legislation identify around 2.3 percent of GDP in measures. Specifically,

- **Public Expenditure Review (PER)**. Most of the budget measures were drawn from our ambitious public expenditure review, aimed at ensuring the sustainability, effectiveness, and social equity of the state expenditure programs, through (i) a wage bill reform; (ii) a pension reform; and (iii) sector specific savings, in line with the understandings reached at the time of the eighth and ninth reviews. As a result of the Parliamentary discussion of the budget law, key wage bill and pension measures have been amended to better protect lower income earners and ensure more equitable savings, with necessary compensating measures already identified in the budget. Moreover, in response to an adverse Constitutional ruling on December 19th on a key provision of the pension reform, aligning the rules and benefits of the public sector pension funds, CGA, to the general pension regime, we have identified offsetting measures of comparable size and quality to ensure the attainment of the fiscal deficit target of 4 percent of GDP. These include the frontloading of the planned increase in the beneficiaries' contributions to the special health insurance schemes (ADSE, SAD and ADM), with corresponding savings for the State, and a recalibration of the parameters of the existing extraordinary solidarity contribution on pensions (CES). Submission to Parliament of the revised CES through a supplementary budget and approval by the Council of Ministers of the decree law on the change in contributions to the special health insurance schemes are *prior actions* for completion of this review. The existing pension legislation of the CGA will be also modified to ensure that the new rules on retirement age effectively apply also to this regime. We are monitoring closely the attainment of the defined budget objectives for each line ministry, through monthly reporting to the Council of Ministers, in particular on the targeted reduction in the size of the public sector workforce. In this context, following the conclusion of the first voluntary separations scheme, we have recently launched two new schemes on teachers and other qualified employees, respectively, and other schemes targeting excessive employment in the

public administration are currently under preparation. In the design of any new programs aimed at reducing over-employment in specific sub-sectors, we will continue to aim at a change in the composition of the public sector workforce towards high-skilled and better-trained civil servants.

- **Additional measures.** The approved budget law and supporting legislation also included additional measures to offset upward expenditure pressures. The supporting legislation necessary to implement these measures is being finalized. In particular, we have approved the ministerial order defining the contribution for the media spectrum, as well as the decree law on the remaining measures on survivors' pensions. We will approve the ministerial order defining the levy on financial institutions by end-March 2014. The final proposal for the measure on online gambling is expected to be sent to the Council of Ministers for approval by end-February 2014. The port concession tender and real estate sale is expected by end-September 2014, while the winning bidder for the Silopor concession has been selected. The transfer from the CTT health fund and the sales of excess oil reserves will take place by end-year.

- **CIT Reform.** In parallel, we have also approved in December a comprehensive reform of the Portuguese corporate income tax (CIT) regime aimed at boosting investment and growth. The reform includes measures to simplify the CIT regime through a broadening of the tax base, the gradual lowering of the rate (frontloaded for SMEs), and the rationalization of surcharges and incentive schemes. The reform also includes steps aimed at lowering compliance costs, reducing litigation, improving international competitiveness, as well as reducing policy-induced debt bias. The measures envisaged in the reform for 2014 and the outer years will be implemented within the existing fiscal target commitments.

Should any risks to the execution of the budget materialize, we remain committed to implement, following discussion with EC/ECB/IMF staff, compensatory measures of equivalent size and quality to meet the agreed deficit target.

6. **Medium-term fiscal consolidation.** We will advance our fiscal consolidation efforts in 2015, with a targeted deficit of 2.5 percent of GDP, consistent with a structural primary adjustment of around 1¼ percent of GDP, securing a successful exit from the EU Excessive Deficit Procedure. Moreover, further fiscal effort of about ½ percent of GDP will be needed in the outer years to keep public debt on a downward trajectory, in compliance with the medium-term fiscal sustainability requirements in the European Treaty on Stability, Coordination, and Governance. To this end, the following initiatives are currently ongoing:

- The new **Public Administration** law—aiming at aligning the current public employment regime to private sector rules—was submitted to Parliament and is expected to be approved by end-March 2014. Building on the principles identified in the law, we are conducting a comprehensive review and reform of wage supplements, with a draft law expected to be submitted to Parliament by end-June. In parallel, we have also started a comprehensive review of public sector remunerations and careers, which we expect to finalize in the second half of 2014. We are also in the process of developing new comprehensive measures as part of the ongoing

structural reform of pensions, in line with the recent Constitutional Court ruling on the CGA convergence reform. Stocktaking on this process will be made during the next review.

- The above-mentioned steps to reform the Public Administration are part of our far-reaching **Proposal for the Reform of the State**, whose general principles were approved by the Council of Ministers last October. The reform will aim at achieving efficient and sustainable public sector policies, underpinning the balanced budget objectives and fiscal sustainability rules in the recently-ratified European Treaty on Stability, Coordination, and Governance—which now ranks higher than ordinary legislation. Broad-based consultations with political and social partners are ongoing to seek consensus on specific reforms. Following this first round of consultations, we will submit a new document to the Council of Ministers by end-March 2014 with draft proposals, preferably with broad-based political and social consensus, on different reform areas, which should ideally include social security sustainability, flexibilization and requalification of the public sector workforce, rationalization of general government entities, as well as greater efficiency in health and education. Progress with this process will be discussed at the time of the next review.

- Moreover, in order to comply with EU budgetary framework requirements, the **2014 Fiscal Strategy Document** will provide details of the medium-term budgetary plans, to be discussed at the time of the eleventh review.

7. **Debt Path.** Under the programmed fiscal path, gross debt is set to have peaked below 129½ percent of GDP in 2013. The increase in the debt peak vis-à-vis the eighth and ninth reviews is largely explained by the higher Treasury cash balance at end-2013. Accordingly, net debt—excluding IGCP's deposits—is projected to smoothly peak at close to 120 percent of GDP in 2013 and 2014, slightly below the previous review. The decline in the general government gross debt-to-GDP ratio starting in 2014 is expected to be partly supported by further use of cash deposits as well as the ongoing reallocation of the Social Security portfolio from foreign assets to government securities.

Containing Fiscal Risks

8. **Public Financial Management.** We have made further progress in advancing our Public Financial Management reform, but stricter compliance with the commitment control law is needed to prevent any new accumulation of domestic arrears, particularly in the health sector.

- Important steps have been taken in transposing the EU economic and governance fiscal framework. We remain committed to complete this process in our Budget Framework Law (BFL) by end-March 2014. In parallel, on the basis of the report of the technical group charged with revising the BFL, we will work, in close consultation with IMF staff, on developing the key principles and elements that will be reflected in the new legislation crystallizing reforms undertaken so far and underpinning an effective public financial management system. As the next step, we will consult in the early part of 2014 with key stakeholders to discuss the key elements of the legislation, notably imparting a medium-term focus to public finance, streamlining the budget appropriation structure, and strengthening accountability relations. We

will aim at reaching an agreement on the key aspects and structure of the new law and completing the underlying technical work by end-April 2014. As part of these efforts, we will undertake an IMF Fiscal Transparency Evaluation by the end of the program, which will be made publicly available. In line with the above, we have already published for the second year a tax expenditure report as well as providing information on the fiscal risks along with the Budget.

- We remain committed to preventing any accumulation of new domestic arrears, the stock of which amounted to €2.7 billion at end-August 2013. We have identified, with support from IMF/EC/ECB staff, selected public entities—including some of the large hospitals—that face structural financial imbalances. As a next step, we will develop, by end-February, targeted programs to underpin the financial sustainability of these entities. The Commitment Control Law will be enforced in full to all public entities—including entities under targeted programs—so as to bring to zero the net accumulation of arrears in line with the continuous indicative target under the program. We will also establish by end-February a dedicated unit with the Ministry of Finance, reporting directly to the State Secretary of the Budget in charge of the expenditure arrears for the public sector. The second settlement program in the health sector—in the value of €432 million— following the same procedures as envisaged in the March 2012 strategy document, was finalized last December.

9. **Revenue Administration.** To bolster revenue performance in support of our medium-term fiscal objectives, we remain determined to make further progress in curbing tax evasion. Recent steps in this direction included hiring 1000 new tax auditors, besides making fully operational the Large Taxpayer Unit and conducting successfully an e-invoice reform. The Compliance Risk Management Unit, created last November, is expected to become fully operational by end-March 2014. This unit aims at strengthening tax compliance by (i) phasing in of a modern compliance risk model; (ii) strengthening PIT compliance management, through the pilot projects on the High Net Wealth Individuals and the Self-employed Professionals; and (iii) enhancing control of the monthly PIT withholding information. Consistent with our ongoing efforts to curb tax and social security fraud, we have increased sanctions for criminal offenders. Moreover, we are planning to establish by end-2014 a dedicated Taxpayer Services Department, unifying most services related to taxpayers and improving their relationship with the tax administration. As part of the reorganization of the tax administration, we are committed to close 25 percent of local tax offices by end-March and additional 25 percent by end-May 2014. Moreover, we will also further strengthen the exchange of information between the tax and the AML authorities, in line with international best practices.

10. **State-Owned Enterprises.** Cost-reduction efforts and voluntary separation programs have helped improve the consolidated operational balance of state-owned enterprises (SOEs), although some of them are expected to have remained in negative territory in 2013, also as a result of the reinstatement of the 13th and 14th month salaries. We will retain formal cost-reduction objectives for loss-making firms, while requiring other firms to continue improving operating balances with a view to reducing debt burdens and financial costs. We also continue to manage the high debt burdens of some firms, ensuring that any treasury support remains within the envelope of budgeted transfers. Moreover, we have further strengthened governance with the entry into force of the new framework

law for SOEs last December. The law enhances financial and operational reporting requirements, concentrates all shareholder functions in the Ministry of Finance, and envisages the creation of a dedicated Technical Unit – which is expected to be operational by end-April 2014. The law also reinforces the monitoring of SOE debt by centralizing borrowing decisions at the Debt Management Agency (IGCP).

11. **Privatization**. The privatization program remains on track. The initial public offering for 70 percent of the shares of the postal company CTT was successfully completed in early December, with shares priced at the upper end of the range. The sale of the airline, TAP, however, is on hold, after the initial privatization plan fell through at end-2012 due to inadequate financial assurances by the final bidder. We continue to actively seek buyers for the group as a whole and expect to re-launch the process in the course of this year. The privatization of the rail cargo firm, CP Carga, has been postponed pending the unbundling of its terminals, expected to take place by June 2014. We have prepared a strategic plan for the water and waste sectors, with a view to improving their efficiency, including by introducing private capital and management in the system. Binding offers for the sale of the waste management company, EGF, are expected by mid-May 2014. Opening water concessions to private capital and management is expected to take longer. The restructuring of transport SOEs in Lisbon and Porto is ongoing, with five concessions expected to be launched by end-March 2014. The government will further consider expanding the privatization program to include additional assets for sale or concessions.

12. **Public-Private Partnerships (PPPs).** We continue taking steps to achieve a fiscally responsible PPP model. We are finalizing a major renegotiation of road contract PPPs with all concessionaires, generating additional structural accumulated savings of more than €2.5 billion over the life cycle of these concessions. Moreover, the renegotiation of the Security Integrated System (SIRESP) PPP contract is proceeding as envisaged, with the objective of generating further permanent savings in 2014 via a reduction on its internal rate of return and scope optimization. The revision of the regulatory framework for the road and rail sectors, reducing operation, maintenance, and major repair requirements, in line with EU standards and with the objective of minimizing fiscal risks is nearly finalized. Furthermore, the Ministry of Finance PPP unit continues working towards enhancing fiscal transparency, improving reporting on PPPs, expanding its field of action to other sectors, namely health and security, and advising the autonomous region of Madeira.

13. **Regional and Local Governments.** We remain committed to fiscal discipline in local and regional governments. The program for local governments' arrears settlement (PAEL) supported 95 municipalities with disbursements of €534 million as of end-December 2013. The remaining 10 municipalities will be supported, for an amount of up to €300 million, pending clearance by the Court of Auditors. With the Regional Finance Law and Local Finance Law (LFL), both approved by Parliament and published last September, we have created a coordination council between the central and subnational governments, which will be operative by end-February. The council is expected to enhance exchange of information in order to support budgetary planning. The LFL also introduced an insolvency procedure for local governments, including an early warning system for debt accumulation and a Municipality Resolution Fund. The rules and procedures of this fund are

being designed by a group of specialists and are expected to be submitted to Parliament in a separate draft law by end-March 2014. In terms of regional governments, Madeira's program with the State (PAEF) remains broadly on track, but we will continue to closely monitor budgetary risks.

Safeguarding Financial Stability

14. **Bank Supervision.** While compliance of the banking system with regulatory requirements has continued to be satisfactory, the Banco de Portugal (BdP) remains vigilant amidst a challenging operating environment.

- *Management of Distressed Loans*. The BdP, supported by an external advisor, has finalized the Special Assessment Program (SAP) that sought to review the policies and procedures of the eight largest banks in the area of distressed loan management. The results of the SAP have been discussed with the banks and the BdP is monitoring the timely implementation of the recommendations issued.

- *Credit Impairment*. Guidelines on measuring credit portfolio impairment and disclosure of asset quality and risk management practices will be published by mid-February, incorporating best practices identified during the three impairment reviews that have been conducted since May 2011. Additional disclosure requirements envisaged in the impairment guidelines will be reflected in banks' financial statements as of June 30, 2014. Where needed, banks have made substantial progress in enhancing their collective impairment models in line with recommendations made as part of the Special Inspections Program. High priority items have been addressed satisfactorily by end-December 2013.

- *Loan Classification***.** The BdP has amended its instruction on the identification and marking of restructured loans due to financial difficulties of the client, incorporating definitions of forbearance that have been developed by the European Banking Authority (EBA). The BdP will review its standards on nonperforming loans, in line with the timeframe set at the EU level for the implementation of relevant technical standards. The BdP will continue to rigorously enforce prudent loan classification by the banks.

- *Real Estate*. The BdP is promoting the development of a consistent and common set of criteria for real estate appraisers for the Portuguese financial system, under the aegis of the National Council of Financial Supervisors. The new standards impose strict rules on appraisers' fit and properness—including remuneration rules and code of conduct, among others. In addition, real estate valuation requirements, applicable to all financial institutions, have been tightened to ensure that institutions' collateral valuations remain sufficiently conservative. Banks have updated valuations of all real estate assets that have been obtained in lieu of payment and whose last valuation was done before July 31, 2012. The BdP will verify compliance with these requirements by the second quarter of 2014.

15. **Stress Test Exercise.** To ensure the rigor of the quarterly stress test exercise, the BdP has further enhanced its quality assurance and review process of the bottom-up results. In particular, the

BdP enhanced its credit risk model. Moreover, the BdP has further developed its top-down stress testing framework, which now can allow for an estimation of key drivers of the results of the bottom-up exercise. The BdP expects to integrate the top-down stress testing framework into the quality assurance process in the next round of quarterly stress tests, to be finalized in February 2014.

16. **Transition to CRD IV.** As of January 1, 2014, banks are expected to maintain, at a minimum, a common equity Tier 1 (CET1) capital ratio of 7 percent, consistent with the CRD IV package considering all the transitional provisions related to the definition of capital. In the context of the ECB's forthcoming asset quality review, the largest banks are expected to maintain a CET1 add-on of 1 percentage point. Additional measures will be in place to preserve banks' current capital buffers, ensuring that they remain commensurate with the challenging operating environment. We will also ensure compliance with the requirements envisaged in the EBA Recommendation on the preservation of capital and any future regulatory initiatives at European level.

17. **BSSF.** We remain committed to providing further support to the banking sector, in the event new capital needs were to arise. While we will continue to encourage banks to seek private solutions, resources from the Bank Solvency Support Facility (BSSF) remain available to support viable banks if needed. The resources in the BSSF will solely be utilized to provide public support, if needed, to the banking system. State aid will remain subject to strict conditionality, in line with the recently amended EU State-aid rules, aimed at avoiding subsidizing private shareholders and preventing migration of private liabilities to the public sector balance sheet, while ensuring adequate lending to the real economy.

18. **Recovery and Resolution Plans.** The BdP has issued recommendations on the recovery plans of the largest banks, and is currently reviewing the plans from all the other banks. The BdP has received the data submission on the resolution plans for the largest banks and initiated on-site visits to these institutions, with a view to validating the data received and enhancing their resolution preparedness. The necessary amendments to the recapitalization law, reflecting the recent updated Banking Communication, issued by the European Commission in July 2013, on the application of the State-aid rules to support measures in favor of banks in the context of the financial crisis, were approved by Parliament in December 2013 and entered into force in January 2014. Moreover, we remain committed to swiftly transposing the new EU Directive on bank recovery and resolution once it has been adopted.

19. **Funding and Liquidity Conditions.** Deposits have remained stable in an environment of gradually decreasing remuneration rates. Furthermore, banks' access to money market funding is improving. Nonstandard measures by the ECB to restore the proper transmission of monetary policy have helped ease liquidity pressures and continue to play a pivotal role in absorbing remaining funding constraints, while strengthened collateral buffers provide an important shield against potential adverse shocks. In parallel, we continue to explore with our European partners further initiatives to support funding conditions, including potential mechanisms to securitize banks' high quality mortgage and SME credit.

20. **Initiatives to Facilitate Access to Finance.** Notwithstanding some improvements, the credit situation remains challenging, especially among SMEs. In this context and consistent with their funding and capital plans, banks continue to ensure that the deleveraging process takes place in an orderly manner to achieve stable market-based funding positions, while adequate and sustainable financing is provided to the economy. Furthermore, we've stepped up our efforts to promote more efficient financing allocation to the productive segments of the economy through further enhancements to our existing government-guaranteed credit instruments as well as the promotion of an efficient use of EU structural funds and alternative private funding options for SMEs. Specifically,

- *Government-Guaranteed Credit Instruments*. To make these schemes more efficient, we have implemented the key policy recommendations from the recent external audit of the National Guarantee System (NGS) and also other measures that resulted from the assessment of the Ministry of Economy. In particular, we have taken steps to improve the competitiveness and transparency of the current pricing system. These include (i) a refinement of the methodology of determining the maximum interest rates (caps) that participating institutions can charge on guaranteed credit lines, updated on a semi-annual basis, reflecting their banks' funding and administrative costs, and differentiated by various risk profiles of SMEs; (ii) a full disclosure by participating institutions of the caps per risk class in the marketing material; (iii) a close monitoring of the rates effectively charged. Moreover, we will explore, by end-February 2014, additional steps to be taken by individual participating institutions to further enhance the transparency of their pricing practices. A report will be prepared by May 15, 2014 to take stock of the impact of these enhancements on actual interest rates and, if needed, to propose remedies and policy alternatives including a competitive bidding system, in order to ensure that guaranteed loans will be priced in a competitive and transparent manner, in favor of end users. Moreover, to support viable firms in financial difficulties and to encourage these firms to go through the debt restructuring process at an early stage, a new guaranteed credit line has been designed, in line with the EU State-aid rules, for viable firms that have successfully completed a corporate debt restructuring process and effectively reduced nominal debt level. We will finalize the general guidelines and start a pilot test within the existing budgetary envelope by end-March 2014. We will continue to monitor the balance sheet performance of the firms benefiting from government-guaranteed credit lines through our quarterly monitoring framework.

- *Development Financial Institution.* The Council of Ministers has approved the establishment of a development financial institution (DFI) aiming at streamlining and centralizing the management of the reimbursable part of the financial instruments of the EU structural funds for the 2014-2020 programming period. The DFI's sole purpose shall be to address market failures in the financing of private nonfinancial corporations, notably SMEs, and in doing so it shall not accept deposits or other repayable funds from the public, nor engage in direct lending. Its final structure and by-laws will reflect in-depth consultation with EC, ECB and IMF staff and will be designed to ensure no additional burden on or risks to public finances.

- *Development of SMEs Commercial Paper*. The necessary amendments to the existing rules regulating the commercial paper market were approved by the Council of Ministers and will become effective by end-January, aiming at facilitating the expansion of the commercial paper market among a wider investor base and increasing the use of this alternative funding option by the corporate sector, notably SMEs.

21. **Central Credit Registry.** We are on track to complete the enhancements in our credit registry, as agreed in the combined eighth and ninth reviews. IT systems have been updated in order to receive additional information, allowing for the earmarking of loans that are classified as nonperforming or have been restructured due to financial difficulties of the borrower. The proposal from the BdP for revising the legal framework of the Central Credit Registry has been sent to the Ministry of Finance for consideration and in consultation with the Portuguese Data Protection Authority, and will be sent to the Council of Ministers for approval by end-April 2014. The proposed legislation allows financial institutions to have access to companies' historical information as well as to the corporate balance sheet database, reducing information asymmetries, especially for smaller companies. We expect to complete the implementation of these changes by end-June 2014.

22. **BPN SPVs.** The gradual recovery of the assets from Banco Português de Negócios (BPN), held by three state-owned Special Purpose Vehicles (SPV), is progressing. Contracts with external service providers for the management of part of the credit portfolio of Parvalorem have been signed, and the disposal of the participations and assets held by the other two state-owned SPVs is continuing. CGD's state-guaranteed claim will be gradually settled in cash, according to the schedule agreed with the EC, ECB, and IMF staff. Any net recoveries realized on the assets will also be applied towards the settlement of CGD's claim.

Boosting Employment, Competitiveness, and Growth

23. **Overall Reform Strategy.** The ultimate objective of our structural reform agenda is to enhance competitiveness and improve the business environment, so as to engineer a sustainable rebalancing of the economy toward the tradable sectors and boost medium-term growth and job creation prospects. Reforms initiated at the beginning of the program are drawing to a close. Significant steps were taken on the labor and product market fronts, where reforms were designed to alleviate nominal rigidities, facilitate adjustment, and foster a reallocation of resources toward the tradable sector. Important steps were also taken to reduce red tape and raise the efficiency of the judicial system. We are now refocusing our efforts on assessing the impact of the reforms already implemented and ensuring that the initial objectives are being achieved. In this context, an outcome-based accountability framework is being prepared to draw more concrete links between notional reforms and actual outcomes. Concurrently, we are working toward identifying the remaining policy distortions and other potential priority areas which will be tackled in the next phase of reforms.

24. **Labor Market Institutions.** Significant steps have been taken over the past couple of years to make the labor market more dynamic and efficient—including reforming the Employment Protection Legislation, streamlining unemployment benefits and reforming the wage-setting

mechanism. In view of the still high unemployment, notwithstanding recent signs of stabilization, we have launched an analysis of policy options to promote an adjustment more favorable to employment. In this context, the government has prepared by end-December 2013 a report assessing policy options in three main areas (i) ensuring more effective decentralization of wage bargaining, (ii) ensuring more wage flexibility, and (iii)study proper alignment of incentives to challenge dismissals in court. The report findings and policy proposals will be discussed in the context of the eleventh review. In light of the recent Constitutional Court ruling against legislative provisions that made it easier for firms to lay off employees in case of redundancy or unsuitability, the government's immediate priority will be to enact alternative measures. In particular, specific economic criteria to select employees in case of redundancies (including performance and cost-related) will be introduced in the law. Regarding dismissals for unsuitability, employers will be required to assess the possibility of finding an alternative position in the same professional category. We will submit these legislative amendments to Parliament by end-January 2014.

25. **Energy.** We continue our efforts to improve the sustainability of the national electricity system. Steps have been taken in the past year to reduce excessive rents, mainly through renegotiation. Nonetheless, our revised medium-term tariff debt projections clearly show strong upward pressures on the system's debt, reflecting partly downward pressures on the demand for electricity. Since we are concerned about the potential impact on competitiveness of the large electricity price increases necessary to eliminate the system's debt by 2020, we are preparing other options to better balance the burden of adjustment between the various stakeholders of the electricity sector, notably by eliminating remaining excess rents. These options will be discussed with the IMF/EC/ECB at the time of the eleventh review. Following the identification by the government of the problem of distortion on the system services market and highlighted in the reports of the relevant regulators, we will implement the necessary measures in line with these reports concerning the risks of overcompensation in the adjustment calculations (*revisibilidade*) of the CMEC scheme, including an independent audit on risk of overcompensation and the amount of past overcompensations. Finally, we will ensure that the energy sector levy introduced in the context of the 2014 budget will not be passed through to end-users.

26. **Ports.** We are taking steps aimed at reducing costs for exporters. Following reductions in fees on port use (*TUP-Carga*) and a revision of the Ports Work Law, we are now seeking further transmission of lower labor costs to end-users of port services. We have prepared detailed timetable for other measures ensuring cost reduction and enhanced performance of both port authorities and port operators. The immediate priority will be to engage with concessionaires with a view to modifying existing concession contracts so as to foster price reduction. However, in view of the ongoing discussions on implementation of the new Port Work Law, negotiations will start in the first quarter of 2014. We will also revise incentives for port operators by adopting a new performance-based model for future concessions and encourage entry of new operators. A review of the overall cost savings for exporters generated by the Port Work Law is being conducted, the result of which will be discussed at the time of the eleventh review.

27. **Competition/Regulation**. A framework law for the functioning of regulators was recently enacted. The law: (i) establishes a regulatory environment that protects the public interest and promotes market efficiency, (ii) guarantees the independence and the financial, administrative and management autonomy of the National Regulatory Authorities in the exercise of their responsibilities, including the necessary conditions to safeguard adequate human and financial resources being able to attract and retain sufficiently qualified staff, and (iii) strengthens the role of the Competition Authority in enforcing competition rules. We will redouble efforts to finalize the amendment of the corresponding bylaws of the National Regulatory Authorities, with the last revised drafts expected to be approved (by the parliament or the government) by end-February 2014. Once the regulators bylaws and internal regulations are in place, the regulators will continue to pursue the adoption of best international regulatory practices, including by organizing international peer review exercises. We are taking the necessary steps to ensure the effective functioning of the Competition Authority financing model and avoid disruptions in the transitory period up to the entry into force of the corresponding provisions in the forthcoming bylaws by enforcing the necessary transfers from the contributing regulators.

28. **Services.** Reforms in the services sector aim at eliminating entry barriers and increase competition. Significant progress has already been made in amending sector-specific legislations to align them with the Services Directive. We expect adoption by Parliament of the remaining necessary amendments—including to the Construction Law—by end-February 2014. The related ordinance, ensuring appropriateness of fees linked to construction activities, will be adopted under the same timeline. The new legal framework aiming at improving the functioning of the regulated professions for which regulation involves a professional body (such as accountants, lawyers, notaries) was published in early 2013. The professional bodies' statutes will be amended accordingly and submitted to Parliament for final approval by end-February 2014. The new legislations eliminate unjustified restrictions to activity and further improve the conditions for mobility of professionals in line with the EU Directives in the area of free movement of professionals.

29. **Licensing and Administrative Burden.** Tackling excessive licensing procedures, regulations and other administrative burdens—which are impeding the establishment, operation, and expansion of firms—is a government priority. The New Legal Regime on Urbanism and Building (RJUE) will be adopted by end-February 2014. To prevent future growth in excessive licenses and regulations, the government will adopt a rule that makes it mandatory to propose eliminating an existing regulation for all new regulations generating costs for businesses. We are preparing an inventory of regulations that are likely to have higher impact in economic activity (at central, regional and local levels), selecting the most burdensome. On this basis, we will devise a cost-analysis (currently under preparation) and roadmap for a regulatory simplification to be discussed at the time of the eleventh review. We have already adopted legislation to ease licensing requirements for tourism and industrial sectors. We have also taken significant steps and will continue our efforts to make fully operational the Point of Single Contact, an e-government portal which allows administrative procedures to be conducted online.

30. **Judiciary.** We are making further progress in the implementation of judicial reforms. The legislation to enhance the supervision of enforcement agents and insolvency administrators (CAAJ) entered into effect on December 21, 2013. We expect CAAJ to be fully implemented by the first half of 2014. We will publish quarterly reports on the clearance rate and disposition time of enforcement cases for the third quarter of 2013 onwards (within four months after the end of the relevant quarter).

Table 1. Portugal: Quantitative Performance Criteria

(Billions of euros, unless otherwise specified)

	Mar-13		Jun-13		Sep-13		Dec-13	Mar-14
	Program	Actual	Program	Actual	Program	Actual		
1. Floor on the consolidated General Government cash balance (cumulative)	-1.9	-1.4	-6.0	-3.8	-7.3	-4.3	-8.9	-1.7
2. Ceiling on accumulation of domestic arrears by the General Government (continuous indicative target) 1/	0	Not met	0	Not met	0	Not met	0	0
3. Ceiling on the overall stock of General Government debt	182.2	178.5	187.3	184.1	188.9	184.7	191.3	193.0
4. Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by the general government (continuous performance criterion)	0	…	0	…	0	0	0	0

1/ As of end-September, domestic arrears for the purpose of the program increased by close to €0.06 billion since end-June and €0.5 billion since end-December 2012, largely due to the accumulation of arrears by SOE hospitals.

Table 2. Portugal: Structural Conditionality: Tenth Review Under the EFF

Measure		Timing	Status
Prior Actions			
1	Submit to Parliament a supplementary budget to enact the necessary changes to the existing extraordinary solidarity contribution on pensions (CES), consistent with the general government deficit target of 4 percent of GDP (MEFP ¶5).		Met
2	Approve the decree law on the increase in the beneficiaries' contributions to the special health insurance schemes (ADSE, SAD and ADM) (MEFP ¶5).		Expected to be met by end-January
Structural Benchmarks			
A. Fiscal policy			
1	Submit to Parliament a new draft public administration labor law that will aim at aligning current public employment regime to the private sector rules, including for working hours and holiday time, and termination of tenure.	July 15, 2013	Met with delay
2	Submit to Parliament a draft law on the redesigned mobility pool.	End-June 2013	Met
3	Submit to Parliament a legislative proposal that increases the statutory retirement age to 66 years.	July 15, 2013	Changed to prior action and met
4	Submit to Parliament a legislative proposal that aligns the rules and benefits of the public sector pension fund, CGA, to the general pension regime.	July 15, 2013	Met with delay
A. Strengthen financial stability			
5	Submit to Parliament amendments to the law governing banks' access to public capital.	End-January, 2013	Met
B. Enhance competitiveness and address bottlenecks to growth			
6	Enact the severance pay reform that reduces severance payments to 12 days per year for all new permanent labor contracts	October 1, 2013	Met
7	Update projections of the medium-term energy tariff debt path and identify policy options to eliminate the tariff debt by 2020 .	June 15, 2013	Met
C. Strengthen fiscal institutions and reduce fiscal risks			
8	Revise and submit to Parliament the draft regional and local public finance law.	End-Dec 2012	Met
9	Implement a full-fledged Large Taxpayer Office (LTO), to cover audit, taxpayer services, and legal functions concerning all large taxpayers, including the adoption of account managers.	End-Dec 2012	Met

Attachment II. Portugal: Technical Memorandum of Understanding

January 27, 2014

1. This Technical Memorandum of Understanding (TMU) sets out the understandings regarding the definitions of the indicators subject to quantitative targets (performance criteria and indicative targets), specified in the tables annexed to the Memorandum of Economic and Financial Policies. It also describes the methods to be used in assessing the Program performance and the information requirements to ensure adequate monitoring of the targets. We will consult with the EC, the ECB, and the IMF before modifying measures contained in this letter or adopting new measures that would deviate from the goals of the Program, and provide the EC, the ECB, and the IMF with the necessary information for Program monitoring.

2. For Program purposes, all foreign currency-related assets, liabilities, and flows will be evaluated at "Program exchange rates" as defined below, with the exception of the items affecting government fiscal balances, which will be measured at spot exchange rate (i.e., the rate for immediate delivery) prevailing on the date of the transaction. The Program exchange rates are those that prevailed on May 5, 2011. In particular, the exchange rates for the purposes of the Program are set €1 = 1.483 U.S. dollar, €1 = 116.8390 Japanese yen, €1.09512 = 1 SDR.

3. For reporting purposes, the MoF and BdP will employ the reporting standards and templates considered to be appropriate given the transmission of data covered by this TMU, unless otherwise stated or agreed with the EC, the ECB and the IMF.

General Government

4. **Definition.** For the purposes of the Program, the General Government, as defined in the Budget Framework Law, Law No. 91/2001 of August 20, amended by Law 22/2011 of May 20, includes**:**

- 4.1. The Central Government. This includes:
  - 4.1.1. The entities covered under the State Budget, which covers the budgets of the Central Administration, including the agencies and services that are not administratively and financially autonomous, agencies and services that are administratively and financially autonomous (*Serviços e Fundos Autónomos* – SFA).
  - 4.1.2. Other entities, including Incorporated State-owned enterprises (ISOE), or extra-budgetary funds (EBF) not part of the State Budget, but which are, under the European System of Accounts (ESA95) and ESA95 Manual on Government Deficit and Debt rules, classified by the National Statistical Institute (INE) as part of the Central Government.

- 4.2. Regional and Local Governments, that include:
  - 4.2.1. Regional Governments of Madeira and Azores and Local Governments (*Administrações Regionais and Locais*);
  - 4.2.2. Regional and local government-owned enterprises or companies, foundations, cooperatives and other agencies and institutions, which are, under the ESA95 and ESA95 Manual on Government Deficit and Debt rules, classified by the INE as Local Government.
- 4.3. Social Security Funds comprising all funds that are established in the general social security system.
- This definition of General Government also includes any new funds, or other special budgetary and extra budgetary programs or entities that may be created during the Program period to carry out operations of a fiscal nature and which are, under the ESA95 and ESA95 Manual on Government Deficit and Debt rules, classified by the INE in the correspondent subsector. The MoF will inform the EC, ECB, and IMF of the creation of any such new funds, programs, entities or operations at the time of its creation or statistical re-classification or, in the case of Regional and Local Governments, at the time the Government acknowledges its creation.
- The General Government, as measured for purposes of Program monitoring in 2013, shall not include entities nor operations (including pension funds) that are re-classified into the General Government during 2013, but shall include those reclassified in 2011-12.[1]
- The General Government, as measured for purposes of Program monitoring in 2014, shall not include entities nor operations (including pension funds) that are re-classified into the General Government during 2014, but shall include those reclassified in 2012-13.

5. **Supporting Material**

- 5.1. Data on cash balances of the State Budget will be provided to the EC, the ECB and the IMF by the MoF within three weeks after the end of the month. Data will include detailed information on revenue and expenditure items, in line with monthly reports that are published by the MoF.

[1] An operation refers to part of a legal entity that is involved in the production or delivery of goods and services—including government services provided on a nonmarket basis. As such, it does not include transactions relating to the assets or liabilities of an entity. For example, should an entity handle a number of PPPs, reclassifying only one PPP would be considered as reclassifying an operation. In contrast, taking over part of an entity's debt by the government would not qualify for the exclusion. On this issue, see also paragraph 13.

- 5.2. Data on the cash balances of the other parts of General Government as defined in paragraph 4[2] will be provided to the EC, the ECB and the IMF by the MoF within seven weeks after the end of the month. Data will include detailed information on revenue and expenditure items. Data will also include detailed information on PPP-related revenues and expenditures for those PPP reclassified within the General Government sector according to ESA 95, and called guarantees.

- 5.3. Data on domestic and external debt redemptions (securities), new domestic and external debt issuance (securities), change in the domestic and foreign currency assets and liabilities of the Central Government at the BdP and other financial institutions will be provided to the EC, the ECB, and the IMF by the BdP within 40 days after the closing of each month.

- 5.4. BdP will provide to the EC, the ECB, and the IMF detailed monthly data on the financing of the General Government, as defined in ESA95, within seven weeks after the closing of each month.

- 5.5. Data on the revenues, operating expenses, capital expenditure, remuneration of personnel, EBITDA, and number of staff will be provided for state-owned enterprises (SOEs) on a quarterly basis, within 7 weeks after the end of each quarter. Aggregate data for the SOEs within the perimeter will be provided, with company-specific information for REFER, Estradas de Portugal, Metro de Lisboa, and Metro de Porto. Furthermore data for Comboios de Portugal and Parpública (outside the perimeter) will also be provided.

Quantitative Performance Criteria, Indicative Ceilings, and Continuous Performance Criteria: Definitions and Reporting Standards

A. Floor on the Consolidated General Government Cash Balance (Performance Criterion)

6. **Definition.** The consolidated General Government cash balance (CGGCB) is defined as the sum of the cash balances of the entities covered by the State Budget, the ISOE, the Regional and Local Governments, and the Social Security Funds, and other entities and EBFs, as defined in paragraph 4. Privatization receipts will be excluded from cash receipts. In 2012 and beyond, revenues from the reclassification of pension funds into the general government will not be accounted for as cash revenues for the purpose of the calculation of the consolidated general government cash balance. In 2012-13, the cash proceeds from the sale of the ANA airport concession will be accounted for as cash expenditure-reducing transactions. The net acquisition of financial assets for policy purposes, including loans and equity participation will be recorded as cash

[2] In 2011, data exclude regional and local government-owned enterprises or companies, foundations, cooperatives and other agencies and institutions, which are, under the ESA95 and ESA95 Manual on Government Deficit and Debt rules, classified by the INE as Local Government, i.e., entities referred in paragraph 4.2.2.

expenditures, except for transactions related to the banking sector support and restructuring strategy under the Program. Called guarantees (excluding those related to the banking sector support and restructuring strategy), where entities of the General Government make cash payments on behalf of entities that are not part of the General Government, will be recorded as cash expenditures.

- 6.1. **The Cash Balance of the State Budget.** The cash balance of the State Budget will be measured from above the line, based on budget revenues (recurrent revenue plus nonrecurrent revenue, including EU revenues, minus tax refunds) minus budget expenditures of the State Budget as published monthly on the official website of the DGO of the MoF, and in line with the corresponding line items established in the State Budget. Budget expenditures will exclude amortization payments but include salaries and other payments to staff and pensions; grants to Social Security Funds, medical care and social protection; operational and other expenditure, interest payments; cash payments for military equipment procurement; and EU expenses.

- 6.2. **The Cash Balance of the Regional and Local Governments, Social Security Funds, ISOE and Other Entities or EBFs.** The cash balance of each of these parts of the General Government will be measured from above the line, based on revenues minus expenditures as it will be provided by the DGO of the MoF in the monthly General Government budget execution report (see Para 5), and in line with the corresponding line items established in their respective budgets. All entities including ISOE that prepare accrual-based financial statements will submit monthly cash flow statement in accordance with form and content specified by the MoF. The reporting by Local Government will be phased as set out in paragraph 8 below.

- 6.3. **Adjustor.** The 2013 and 2014 quarterly floors on the consolidated general government cash balance will be adjusted for the cumulative amount of arrears settled in the context of the arrears clearance strategy: (i) health sector arrears (up to €432 million), (i) local government arrears settled through the €1 billion credit facility created in May 2012, and (ii) RAM government arrears subject to concluding the agreement with the central government (up to €1.1 billion).

Other Provisions

7. For the purpose of the program, the expenditure of the central government that is monitored excludes payments related to bank support, when carried out under the program's banking sector and restructuring strategy. However, any financial operation by central government to support banks, including the issuance of guarantees or provision of liquidity, will be immediately reported to the EC, ECB, and IMF.

8. Quarterly consolidated accounts for the General Government on a cash basis will be reported for internal, EC, ECB, and IMF monitoring 7 weeks after the reference period, starting with the first quarter of 2012. The reports will be published externally starting with December 2011 data.

SOEs will be consolidated with the general government accounts starting with the first quarter 2012. The larger municipalities (defined as those with a population of 100,000 voters or more) are required to provide monthly reports under current arrangements, and their cash balance will be included in the calculation of the monthly cash General Government balance. The cash balance of the smaller municipalities, i.e. those with a population of under 100,000 voters, will be excluded until any necessary legal changes requiring them to provide monthly reports have been put in place. In this transitory period, the MoF will provide a monthly estimate of the cash balance of these smaller municipalities excluded from the General Government reports to the EC, the ECB, and the IMF.

9. **Supporting Material**

9.1. Data on cash balances of the State Government, ISOEs, Regional and Local Government and Social Security Funds will be provided to the EC, the ECB and the IMF by the MoF within seven weeks after the end of each month. The information provided will include general government net acquisitions of financial assets for policy purposes, including loans and equity participations, as well as called guarantees where entities that are part of the General Government make cash payments on behalf of entities that are not part of the General Government.

9.2. The MoF will submit quarterly data on General Government accounts determined by the INE in accordance with ESA 95 rules, showing also the main items of the transition from cash balances to the General Government balances in national accounts. The reconciliation will be accompanied by necessary explanatory materials for any indication of potential deviation of the annual general government cash target from the annual general government accrual target determined in accordance with ESA 95 rules.

B. Non-Accumulation of New Domestic Arrears by the General Government (Continuous Indicative Target)

10. **Definitions.** Commitment, liabilities, payables/creditors, and arrears can arise in respect of all types of expenditure. These include employment costs, utilities, transfer payments, interest, goods and services and capital expenditure. Commitments are explicit or implicit agreements to make payment(s) to another party in exchange for that party supplying goods and services or fulfilling other conditions. Commitments can be for specific goods and services and arise when a formal action is taken by a government agency, e.g., issuance of a purchase order or signing a contract. Commitment can also be of a continuing nature that require a series of payments over an indeterminate period of time and may or may not involve a contract, e.g. salaries, utilities, and entitlement payments. Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources (usually cash) embodying economic benefits or service potential. In relation to commitment, the liability arises when a third party satisfies the terms of the contract or similar arrangement. Payables/creditors are a subset of liabilities. For the purposes of the program payables/creditors exclude provisions, accrued liabilities. Arrears are a subset of payables/creditors. For the purposes of the Program domestic arrears are defined as payables/creditors (including foreigner commercial creditors), that have remained unpaid for 90 days or more beyond any specified due date (regardless of any

contractual grace period). In case no due date is specified, arrears are defined as payables/creditors that have remained unpaid for 90 days or more after the date of the invoice or contract. Data on arrears will be provided within seven weeks after the end of each month. The continuous indicative target of non-accumulation of new domestic arrears requires that the total arrears at the end of any month are not greater than the corresponding total at the end of the previous month—based on the same perimeter with respect to the entities covered. This also includes arrears that are being accumulated by the SOEs not included in the General Government.

11. **Supporting Material.** The stock of arrears will be measured through a survey. Reports on the stock of arrears of the General Government are being published monthly. The MoF will provide consistent data on monthly expenditure arrears of the General Government, as defined above. Data will be provided within seven weeks after the end of each month and will include total arrears classified by the different constituent sectors of the General Government sub-sector as defined in paragraph 4, as well as the monthly amounts of arrears cleared under the arrears clearance strategy (see paragraph 6.3).

12. **Adjustor.** In 2013 and 2014, the monthly change in the stock of arrears will be adjusted for any stock adjustment related to the arrears clearance strategy as per paragraph 6.3. This will allow monitoring the underlying flow of new arrears.

C. Ceiling on the Overall Stock of General Government Debt (Performance Criterion)

13. **Definition.** The overall stock of General Government debt will refer to the definition established by Council Regulation (EC) No 479/2009 of 25 May 2009 on the application of the Protocol on the Excessive Deficit Procedure annexed to the Treaty establishing the European Community. For the purposes of the Program, the stock of General Government debt will exclude: (i) debt contracted for bank restructuring, when carried out under the Program's banking sector support and restructuring strategy; (ii) IGCP deposits; and (iii) (from end-September 2011) the *'prepaid margin'* on all EFSF loans.

14. **Adjusters.** For 2013, the ceiling of the overall stock of General Government debt will be adjusted upward (downward) by the amount of any upward (downward) revision to the stock at end-December 2012 general government debt of EUR 204.5 billion. For 2014, the ceiling of the overall stock of General Government debt will be adjusted upward (downward) by the amount of any upward (downward) reclassification of entities or operations that affects the stock at end-December of the previous year.

15. **Supporting Material.** Quarterly data on the total stock of General Government debt as defined in paragraph 12 will be provided to the EC, ECB, and IMF by the BdP no later than 90 days after the end of each quarter, as reported to the ECB and the Eurostat. Monthly estimates will be provided to the EC, ECB and IMF by BdP no later than seven weeks after the end of each month.

D. Non-Accumulation of New External Debt Payments Arrears by the General Government (Continuous Performance Criterion)

16. **Definition.** For the purposes of the Program, the definition of debt is the same as in paragraph 12. An external debt payment arrear will be defined as a payment on debt to nonresidents, contracted or guaranteed by the general government, which has not been made within seven days after falling due (taking into account any applicable contractual grace period). The performance criterion will apply on a continuous basis throughout the Program period.

17. **Supporting Material.** Any external debt payment arrears of the General Government will be immediately reported by the MoF.

E. Bank Solvency Support Facility

18. The dedicated Bank Solvency Support Facility (BSSF) account will be maintained at the Bank of Portugal. As per previous review, resources for the BSSF will be agreed at each review and deposited in the dedicated account.

F. Overall Monitoring and Reporting Requirements

19. Performance under the Program will be monitored from data supplied to the EC, the ECB, and the IMF by the MoF and BdP. The authorities will transmit to the EC, ECB, and IMF any data revisions in a timely manner.

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FOR IMMEDIATE RELEASE
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International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Tenth Review Under an EFF Arrangement with Portugal, Approves €0.91 Billion Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the tenth review of Portugal's performance under an economic program supported by a 3-year, SDR 23.742 billion (about €26.87 billion) Extended Fund Facility (EFF) arrangement. The completion of the review enables the immediate disbursement of an amount equivalent to SDR 0.803 billion (about € 0.91 billion), bringing total disbursements under the EFF arrangement to SDR 22.182 billion (about €25.1 billion).

All the prior actions for completion of this review were met. The Executive Board also approved a request for waivers of applicability for the end-December 2013 performance criteria (PC). This waiver was necessary because the Executive Board meeting was scheduled to take place after end-December 2013 but prior to the availability of data to assess the relevant PCs.

The EFF arrangement, which was approved on May 20, 2011 (see Press Release No. 11/190) is part of a cooperative package of financing with the European Union amounting to €78 billion over three years. It entails exceptional access to IMF resources, amounting to 2,306 percent of Portugal's IMF quota.

After the Board discussion, Ms. Nemat Shafik, Deputy Managing Director and Acting Chair, said:

"The Portuguese authorities' implementation of their Fund-supported program has been commendable, despite recent legal setbacks. The authorities have promulgated a 2014 budget consistent with program objectives, and have introduced measures to offset the component of the pension reform invalidated by the constitutional court. At the same time, while the short-term outlook has improved, unemployment, while declining, remains high and risks remain. The authorities' continued strong commitment to program implementation is crucial to

strengthen the recovery and make further progress in achieving fiscal and external sustainability.

“It will be important to complete fiscal consolidation to put the public debt firmly on a downward path. Pressures to increase public expenditure should be resisted, and efforts to rationalize public administration and narrow the gap between social transfers and contributions should be continued. Further fiscal structural reforms, including in revenue administration and arrears control, are critical to maintain sustainable public finances and minimize budgetary risks.

“Preserving financial stability while promoting access to credit is necessary to facilitate a durable recovery. Given high levels of corporate debt that constrain bank credit, stepped-up efforts to facilitate an orderly deleveraging process and measures to promote access to funding for viable firms are needed.

“Structural reforms are key to raising the Portuguese economy’s growth potential. Greater product market competition and labor market flexibility are still needed. In addition, higher investment, especially in the tradable sector, is needed to generate greater employment and the sustained external surpluses necessary to unwind imbalances.

“The commitment by the European leaders to support Portugal until full market access is regained, combined with continued strong program implementation, is essential to help the country remain resilient to shocks and consolidate progress.”

Statement by Andrea Montanino, Executive Director for Portugal and Ines Lopes, Advisor to Executive Director

1. Overview

We welcome the IMF Staff Report on the 10th review, we particularly appreciate the stocktaking of the continuous progress in all dimensions of the Program and the recognition of the improvement in the short-term economic outlook.

The two prior actions set for the conclusion of this review, following the Constitutional Court ruling of December 19th, have been met. The supplementary budget enacting the necessary changes to the existing extraordinary solidarity contribution on pensions (CES) was approved in Parliament on February 7th (final vote). The document will be sent to the President of the Republic, who will have a maximum of twenty days to approve. The decree law on the increase in the beneficiaries' contributions to the special health insurance schemes (ADSE, SAD and ADM) was approved by the Council of Ministers on January 30th, therefore meeting the expected date in the MEFP. The entry into force of this measure also depends on a final decision by the President of the Republic, but it is expected to be in force by March 1st. By completing these measures in the agreed timeframe, the Portuguese Government reaffirmed its firm commitment to the Program's targets and to the fiscal consolidation effort as a whole.

Over the past two and a half years, strong compliance with the Program has translated into important progress in the adjustment and allowed for a gradual recovery of economic activity. In early 2014, signs are encouraging at several levels. On the fiscal side, preliminary results from the 2013 budget execution indicate that the 5.5% of GDP deficit target has been met by a comfortable margin. Additionally, the Treasury's financing conditions continue to improve, with the strong downward correction in yields having paved the way for a successful issuance of a 5-year bond. Finally, monthly economic indicators continue to recover steadily, confirming that recession may have in fact bottomed out in early 2013.

While the authorities acknowledge these positive developments, they are also aware of the risks that lie ahead. Firstly, although economic activity seems to be gradually recovering throughout the euro area, uncertainty remains high. In particular, if recovery is not sustained, the performance of the Portuguese economy, which is increasingly leaning on export growth, could be strongly affected. Secondly, while Treasury bond yields in secondary markets and 5-year CDS spreads continue to decrease – standing close to mid-2010 levels – the evolution of financing conditions remains sensitive to changes in market sentiment, which could be strongly influenced by US monetary policy or the progress towards Banking Union in Europe. Finally, at the internal level, risks of future adverse rulings by the Constitutional Court do remain, namely in what relates to 2014 fiscal consolidation measures. Nevertheless, as mentioned in the Staff Report, the Portuguese Government has designed all supporting

legislation so as to ensure that the adjustment effort is equitable and, thus, that the concerns previously raised by the Constitutional Court are attended to. In addition, as demonstrated – yet again – with the rapid response to the December ruling, the Portuguese Government remains confident that these challenges can be overcome by swiftly implementing compensatory measures and stands by the commitment to pursue with fiscal adjustment in the short and in the long run.

2. Economic Activity

While the structural transformation is still ongoing, the performance of the Portuguese economy seems to be gradually improving. The second and third quarter marked two consecutive quarters of GDP growth, which was underpinned by stronger domestic demand, representing an important turnaround in the economy since the beginning of the Program. Additionally, quantitative and qualitative indicators suggest that economic activity continued to recover in the fourth quarter and in early 2014.

The Portuguese authorities acknowledge that the adjustment has come at a high economic and social cost, which is most evident in the increase in the unemployment rate. Notwithstanding, recent developments seem to confirm that there is a reversion of this trend. In fact, and according to INE's data that was only available after the closure of the Staff Report, the unemployment rate stood at 15.3% in Q4-2013, which compares with 16.9% in the same quarter of 2012 and 15.6% in the previous quarter (Q3-2013). This result also confirms that the unemployment rate has now fallen for three consecutive quarters. In addition, data from INE place the average unemployment rate in 2013 at 16.3%, which is 0.2 percentage points below the 10th review projection, and 1.1 percentage points below the combined 8th and 9th review estimate. The latter hence represents a significant downward revision in under five months and contributes to the further improvement of the short-term economic outlook.

External adjustment also continues to progress at a good pace, as Eurostat data indicate the current account balance registered a surplus for two consecutive quarters in 2013 (Q2 and Q3). The authorities are aware that the adjustment needs to advance further so as to effectively reduce the stock of external debt, but remain confident that the positive performance of exports – which now represent about 40% of GDP – will continue to underpin the correction of the external deficit.

3. Fiscal Policy

Preliminary data, which, once again, was known after the closing of the Staff Report, indicate that the 2013 General Government deficit was €7151.5 million, hence significantly below the end-December target of €8900 million. This important result derives from the solid

performance of tax revenue and social security contributions and from the tight control of public expenditure.

Compared to 2012, State tax revenue grew by 13.1% (or €4212 million) in net terms, thus exceeding the estimated increase in the Second Supplementary Budget by 4.2 percentage points. More importantly, this outcome was underpinned by the growth of current tax revenue. In fact, when excluding the effect of the outperforming debt recovery scheme, tax collection still increased by 10.1%. While an important part of this result derives from the increase in tax rates, it also reflects an improvement in economic activity compared to previous forecasts, as well as important gains from the ongoing fight against tax fraud and evasion.

Social security recorded a surplus in 2013, which is partly justified by the effect of transfers from the State Budget, but also results from a 2.5% increase in social security contributions and stabilization in unemployment benefits expenditure. Contributory revenue does however include the revenues obtained through the extraordinary debt recovery scheme. Excluding this effect, social security contributions would have grown by 0.7% compared to 2012.

On the expenditure side, confirming the Government's determination to reduce costs and promote fiscal discipline, preliminary data indicate that Central Administration expenditure stood €1260 million below the estimate included in the Second Supplementary Budget. In addition, while compensation of employees did increase by 10.4%, this reflects the reinstatement of the 13th and 14th monthly payments and higher contributions of public entities to social protection schemes. Excluding these effects, compensation of employees would have declined by 4.2% relative to 2012, mainly due to the reduction in the number of civil servants.

As for the balances of Local and Regional Administration, it should be referred that these were strongly influenced by the repayment of debt, including the settlement of arrears. Excluding these effects, both subsectors would have registered a surplus.

Overall, these results clearly prove the authorities' determination and commitment towards fiscal consolidation effort during the Economic Adjustment Program and afterwards, with a view to effectively assure the sustainability of public finances. In addition, the 2013 budget execution also reinforces the confidence that the 4% of GDP deficit target for 2014 will be met and that the structural adjustment continues to advance so as to achieve the medium-term objective as defined in the Fiscal Compact framework.

Finally, while the level of gross public debt in 2013 has been revised upwards, it is important to acknowledge that it mainly reflects the accumulation of higher cash buffers than estimated at the time of the last review. In fact, the path of public debt excluding Central Government deposits has been revised downwards. Additionally, it is still expected that the public debt ratio will start to decrease in the current year, as foreseen in earlier projections.

4. Financial Sector Policies

The Program involved the adoption of measures aimed at an orderly deleveraging process, reinforcing banks' capitalization, improving the accuracy of valuations in banks' books and strengthening supervision. As a result, the banking system is now more transparent, better capitalized and has a more comfortable liquidity position. This occurred in a setting of challenging domestic economic conditions, as well as a demanding external environment. Financial fragmentation and a subdued economic activity persisted in the euro area, alongside an encompassing adjustment process in the Portuguese economy.

The core tier 1 ratio of the banking system increased further, reaching 12.2 percent in the third quarter of 2013, as compared to 11.9 percent in June 2013 (9.6 percent in December 2011 and 8.1 percent in December 2010). This occurred notwithstanding the overall negative profitability on account of compressed net interest income and high levels of loan impairments. Credit impairments were reinforced following asset quality reviews. Nevertheless, the non-performing loans ratios of some segments of the corporate sector appear to be stabilizing and coverage levels have remained broadly stable.

The deleveraging process has also further progressed, with the ratio of credit to deposits of the banking system declining from 123 percent in June 2013 to 121 percent in September 2013 (from high levels of 158 percent in December 2010). The recent decline results mainly from the reduction in credit granted, as deposits showed a year-on-year stabilization, despite the challenging juncture. Developments in credit hide important heterogeneity. In fact, the sectors displaying the highest decrease are the ones most dependent on domestic demand (domestic trade, construction and real estate development), while credit to exporting firms present a steady growth path. This is consistent with the desirable shift of resources to the most productive sectors, most notably the tradable sector.

The major challenge banks are now facing is the return to sustainable profitability levels. Domestic operations are likely to remain constrained by the low short term interest rates, weighing on net interest income, and still elevated loan impairments may continue to impact on the profit and loss account. A gradual return to profitability is expected as the projected economic recovery materializes and banks' efforts to reduce their operational costs bear fruit.

Banks have continued to submit to Banco de Portugal funding and capital plans and stress test exercises on a quarterly basis and the stress testing framework has been further strengthened with the development by Banco de Portugal of a new top-down stress testing methodology.

Several additional initiatives will ensure that Portuguese banks are still in a better position for the Comprehensive Assessment in the context of the SSM.

First, the asset quality reviews undertaken over the last three years allowed banks to accumulate experience and apply best practices on the prompt identification of credit

impairments. Banco de Portugal is preparing guidelines in order to improve the infrastructure in place concerning the recognition of losses and public disclosure of information on asset quality and credit risk management and governance.

Second, the regulation on identification and marking of restructured loans due to financial difficulties of the borrower has been amended in order to reflect even more conservative criteria. This amendment is pursuant to the fulfillment of the provisions of the draft implementing technical standards on non-performing loans and forbearance developed by the European Banking Authority.

Finally, in view of the recent developments in real estate markets, Banco de Portugal reviewed the requirements on real estate valuations and required banks to maintain a conservative stance in collateral valuations. In addition, valuations of all real estate received in lieu of payment and whose last valuation occurred before end July 2012 had to be updated.

5. Structural Reforms

The Portuguese Government remains committed to an ambitious reform agenda and to the constant and careful monitoring of its impacts.

As was recognized in the Staff Report, over the last 2 ½ years, a large number of structural measures in various areas were implemented: labor market, education, judicial system, competition & regulation, business environment, regulated professions. Currently, most measures included in the memoranda are now in place, some in its early days and others already showing concrete impact in the economy.

As we have already noted in this statement, there has been a reversal in the labor market, performance, and we believe that the implemented reforms have supported the decrease in unemployment – according to Eurostat data, from 17.7% in March to 15.4% in December 2013. These very profound changes were achieved with minimum social unrest due to the tripartite agreement, which served as a basis for the revised labor code, and was signed by the Government, all the employers' associations and the confederation of labor unions UGT.

More specifically, in the context of employment protection, the reduction in severance payments, which entered into force on October 1st, brought the value from 30-36 days/year in the beginning of the program to a value aligned with the EU average (12 days/year). Following the proposed changes in the law regarding individual dismissals and the recent Constitutional Court ruling on specific provisions, the Portuguese Government is actively negotiating alternative options and will shortly present a new proposal to ensure that the successful labor market reform continues.

Overall, as noted in the past, the authorities' view of the labor market is not in full alignment with the one expressed in the staff report, but we note some progress towards a convergence of views. The Portuguese Government believes that more time is needed to assess the impact

of recent reforms, not only in employment protection but also in wage-setting mechanisms and in reduction of unemployment benefits, in order to guarantee the expected results in terms of job creation and enhanced competitiveness in the economy. This recommends restraint in privileging a dominant explanatory variable from the usual ones: wage rigidity, structural change, reallocation of resources, or credit constraints. More specifically, views of "persistent nominal rigidities" or "modest improvement in the overall price competitiveness" are, in the view of the Government, not supported by the data. The recent positive surprise in employment creation in a context of a still moderate recovery may suggest that reforms are starting to have some positive effect. Despite some differences in views, the authorities agree with the staff that this issue is central and that unemployment is still very high. Authorities will continue to monitor closely developments in the labor market and fine tune reforms as needed.

While reforming the labor market has been a priority, the significant changes achieved in other sectors of the economy should not be disregarded.

The competition framework and the regulatory environment have improved and several measures were taken with these purposes: the by-laws of 18 public professional associations and related regimes are being adapted to the horizontal legal framework on public professional associations; a new regulatory architecture was approved by the framework law governing national regulators, and each of the national regulators by-laws were adjusted and all drafts were submitted to IMF/EC/ECB evaluation; full transposition of the Services Directive is near completion (only 5 out of nearly 70 diplomas still need to be adjusted).

The removal of the bottlenecks of the Portuguese economy as well as the improvement of the business environment has also been targeted in the reform agenda. Several reforms were recently implemented aimed at removing excessive licensing procedures, regulations and other administrative burdens: a new Base Law of Soil and Territorial Planning, which is now in Parliament, was recently approved; the legal regime for Environment Impact Evaluation was changed in order to increase the speed of approval and reduce associated monetary and time costs and; the new fast-track applications regime for the licensing of planned investment projects was approved. A new legal regime on touristic licensing, which aims to simplify licensing procedures, as well as to reduce its related costs, was also approved. At this point in time, and in order to tackle remaining vulnerabilities, a comprehensive review and cost--benefit analysis of bureaucratic procedures of licensing with higher impact in the economy is being performed. A regulatory simplification rule – the "one-in, one-out" rule – by which the public body proposing a new regulation generating costs for business or citizens needs to eliminate existing regulations of equivalent cost is also being prepared. It should also be noted that all the foreseen reforms in the judicial system have been approved by the Portuguese Government and are under implementation.

In the energy sector, with the liberalization of both the electricity and gas market already in place, the goal of ensuring the sustainability of the National Electricity System (NES) is

maintained. Adding to the measures announced in May 2012, which resulted in reductions of various types of public subsidies in the amount of €2.1 Bn, several measures have been presented (actually, two of them have already been implemented). Their aim is to address the pressures in the NES, namely the drop in demand that has resulted from lower than expected economic activity. A major new measure presented in the context of the 2014 budget was the introduction of a levy on the energy operators which will be used for fiscal consolidation purposes and for the sustainability of the NES.

The Portuguese Government considers that the privatization program was and is an important tool for opening up the Portuguese economy and attracting new investment that will increase Portugal's competitiveness in the medium-term. Currently, the program has already surpassed the initial overall financial objective. Work is proceeding on schedule towards the privatization of EGF (Waste Management) and the decree-law for the privatization was approved in late January. Furthermore, the restructuring of Águas de Portugal is underway.

In the postal sector, following the amendment of the decree-law laying down the framework of the postal concession contract, the CTT concession contract was renegotiated and also amended, leading into the company's successful IPO.

Lastly, in the health sector, operational improvements geared at cost control and efficiency continue to be implemented such as the publication of clinical and prescription guidelines. Following the difficult but successful negotiations with the pharmaceutical industry limiting the state's drug expenditure in to 1% of GDP in 2013, this goal continues throughout 2014. The reorganization plans for the hospital network and the improvement of the expenditure control mechanisms so as to fully eliminate arrears in the health sector (which decreased from a monthly accumulation rate of 76 million Euros in 2012 to 34 million Euros in 2013) are being continued.