IMF Country Report No. 15/126

PORTUGAL

May 2015

2015 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR PORTUGAL

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2015 Article IV consultation with Portugal, 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 May 6, 2015, following discussions that ended on March 17, 2015, with the officials of Portugal on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 15, 2015.
- The **Informational Annex** prepared the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its May 6, 2015 consideration of the staff report that concluded the Article IV consultation with Portugal.
- A **Statement by the Executive Director** for Portugal.

The document listed below has been or will be separately released.

Selected Issues Paper

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

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INTERNATIONAL MONETARY FUND

PORTUGAL

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

April 15, 2015

EXECUTIVE SUMMARY

The recovery is addressing flow imbalances from past current account and fiscal deficits, but stock vulnerabilities from public, private, and external debt remain high. The unemployment rate has retreated from its crisis peak, growth has resumed, and the current account is posting surpluses for the first time in decades. At the same time, a durable rebalancing of the economy has not taken place and the nontradable sector is still dominant. The strength of the economic recovery remains modest, the labor market slack large, and there are still material vulnerabilities, notably, high leverage in the public and corporate sectors, and high external debt.

Portugal is benefiting from favorable cyclical tailwinds, but growth is projected to moderate in the medium term. The initiation of ECB's expanded asset purchase program pushed sovereign yields to record lows and effectively eliminated any remaining financing concerns. It should also help to raise inflation over the forecast horizon. A sharply weaker euro and lower oil prices have improved the short-term outlook. In the medium term, growth is projected to moderate, as several remaining challenges, notably low investment, high leverage, and structural bottlenecks still need to be decisively addressed.

The authorities should use this opportunity to strengthen the economy's resilience and raise its growth potential. Fiscal adjustment should continue, with an emphasis on expenditure rationalization by way of a comprehensive reform of public sector wages and pensions. To maintain financial stability and allow for an efficient allocation of resources in the economy, the authorities should adopt a more proactive approach led by banks to the deleveraging process. Finally, in the context of rigid labor markets and limited domestic competition, the authorities must implement additional structural reforms to absorb the large labor slack and spur economic growth.

Approved By
Mahmood Pradhan and Seán Nolan

Discussions took place in Lisbon during March 5-17, 2015. The staff team comprised S. Lall (head), M. Gaertner, D. Gershenson, L. Juvenal, I. Yackovlev, and L. Zeng (all EUR); K. Wiseman (SPR); M. Queyranne (FAD); A. Bouveret (MCM); and A. Jaeger (RR). Mr. Cottarelli and Ms. Lopes (OED) participated in key meetings. W. Bergthaler and S. Pompe (both LEG) participated from HQ; M. Song and D. Santos (both EUR) provided assistance from HQ; E. Martins and A. Gomes (both local staff) provided assistance from the Lisbon office.

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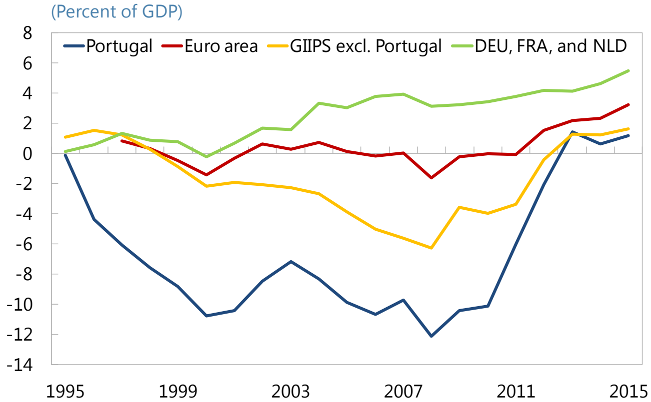
CONTEXT—POST-CRISIS STABILIZATION

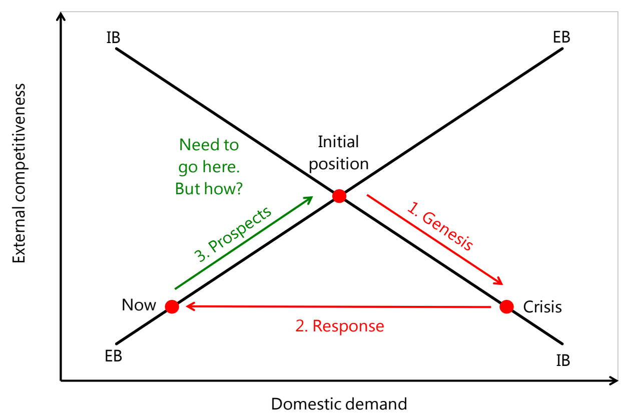
1. **Following a decade of running large current account deficits, Portugal attained a balanced current account position over the course of the 2011–14 EFF, but at the cost of large internal slack.** In the run-up to and since euro adoption, easy access to external financing enabled Portugal to finance imports, largely for consumption and investment in the non-tradable sector. With the accompanying erosion of competitiveness, productivity growth continued its inexorable decline while economic growth stagnated—real GDP barely grew between the early 2000s and today—and a large external imbalance arose.[1] The "sudden stop" in 2011 forced an adjustment that corrected the flow imbalance, and Portugal's external position stabilized. The accompanying collapse in domestic demand contributed to a large internal imbalance, with unemployment peaking at 17.5 percent in 2013 before beginning to decline; labor market slack, a broader measure of labor under-utilization, is still around 20 percent.[2]

Current Account Balance
(Percent of GDP)



Source: World Economic Outlook database; and IMF staff estimates.

Portugal: Swan Diagram



Source: IMF staff.

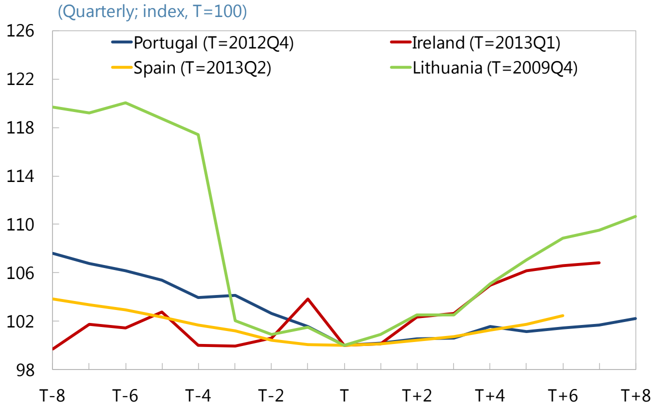
2. **Portugal's rebound has been characterized by a U-shaped recovery.** The economy has expanded at close to 1 percent per year on average since early 2013, with growth driven largely by consumption. Following the front-loaded fiscal adjustment under the program, the 2014 fiscal deficit narrowed to 3.5 percent of GDP (excluding one-off operations), resulting in a second successive year of 1 percent structural primary adjustment. The better fiscal outturn relative to earlier projections partly reflected cyclical factors, as rising consumption and employment contributed to good revenue

[1] This analysis uses the Swan diagram, a macroeconomic model of a small open economy. An economy attains internal balance (IB) when it has full employment and stable prices. External balance (EB) requires equilibrium in the balance of payments. For a discussion of the Swan diagram see Reinert, K. (ed.) 2009. *The Princeton encyclopedia of the world economy,* pp. 1049–1052.

[2] Labor market slack adds discouraged workers to official unemployment and labor force and adjusts for involuntary part-time work. For further discussion, see Box 1 in *IMF Country Report 15/21*.

performance and savings on unemployment benefits. In addition, a sizable under-execution of investments spending helped offset the adverse Constitutional Court (CC) rulings on public sector wages and on survivor pensions.

Real GDP
(Quarterly; index, T=100)



Sources: Haver Analytics; and IMF staff calculations.

Contributions to Growth
(Percentage points, unless indicated otherwise)

	2013	2014
Total domestic demand	**-2.5**	**2.1**
Final consumption expenditure	-1.4	1.3
Public	-0.5	-0.1
Private	-1.0	1.4
Gross fixed capital formation	-1.1	0.4
Structures	-1.3	-0.3
Equipment, machinery	0.2	0.7
Changes in inventories	0.0	0.4
Foreign balance	**0.9**	**-1.2**
Exports GS	2.4	1.3
Imports GS	-1.5	-2.5
Real GDP growth, percent	**-1.6**	**0.9**

Source: INE

3. **The main recommendations of the 2012 Article IV Consultation were incorporated into the EFF** (see Annex I). Despite significant progress made on many fronts in the period since then, increasing competitiveness remains an important challenge, as elaborated in the current report.

4. **The banking system is recovering gradually, but the return to profitability remains elusive.** Banks' capital declined in 2014, with the average CT1 ratio falling by 0.5 percentage point to 11.4 percent. The loan-to-deposit ratio has been declining steadily, allowing banks to reduce their reliance on Eurosystem refinancing operations. The stock of non-performing loans continued to rise, a reflection of the slow progress toward repairing corporate balance sheets. Income from financial operations and trading has not been sufficient to offset losses due to provisions and impairments, and high operating costs. The sale of Novo Banco is proceeding as scheduled, and other mergers and acquisitions of large banks are under consideration.[3]

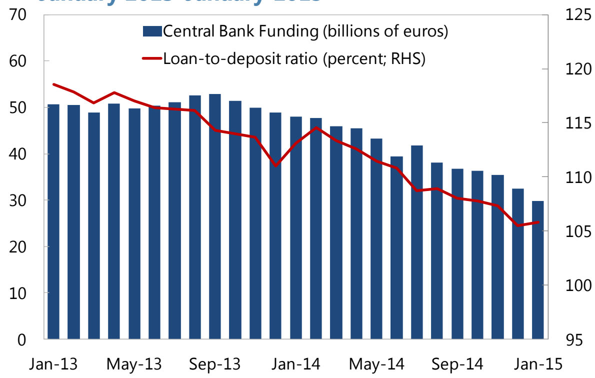
[3] Novo Banco is the bridge bank created at the time of the resolution of Banco Espírito Santo (BES), to which critical functions and viable operations of BES were transferred. For further discussion, see Box 4 in *IMF Country Report 15/21*.

Figure 1. Recovery and Risk in the Banking System

Liquidity improved…

…but banks continue to operate at a loss.

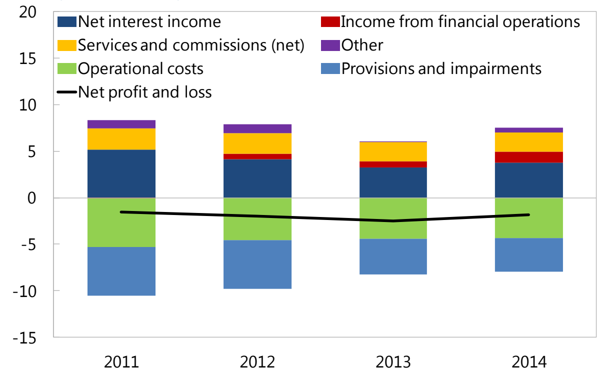
Portugal: Banking System Funding, January 2013–January 2015[1]



[1] Aggregated data. Loan-to-deposit ratio vis-à-vis non-monetary resident sector.

Portugal: Net Profit and Loss, 2011–14[1]

(Billions of euros)

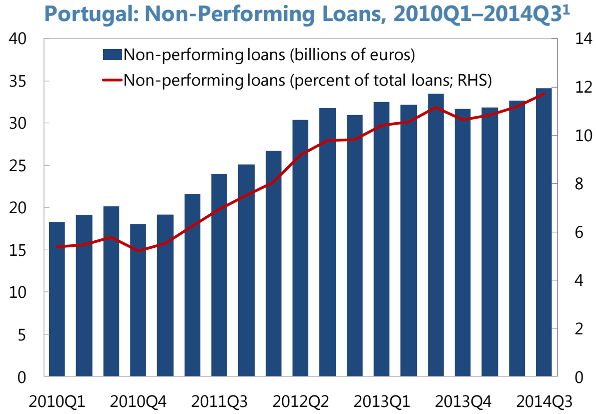


[1] Consolidated data for large banks, excluding ESFG/BES/Novo Banco.

Non-performing loans are rising in Portugal…

…and in peer countries.

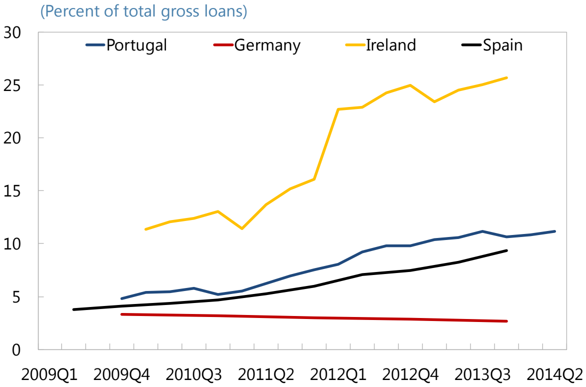
Portugal: Non-Performing Loans, 2010Q1–2014Q3[1]



[1] Consolidated data for large banks, excluding ESFG/BES/Novo Banco.

Non-Performing Loans, 2009Q1–2014Q2[1]

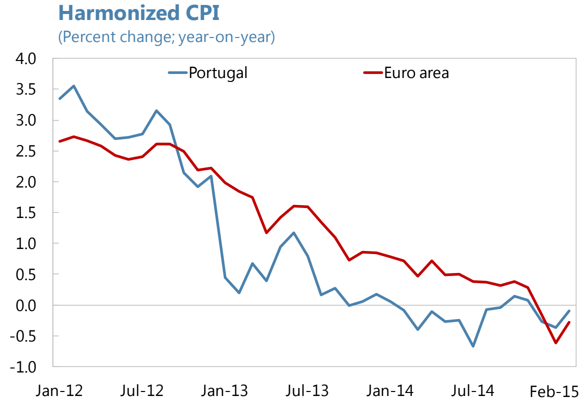
(Percent of total gross loans)



[1] Consolidated data.

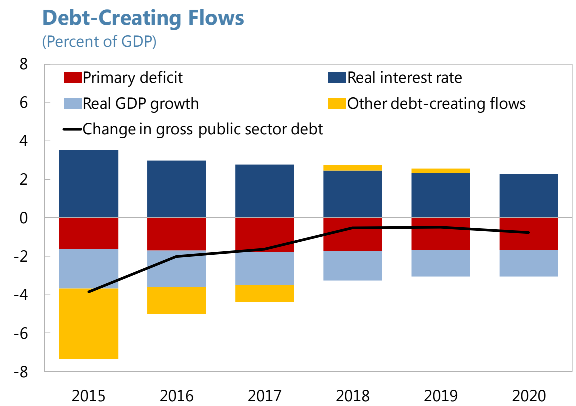
Sources: Bank of Portugal; Financial Soundness Indicators; and IMF staff estimates.

5. The trend of downward inflation pressures, boosted more recently by falling energy prices, appears to have been arrested. Core inflation has stabilized in recent months, but remains low at 0.3 percent due to the sizeable output gap. Portugal's overall inflation now exceeds that of the euro area for the first time in two years.



Sources: Eurostat; INE; and IMF staff calculations.

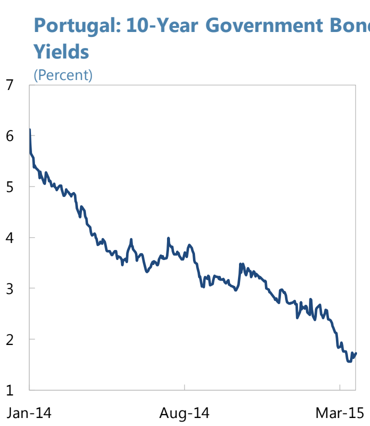
6. The authorities have begun early repurchases of outstanding Fund credit. In March, the authorities repurchased €6.6 billion—almost one quarter of the total owed to the Fund—coinciding with the initiation of the European Central Bank's expanded asset purchase program (QE), and benefitting from favorable market conditions. Early repurchases are overall expected to result in interest cost savings exceeding €500 million, but offset to some degree by recent valuation losses from the euro's depreciation against the SDR basket, as the initial IMF purchases were not fully hedged.



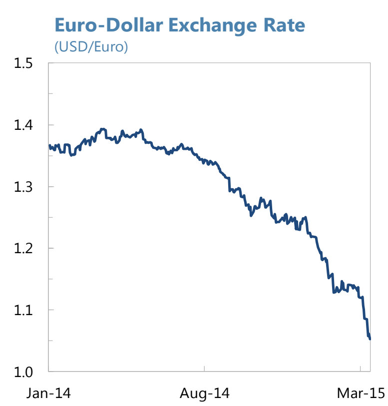
Source: IMF staff estimates.

Staff's views

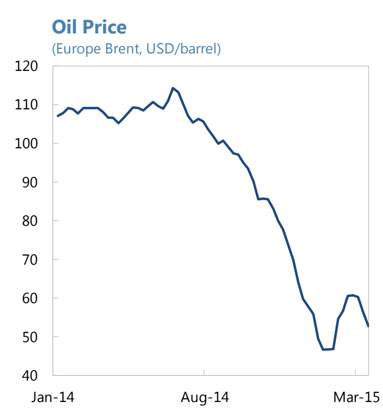
7. The near-term outlook is benefiting from the trifecta of record-low interest rates, a weakening euro, and low oil prices. The initiation of QE proved to be a sea change. With a total envelope for Portugal of to up to €1 billion a month, sovereign bond purchases could amount to the equivalent of about 60 percent of planned debt issuance in 2015, alleviating remaining concerns on Portugal meeting its financing needs in 2015–16. A sharply weaker euro—also likely associated at least in part with QE—and lower oil prices have improved the outlook further. Staff's growth projections for 2015 and 2016 have accordingly been revised up. The outlook for inflation has also improved over the forecast horizon.



Source: Bloomberg.



Source: Bloomberg.



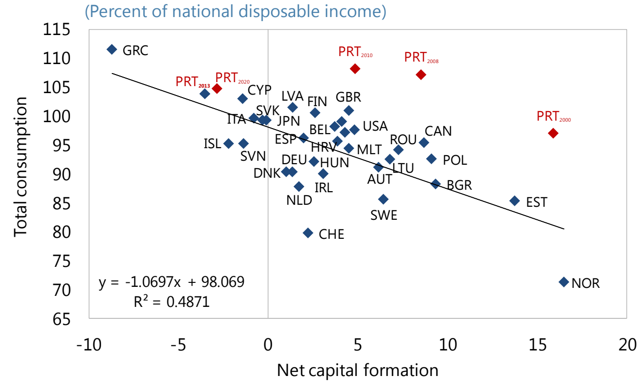
Source: Bloomberg.

8. As the additional bounce from short-term factors fades, growth is projected to moderate over the medium term.

- To absorb the large labor market slack by creating jobs, the economy needs to raise investment, while enhancing external competitiveness to avoid generating an external imbalance. For a currency union member with limited fiscal space, this can only be achieved through structural reforms, which have so far not fully delivered the desired outcomes. Many of the structural reforms initiated since 2011 still need to be fully implemented. There also appears to be a need to revisit or step up many of the structural reforms, especially in the public and financial sector areas (Box 1). At the same time, other indicators suggest that Portugal continues to lag behind most peers and trade competitors, including in Eastern Europe, regarding labor and product market reforms (Figure 2). In addition, excessive leverage and elevated economic policy uncertainty acts as a brake on investment prospects.

OECD Countries: Total Consumption and Net Capital Formation, 2013

(Percent of national disposable income)



Source: AMECO.

Medium-Term Macroeconomic Objectives, Influencing Factors, and Current Status

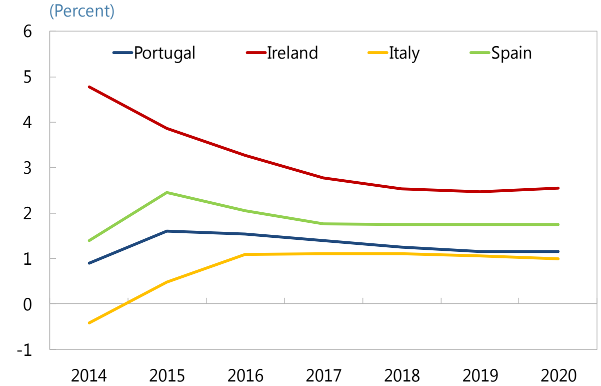
Objectives	Deviation from objective indicated by	Objective status pre-crisis	Influencing factors	Objective status now
Internal balance	High labor slack	Met	Structural reforms	Not met
External balance	Excessive current account deficit	Not met	Domestic demand compression; structural reforms	Met
Aggregate supply	Slow potential growth	Not met	Structural reforms	Not met
Private leverage	Excessive private debt	Not met	Deleveraging; structural reforms	Not met
Fiscal sustainability	Excessive public debt	Not met	Fiscal policy Structural reforms	Not met

Source: IMF staff.

- During the program, staff was of the view that sustained implementation of structural reforms would reverse the decline in productivity growth observed over the last half-century, resulting in medium-term growth of 1¾ percent. With more limited progress on structural reforms, however, staff projects growth of only around 1¼ percent in the medium term, ¼ percentage points below the euro-area average.

Real GDP Growth: 2014 Outturn and Forecast

(Percent)



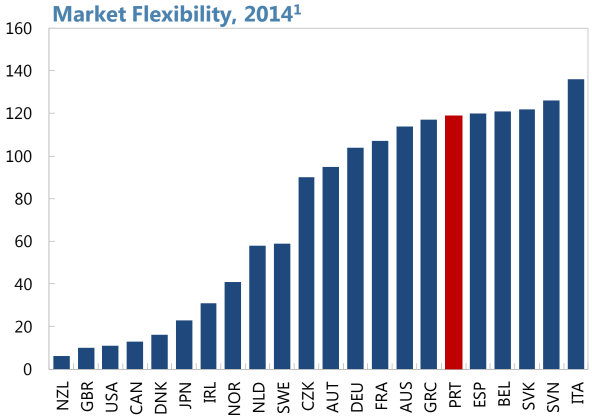
Sources: Banco de Portugal; World Economic Outlook database; and IMF staff estimates.

9. Portugal's external position remains slightly weaker than implied by medium-term fundamentals and desirable policy settings. The EBA estimates are mixed, with the REER gap estimates—ranging from -5 to 9 percent—broadly reflecting the achievement of short-term external balance. As internal demand conditions normalize, competitiveness will suffer, barring further reform effort (see Swan Diagram). Furthermore, the EBA estimates do not fully capture the burden of the large negative NIIP and the need to ambitiously reduce labor slack. Alleviating this burden will require sustained current account surpluses at or above the projected 2015 level over the medium term (see Annex III).

Figure 2. Structural Challenges Remain

Despite recent progress, Portugal's labor market flexibility remains a sizable distance from the frontier…

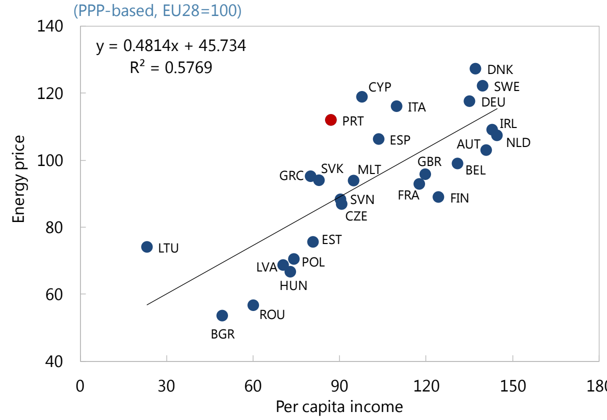
Global Competitiveness Index Ranking, Labor Market Flexibility, 2014[1]



…while energy prices are high given the economy's relative position in Europe.

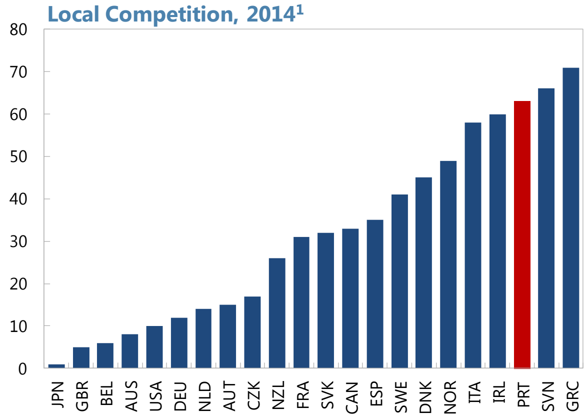
Energy Price and Per Capita Income, 2013

(PPP-based, EU28=100)



Local competition shows significant room for improvement…

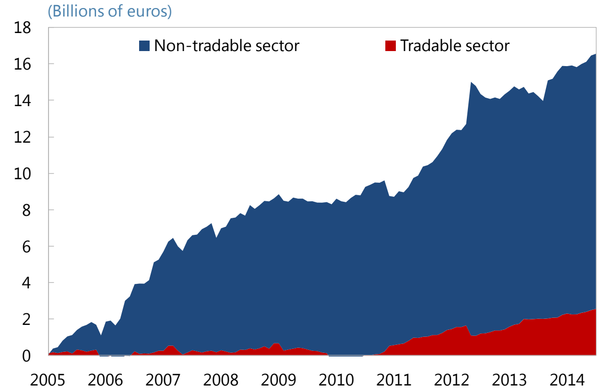
Global Competitiveness Index Ranking, Intensity of Local Competition, 2014[1]



…and FDI remains largely skewed toward the non-tradable sector.

Cumulative FDI to the Tradable and Non-Tradable Sectors, Jan. 2005-July 2014

(Billions of euros)



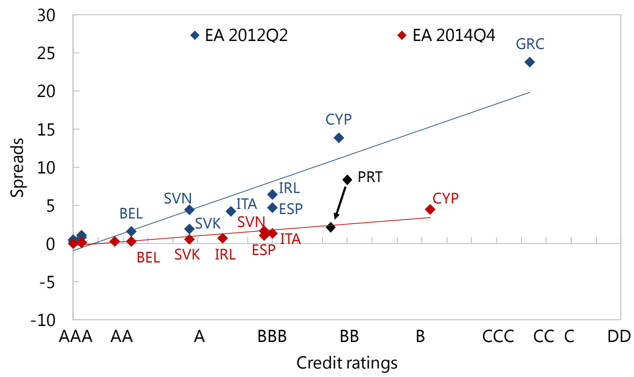
[1]A lower rank corresponds to a more advantageous competitive position.

Sources: Banco de Portugal; Eurostat; World Economic Forum; and IMF staff calculations.

10. The risks to the outlook are mostly on the upside. Global liquidity and risk aversion are favorable but could unwind rapidly due to potentially disruptive tail events—most notably, any volatility associated with turmoil at the euro-area level (see Risk Assessment Matrix). Public and private balance sheets are highly exposed to these risks. In addition, Portugal's trade with and investment in Angola—its fourth-largest goods export market—could suffer more than expected, should the latter's growth prospects deteriorate due to low oil prices. Finally, the region-wide compression in bond spreads appears to be not strongly associated with country-specific economic fundamentals (see Box 2). Notwithstanding these concerns, given the recent speed and strength of market reaction to the QE announcement, growth and inflation may very well surprise on the upside in the short term.

Credit Ratings and Spreads

(10-year spread vs. Bund, basis points; 2012Q2-2014Q4)



Sources: Bloomberg; and IMF staff estimates.

Authorities' views

11. Authorities emphasized the role of largely permanent factors in spread compression. A comprehensive European crisis backstop has successfully been put in place, and market participants now view the new arrangements as credible, though most expect a slightly larger spread differentiation than before the crisis. This favorable environment will raise growth in 2015 and 2016 above what had been expected only a few months ago. The authorities, however, expressed concern that low yields and compressed spreads could possibly lead to the accumulation of external imbalances in the future.

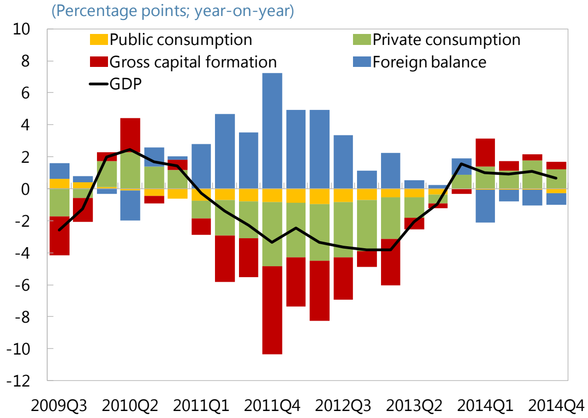
12. The medium-term outlook is positive. Portugal's external competitiveness has improved and the re-balancing between tradable and nontradable sector is well underway, as signified by both stronger employment and credit growth in the tradable sector, and the robust growth of exports. As a result, the economy will grow faster in the medium term, fueled by investment, the rising stock of human capital, and the continued strength of external demand. Even though the banking system still faces important challenges, the economic recovery (in tandem with a supportive monetary policy stance) should create supportive conditions for corporate and bank balance sheet repair.

Figure 3. Flow Indicators Have Improved

The economy went through a severe contraction…

Contributions to Real GDP Growth

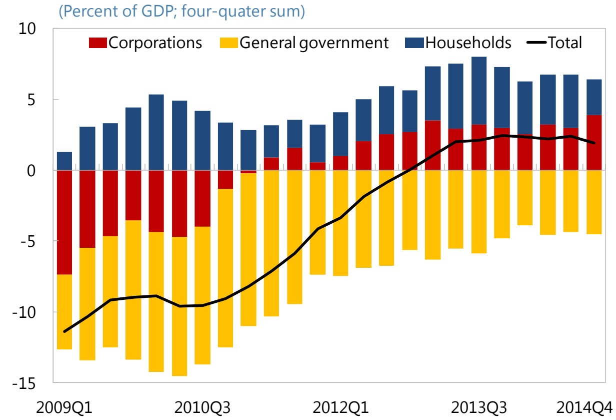
(Percentage points; year-on-year)



…as the country's borrowing turned into lending.

Net Lending by Sector

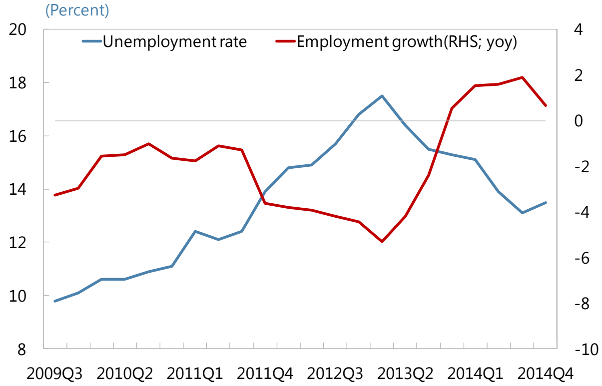
(Percent of GDP; four-quater sum)



Unemployment came down from its peak…

Labor Market Trends

(Percent)

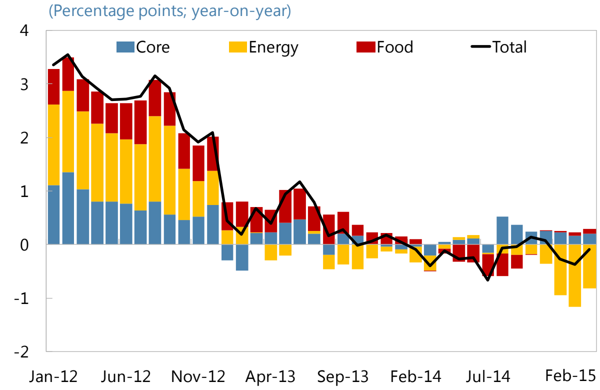


Sources: Haver Analytics; and IMF staff calculations.

…with core inflation remaining low reflecting in part output gap.

Contributions to Change in Harmonized CPI, by Category

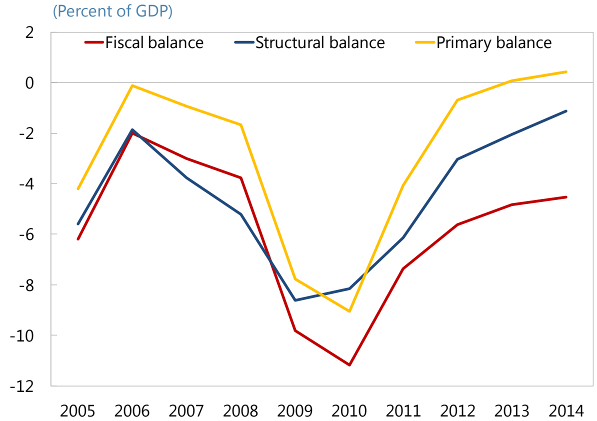
(Percentage points; year-on-year)



The fiscal stance has improved…

Fiscal Balance

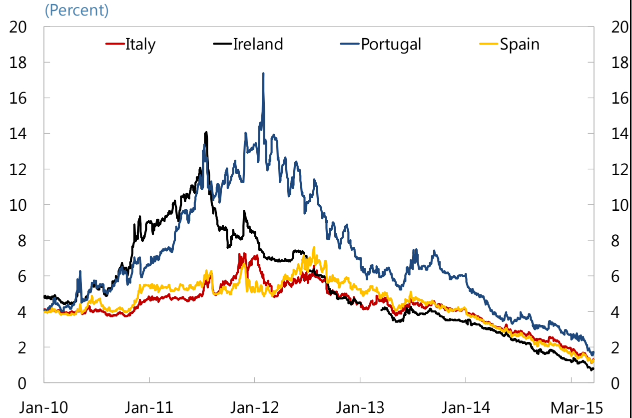
(Percent of GDP)



…and borrowing costs have reached historic lows.

10-Year Govenment Bond Yield

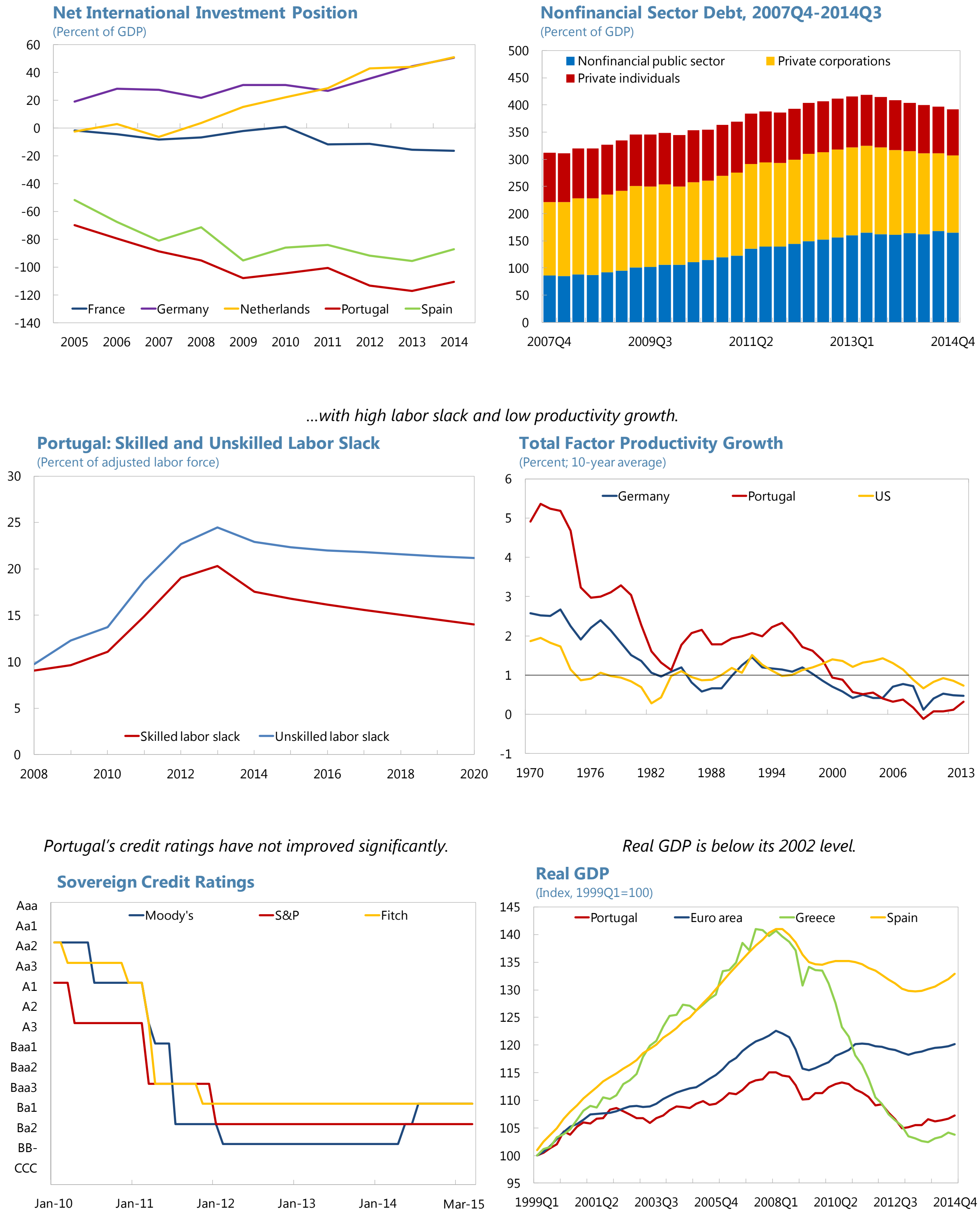
(Percent)



Sources: Bloomberg; Eurostat; Haver Analytics; INE; World Economic Outlook; and IMF staff calculations.

Figure 4. Underlying Vulnerabilities Persist

Portugal remains highly vulnerable…



Sources: Bloomberg; Haver Analytics; World Economic Outlook database; Banco de Portugal; and IMF staff projections.

FOCUS—RESILIENCE AND GROWTH

A. Fiscal Path

Fiscal adjustment, with an emphasis on expenditure rationalization, should continue.

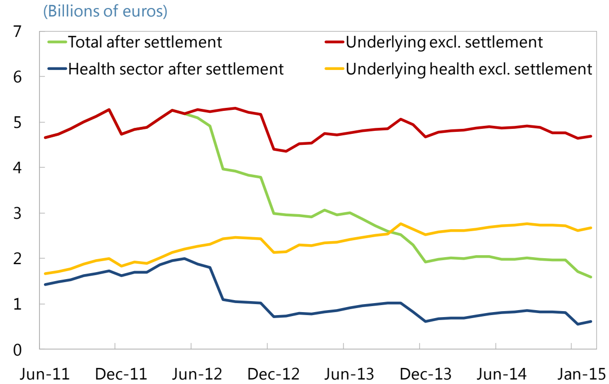
Background

13. In 2014, fiscal adjustment continued, but the stock of public debt increased. The fiscal deficit narrowed to 4.5 percent of GDP in 2014, below the authorities' target of 4.8 percent, primarily reflecting an under-execution of investment spending. Excluding several large one-off transactions related to SOE and banking support operations the deficit fell to 3.5 percent of GDP, amounting to a structural fiscal adjustment of 1 percent of GDP. The debt-to-GDP ratio, at 130.2 percent, was slightly higher than originally projected—despite the better-than-expected outturn—due to the adverse valuation effects of euro depreciation, additional debt issuance to maintain the government's cash buffer, and a downward revision to nominal GDP.

14. The authorities have not yet defined a structural primary adjustment path beyond 2015. The 2014 Fiscal Strategy Document envisages a minimum structural adjustment effort of ½ percent of GDP per year, in line with the European Treaty on Stability, Coordination, and Governance framework.[4] The authorities, however, have not yet specified concrete measures to support their medium-term fiscal strategy; a new Stability Program is expected to be issued at the end of April.

15. Arrears remain a challenge, although significant progress has been made. In 2014, arrears were reduced by €367 million (20 percent), mainly through the implementation of the government clearance strategy. In particular, the strategy provided additional funding to public hospitals (€151 million), leading to the settlement of €59 million of arrears in the health sector. Arrears had initially accumulated in early 2014, before being cleared at the end of the year. In early 2015, the stock of arrears began to rise again (an increase of €47 million in January), pointing to a recurrent pattern of accumulation in the first months of the year. In January, the parliament approved an amendment of the commitment law, which requires line ministries create contingency reserves to forestall accumulation of new arrears.

Stock of Arrears
(Billions of euros)



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

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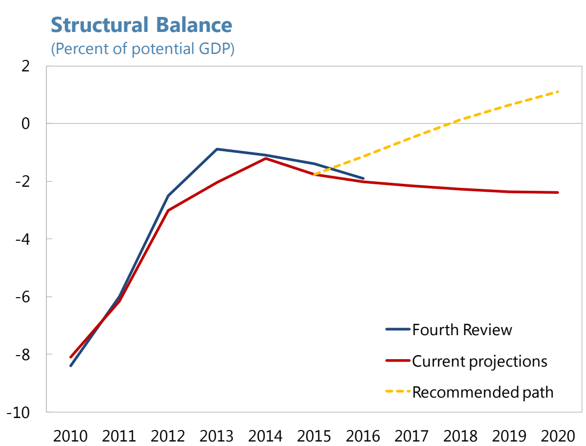
[4] *Documento de Estratégia Orçamental 2014–2018* (in Portuguese), available at http://www.parlamento.pt/ActividadeParlamentar/Paginas/DetalheActividadeParlamentar.aspx?BID=97647&ACT_TP=PEC.

Staff's views

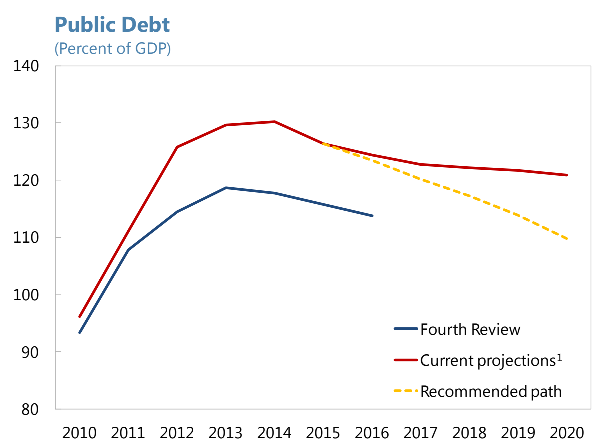
16. Fiscal policy should be guided foremost by sustainability considerations. Despite the notable consolidation achieved to date, Portugal remains vulnerable to shifts in market sentiment due to its high stock of public debt (the third-highest in the euro area following Greece and Italy), large refinancing needs, small size of the economy, and weak growth prospects. Even though the debt-to-GDP ratio is to see decline in 2015, the projected decline over the medium term is modest, reaching 121 percent in 2020. As noted in Annex IV, debt dynamics remain highly vulnerable to adverse yet plausible macro-fiscal and contingent liabilities shocks. A more pronounced decline in the debt ratio, consistent with a return to debt sustainability, would hinge on greater fiscal adjustment than under the baseline in addition to structural reforms to boost growth.

17. There will be a slight relaxation of the fiscal stance in 2015. Staff projects a fiscal deficit of 3.2 percent of GDP for 2015—marginally above the excessive deficit procedure target of 3 percent of GDP—and higher than the budgeted 2.7 percent of GDP. The difference relative to the budget target primarily reflects more pessimistic revenue assumptions, as the budget incorporates large revenue gains from a range of measures to improve tax compliance and recover outstanding tax debt. As a result, the structural primary balance is projected to deteriorate.

18. Going forward, fiscal policy should be anchored around an annual structural primary adjustment of 0.5 percent of GDP (Box 3). The current level of public debt and large borrowing needs allow little space for counter-cyclical fiscal policy, and leaves Portugal vulnerable to a significant worsening of debt dynamics should downside risks materialize. A primary adjustment target would ensure that savings from the current low sovereign yields do not dilute the adjustment effort and that the windfall gains from lower yields are fully devoted to reducing public debt and restoring appropriate fiscal buffers. The adjustment should be achieved mainly through expenditure rationalization in the context of introducing expenditure targets for each level of government. Under this adjustment scenario, debt would decline to around 110 percent of GDP by 2020.



Sources: Portuguese authorities and IMF staff estimates.



Sources: Portuguese authorities and IMF staff estimates.

19. The authorities should introduce multi-year expenditure targets to underpin a fiscal adjustment based on spending rationalization. These targets would be consistent with the structural primary balance targets discussed above, and in line with the expenditure benchmark of the Stability and Growth Pact (SGP). This would help ensure that future adjustment focuses on spending reform rather than on further revenue measures, given Portugal's already-high tax burden. To ensure effectiveness, such expenditure objectives should cover all general government expenditure, and be sufficiently binding to anchor fiscal policy at all levels of government. This would require enhancing the medium-term fiscal strategy and the central government medium-term budget framework. Aggregate spending targets should also be set for local governments and social security funds, with the recently created intergovernmental coordination council being responsible for monitoring outturns and identifying in-year corrective measures.

20. Specific policy measures to contain spending should be identified to enforce the expenditure targets, with a focus on public sector wages and pensions, which together account for nearly 25 percent of GDP and more than half of non-interest government spending. Under the program, public wages were contained through temporary measures, while increases in pensions have moderated. Still, the public wage cuts will be cancelled by 2016, and pension spending is expected to rise, particularly in the public sector scheme (CGA). Additional offsetting measures are therefore needed to alleviate spending pressures in these areas:

- Measures on the wage bill have yielded smaller savings than expected due to successive CC rulings and insufficiently robust reform design, and have not sufficiently addressed structural weaknesses. While public employment was significantly reduced under the program (by almost 10 percent), cuts in public sector wages have failed to reduce the public-private sector compensation gap. Schemes to increase efficiency and reduce costs in the public service—special requalification pool and voluntary separations—have underperformed. In addition, the modalities and phasing of the new single wage and supplement scales should be carefully designed to avoid additional cost and excessive back-loading. Going forward, the CC has ruled out additional nominal cuts in public wages, and required reforms be of a structural nature rather than across-the-board cuts. Hence, priority should be given to further reducing the number of employees through higher natural attrition and targeted cuts in overstaffed areas. Mechanisms for departure should also be enhanced.[5] Structural measures should aim at limiting automatic wage increases and career progression in order to generate permanent savings of about 0.1 percent of GDP per year.

- The recent CC rulings cancelling the targeted pension measures call for a more comprehensive approach to pension reform. The authorities should make progress in adopting a new indexation rule based on economic factors that would automatically adjust benefits to ensure sustainability of the pension system. In addition, the suspension of early retirements that was introduced in 2012, and lifted in 2015, should be reinstated, to contain the increase in the number of retirees

[5] Savings from a reduction of the workforce by additional 10 percent are estimated at around 0.5 percent of GDP. See "Rethinking the State – Selected Expenditure Reform Options," *IMF Country Report 13/6*.

over the coming years. In the short and medium term, public sector employees' contribution to CGA could increase to improve its financial sustainability.

21. Further structural fiscal reforms are needed to reduce fiscal risks enforce fiscal adjustment, and support growth. While reforms of tax administration and health care have already yielded tangible pay-offs, fiscal risks persist in the following areas:

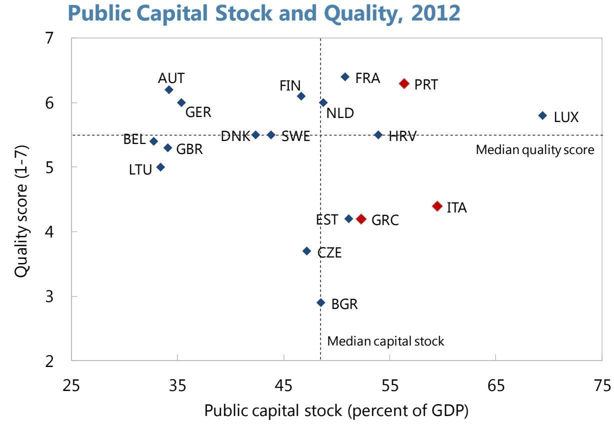
- *SOEs and hospitals.* The financial situation of SOEs and hospitals has generally improved with the additional financing provided by the government in 2014, but restructuring should proceed resolutely to address structural challenges and reduce high levels of debt.

- *PPPs.* While annual gross payments related to PPPs are expected to be reduced by about 20-25 percent following successful contract renegotiations, they will remain a drag on the budget, stabilizing at about €1.5 billion (0.8 percent of 2015 GDP) until 2022, before slowly declining to about €0.6 billion in 2030. Re-negotiations of concessions and PPPs should therefore be pursued forcefully.

- *Budgeting and public administration.* Priority should be given to the finalization and adoption of a new Budget Framework Law. Envisaged reforms are in line with staff advice, with a more strategic and medium-term perspective to budgeting, a consolidation of all government revenues in the Treasury single account, and a gradual move to accrual accounting. In addition, staff recommends that more responsibility be devolved to line ministries for managing their budget, with their financial accountability should be strengthened accordingly. The authorities should also reduce public administration fragmentation, particularly at the central government level, to limit duplication and to better monitor fiscal risks.

- Within the sustainability constraint, fiscal policy should promote growth and alleviate bottlenecks to employment. Spending reforms should create space for targeted tax measures to support private sector deleveraging through the introduction of a deduction for corporate equity, and increase labor force participation through social security cuts to address localized labor market malfunctions. Scaling up public investment to support growth may not be needed, given the high level and quality of public capital stock compared to other euro area countries.

Public Capital Stock and Quality, 2012



Source: Eurostat.

Authorities' views

22. The authorities' 2015 deficit target of 2.7 percent of GDP is well within reach. The authorities were encouraged by the initial results from their efforts to improve tax compliance. They believe that the revenue from their efforts to (i) reduce fraudulent VAT refund claims, (ii) curb tax evasion related to income from rental properties, and (iii) recover outstanding tax debt will exceed staff's expectations. In addition, the authorities were confident that any spending pressures could be accommodated within their budgeted contingency reserve. The cash revenue outturn for January-February was in line with the authorities' projections.

23. Further fiscal adjustment—properly measured—is needed. The authorities agreed in principle that further fiscal adjustment is needed to safeguard debt sustainability, with a medium-term focus on expenditure rationalization. However, they noted complications in defining the adjustment in structural terms in order to provide a useful operational target. In particular, they cited significant uncertainly about calculations of potential output in Portugal, and the related difficulties in differentiating between structural and cyclical developments in assessing fiscal performance.

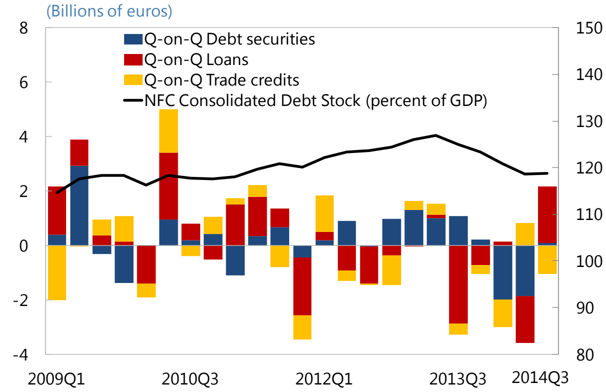
B. Deleveraging

Successful deleveraging is a precondition for strong growth.

Background

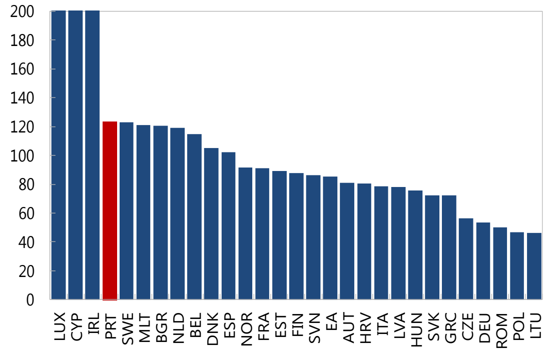
24. The authorities' deleveraging framework has stopped short of a systemic solution, and the level of corporate debt—albeit declining—remains high. The deleveraging framework has been largely put in place. It includes significant changes to the institutional and legal framework for corporate debt restructuring (such as lowering the threshold required for creditor approval of restructuring plans and changing the tax code to favor equity over debt) and timely monitoring of corporate borrowing. However, a systemic solution—entailing an accelerated pace of SME restructuring and large-scale write-offs for the banks—has not been introduced. Corporate debt began to decline slowly in 2013 and now stands at 119 percent of GDP, close to its level at the beginning of the EFF program and still one of the highest in the EU.

Portugal: Change in NFC Debt
(Billions of euros)



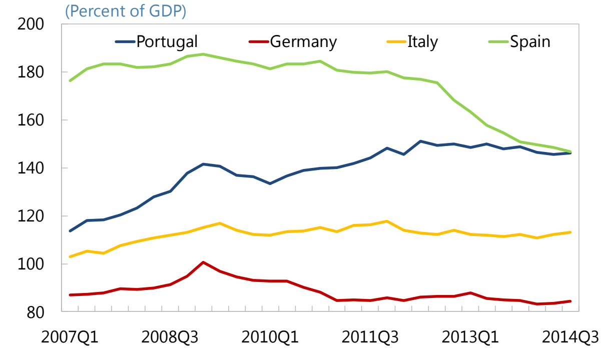
Source: Banco de Portugal.

EU Members: NFC Debt, 2013[1]
(Percent of GDP)



[1] Consolidated data. Luxembourg: 323%, Cyprus: 230%, Ireland: 201%.
Source: Eurostat.

Nonfinancial Corporation Debt Outstanding[1]
(Percent of GDP)



[1]Non-consolidated data. Debt includes loans, securities other than shares, and other accounts payable.
Source: Haver analytics.

Staff's views

25. Eliminating the corporate debt overhang is essential for Portugal's recovery (Box 4). With the banking system still facing high operating costs, overcapacity, and weakening asset quality, waiting for economic growth to improve bank profitability would likely be disappointing. Therefore, credit misallocation would persist, as bank assets remain to a large extent tied up in less productive sectors and investment would remain constrained, further weakening the economic recovery.[6] Successful deleveraging would reverse this dynamic by allowing banks to reallocate resources toward viable firms that will in turn increase their investment, supporting economic growth.

26. Banks should take advantage of the current supportive economic and financial environment to tackle the corporate debt overhang more ambitiously. They should raise more capital, increase provisioning and accelerate the pace of write-offs. This would open up space for new growth-enhancing lending and lower the risks to financial stability.

27. Corporations, with the authorities' help, should do their part as well. The authorities must encourage corporate governance reform to encourage firm owners to retain more earnings and inject new equity into their companies. To reduce the tax debt bias, the authorities could complement their on-going efforts to reduce the deductibility of debt interest by introducing a deduction of equity for corporate income tax.

Authorities' views

28. The deleveraging strategy in place appears to be working. The recent decline in corporate debt—across all sectors and firms' sizes—has been facilitated in part by equity injections from foreign investors and by the equity-favoring tax incentives. The authorities felt that a gradual pace of deleveraging would better safeguard financial stability and that banks may not be able to raise sufficient capital should the process be accelerated.

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[6]Constrained-credit recoveries tend to be slow, with lower productivity and investment growth, compared with recoveries where credit to the private sector is increasing. See Abiad, A., Dell'Ariccia, G., and B. Li. 2011. "Creditless recoveries". *IMF Working Paper 11/58.*

C. Structural Reforms

With fiscal adjustment set to remain a drag on domestic demand and corporate deleveraging taking time, structural reforms offer the main tool to increase external competitiveness and potential growth.

Background

29. Even though the number of newly implemented structural measures has fallen with the expiration of the program, there were several notable developments.

- The number of new collective bargaining contracts in 2014 approached levels last seen in 2011, and more contracts were reached at the firm level.
- GPEARI—the planning unit of the Ministry of Finance—has been given a formal mandate by the Council of Ministers to coordinate the process of evaluating structural reforms
- There is now a proposal to impose a one-time levy on GALP, the largest natural gas provider. If the levy becomes effective, it would be applied to reduce gas prices by 3 to 5 percent for end users for each of the next three years.
- Renegotiation of one port concession contract has been completed, with the remaining four expected to follow suit soon.
- New bylaws for 18 services and regulated professions were approved by the Council of Ministers and are currently under discussion in Parliament.
- The judicial reforms are starting to pay off. For instance, the simplified, centralized, and electronic system of garnishments of bank accounts under the new Code of Civil Procedure enabled the seizure and recovery of €0.3 billion in enforced claims in a little over a year.

Staff's views

30. The recovery projected in the baseline is too mild to return the economy to full employment over the medium term. Portugal faces adverse capital and labor trends, i.e. negative net investment in the short term, and a falling working-age population in the short- and medium term. Therefore, the baseline rate of growth is insufficient to absorb the slack in the labor market through job creation, and job prospects for the lower-skilled in particular would remain dire (Box 5).

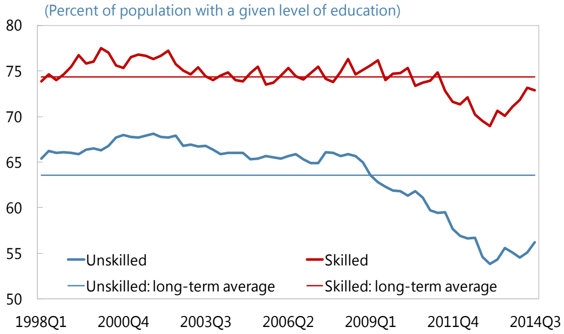
31. To raise growth and absorb the large internal slack, further structural reforms should zero in on alleviating impediments to external competitiveness (Box 6) and potential growth. The adjustment program already initiated and implemented a large number of structural reforms, sometimes against the opposition of well-entrenched lobbies and interests. The challenge for policymakers will be to build on this achievement. And this should involve revisiting those reforms that have not yielded the hoped-for-results, fully implementing already initiated reforms, and addressing remaining bottlenecks through fresh reforms.

32. Upgrading the quality of public services and policies remains critical for the competitiveness of firms and the well-being of citizens. Staff's firm survey suggests that some of the public sector reforms are in urgent need of being revisited or stepped up, with firms that export particularly concerned about the lack of reform pay-offs so far (Box 1). In this context, reform areas that deserve special attention include raising the effectiveness of public administrations at the central and local levels, reviewing the functioning of the courts, and increasing the payment discipline of public sector entities. Only a deep-rooted reform of the state may be able to yield tangible results in these reform areas.

33. Improving the functioning of product markets requires fully implementing initiated reforms. Measures aimed at reducing the cost of energy, the use of transport infrastructure, and the costs of professional and other services still need to be implemented and then evaluated whether they achieved their objectives. The competition authority needs to have the resources and political support to move more aggressively against anti-competitive practices in sheltered sectors. Moreover, more market integration at the European level would benefit Portugal. While the legacy costs of past policy mistakes are now difficult to fully undo in areas such as energy or road transport infrastructure, it will be important to avoid sliding back to previous policy habits in these areas.

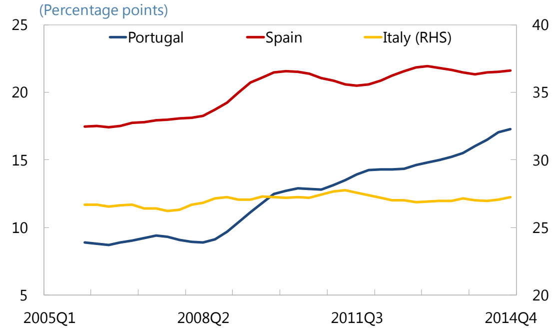
34. Fresh reform ideas and initiatives are especially needed in the labor market area, while avoiding policies that undermine job creation. A significant effort has already been made to use active labor market policies to improve skills and labor market attachment of workers. But the productivity of workers, especially of the low skilled, also depends critically on the skills of managers, where Portugal ranks relatively low in cross-country comparisons. The effectiveness and scope of programs to promote managerial skills in Portugal should therefore be reviewed. Keeping workers without jobs attached to the labor market will require a more inclusive unemployment support system, for example by reducing the minimum contribution period for eligibility and reducing inactivity traps, especially for older workers. With an increasing share of workers paid at the minimum wage, further premature increases would lower the chances of lower-skilled workers to make the transition from inactive or unemployed status to jobs. While minimum wages can be useful to prevent worker abuse and provide a floor for income, excessive increases can hurt the very people they are intended to help. Experiences in other countries suggest there are more effective tools available to fight poverty than the minimum wage.

Portugal: Employment Rates of Skilled and Unskilled Workers
(Percent of population with a given level of education)



Sources: Eurostat; and IMF staff calculations.

Employment Rate Gap: High-Skilled versus Low-Skilled Workers
(Percentage points)



Source: Eurostat; and IMF staff calculations.

35. Structural reforms are never easy, but the current environment is the most conducive for undertaking them from an economic and financial stability point of view. (Box 7). Natural inertia and substantial vested interests will work to neutralize challenges to the *status quo*. The current post-crisis recovery, however, is a good time to push for institutional change, as the pitfalls of the existing system have just been vividly demonstrated. The nascent recovery and the benign financing conditions—helped by the cyclical tailwinds—can mitigate the costs of transition. For the long term, the key would be to create a natural domestic constituency for such a change. In this context, social partners have a special responsibility to promote job creation by supporting policies that increase the country's competitiveness. A more inclusive and transparent social partner dialogue would facilitate reaching cooperative solutions that benefit all stakeholders.

Authorities' views

36. The wide range of structural reforms implemented under the program is already paying off. While the authorities agree that more needs to be done, they stress that (i) the yet-unseen benefits of many reforms, such as the corporate deleveraging strategy, will become more visible in the near future and (ii) the already-observed improvements, such as gains in external competitiveness, can be easily sustained in the medium term. The authorities also argued that implementation of product market reforms remains on track, as illustrated by recent steps in the areas of energy and transport infrastructure. On labor market, the authorities noted the challenges inherent in further reducing employment protection and argued that lowering duration of unemployment benefits for older workers while widening the coverage would go against their contributive nature.

POINT—COUNTERPOINT

The key elements of the staff's views are challenged below, in order to provide the reader a better sense of the arguments and counterarguments.

37. Following the large fiscal effort under the program, further adjustment is not needed.

Argument: With yields at record lows and substantial fiscal adjustment already implemented, further fiscal effort will only depress domestic demand and jeopardize the nascent recovery.

Counterargument: Under the baseline scenario, the high level of public debt is projected to decline, but only gradually. Should the current favorable financing conditions be reversed or the recovery stall, debt sustainability concerns could quickly re-emerge, especially since the borrowing needs remain large. In that case, another pro-cyclical fiscal adjustment would become unavoidable. Consequently, the authorities must take advantage of the favorable external environment to reduce debt and begin rebuilding fiscal buffers.

38. Portugal has substantially completed critical structural reforms under the program.

Argument: Structural reforms take time and should be allowed to bear fruit. Introducing additional reforms now will exacerbate uncertainty (which is detrimental to growth), while any potential benefits will only accrue in the distant future, if at all.

Counterargument: It must be acknowledged that much has been done and these reforms take time to bear fruit. Nevertheless, doing nothing more is a risky strategy. As described in the report, Portugal is still lagging behind its peers in key structural indicators. Modest economic growth, persistent slack in the labor market, and the remaining vulnerabilities all point to the need to push forward the reform agenda in key areas.

39. The focus on corporate deleveraging is misplaced, as improved growth prospects will alleviate any remaining debt overhang.

Argument: Large-scale corporate deleveraging will only exacerbate the banks' losses and eventually necessitate public intervention at the taxpayers' expense. It is much better to let the economy grow and the problem will take care of itself.

Counterargument: The gradual approach used so far has been less than fully successful. The banks have incentives to keep unviable companies afloat, and the stock of non-performing loans has continued to rise while profitability has been difficult to achieve, increasing the risks to financial stability. More broadly, delaying the deleveraging process perpetuates the misallocation of resources and undermines the prospects for economic recovery.

40. The burden of adjustment was not shared fairly across stakeholders over the past few years.

Argument: The adjustment may have been necessary, but its burden was borne excessively by the ordinary citizens. In particular, labor market reforms undermined collective bargaining at a great cost to workers, while the financial institutions (and their wealthy owners) were bailed out.

Counterargument: Job creation in Portugal required easing constraints on exports, through greater labor market flexibility, and restoring credit to viable firms, by strengthening financial stability. Labor market reforms have introduced much-needed flexibility into the labor market by allowing contracts to be negotiated at the firm level. Financial sector reforms, aimed at shoring up bank capital and restoring profitability, averted widespread financial system instability, which would have imposed even higher costs on taxpayers. In addition, even though the number of new collective bargaining contracts did decline during the crisis period, it was likely due to the challenging economic environment. As the recovery took hold in 2014, the number of new contracts increased.

STAFF APPRAISAL

41. **In the wake of the crisis, Portugal has successfully attained a balanced current account position, but unavoidably at the cost of generating large internal slack.** The rising flow imbalances from excessive current account and fiscal deficits in the pre-crisis years were reversed, as the current account turned to surplus for the first time in decades and fiscal deficits declined. That, however, came at the cost of weak domestic demand leading to output contraction and high unemployment. The subsequent recovery, already two years old, has not been strong enough to bring output and employment back to pre-crisis levels, and labor market slack remains high. Restoring internal balance without undermining the external position thus remains the most important policy priority.

42. **A confluence of factors has boosted the near-term outlook significantly, but raising medium-term growth prospects remains a challenge.** The ECB's expanded asset purchase program brought about historically low sovereign yields and contributed to the weak euro, and Portugal—a net oil importer—is benefitting further from a dramatic fall in oil prices. Taking advantage of this favorable environment, the authorities have begun early repurchases of the Fund credit outstanding, which are welcome. At the same time, the economic recovery is being driven largely by consumption, and Portugal still lags behind its peers in key structural reform indicators, resulting in weaker medium-term growth prospects.

43. **The authorities should use the unique opportunity afforded by the strong cyclical tailwinds wisely.** Despite the notable flow improvements, Portugal's position is still precarious due to the remaining large stocks of public, private, and external debt. To minimize risks and improve the country's growth prospects, the authorities should focus on rationalizing public expenditure, encouraging the corporate deleveraging process, and improving competitiveness by way of structural reforms.

44. **The authorities should target an annual structural primary adjustment of 0.5 percent of GDP based on expenditure rationalization.** Given Portugal's already-high tax burden, the authorities should introduce multi-year expenditure targets to ensure that adjustment focuses on expenditure reform. Particular attention should be paid to the comprehensive reform of wages and pensions, which together account for more than a half of all non-interest government spending.

45. **A systemic solution to the problem of excessive leverage is needed.** Not only do the banks that keep too much bad credit on their books endanger financial stability, they are also unable to finance the economic recovery. With the authorities' involvement and encouragement, banks should raise more capital and accelerate the pace of debt write-offs, while corporates must end their excessive reliance on debt at the expense of equity.

46. The authorities should implement further structural reforms to improve growth prospects and reduce labor market slack. The efforts should focus on alleviating bottlenecks by enhancing local competition (notably in the energy sector) and labor market flexibility. Particular attention should be paid to the problem of low-skilled workers, who suffered disproportionally during the crisis. Investing in vocational training, improving managerial skills, reducing disincentives to work, and making the social dialogue more inclusive are all important steps in that direction.

47. Staff recommends the next Article IV consultation be held on the standard 12-month cycle.

Box 1. How Effective Were Structural Reforms? A Firm-Level Perspective

This box summarizes the results of a survey of Portuguese firms about the effectiveness of structural reforms. The survey questions covered 35 structural reform areas implemented under the adjustment program and asked for firms' views on the impact of the reforms on their competitiveness and growth prospects as well as firms' perceptions of the urgency of further structural reform efforts in a given area. The survey sample included a group of large firms and a group of small- and medium-sized (SMEs) firms. The results reported in Box 1 Table 1 are broken down by firms classified as exporters and non-exporters. More details on survey design and results are reported in the Selected Issues Paper.

Starting with the perceived impact of reforms (first two columns in Box 1 Table 1), the survey results suggest that most reforms had some positive impact. Exporting firms generally perceived that reforms had more positive impacts than non-exporting firms. Labor market reforms were seen as the reform field with the highest positive impact, while product market reforms were singled out as the reform field with least impact. However, very few reforms were perceived as having had significant impacts. Exporting firms considered that reforms in the areas of increasing work time flexibility and reducing the cost of paying taxes had significant positive impacts. Non-exporting firms shared this view as regards reducing the cost of paying taxes.

There seemed to be strong consensus across firms that many of the structural reforms in the public and financial sectors are in need of being re-visited or stepped up (last two columns in Box 1 Table 1). Exporting firms in particular see an urgent need for additional reforms to increase the effectiveness of public administration, both at the central and local levels. They also see an urgent need to upgrade the effectiveness of the various courts of the justice system, to improve the payments discipline of public sector entities, particularly of state-owned enterprises (SOEs), and to further ameliorate the workings of the insolvency and corporate debt restructuring frameworks.

The perceived urgency of additional reforms was generally much lower with respect to labor and product market reforms. However, exporters tended to perceive close-to-urgent needs to step up reforms in the areas of energy, road pricing, costs of using railways, enforcement of competition, and hiring and firing costs.

Firm surveys may not always capture the actual outcomes of structural reforms. Respondents may not be aware of the actual reform outcomes but nevertheless have opinions. To mitigate this bias, the survey provided the option to decline answering a question if the respondent felt she lacked the information to assess the impact of or need for more reforms. At the same time, perceptions, whether they are rooted in actual reform outcomes or not, may matter greatly for firms' decisions regarding job creation or investments.

Some of the structural reforms may also need more time to be perceived as having had an impact. This may in particular be the case for some of the public and financial sector reforms whose effectiveness depends on changing deep-rooted behaviors on the sides of public administration, the justice system, regulators, or banks. In these cases, if firms perceive an urgent need for more reforms, this could also be consistent with reforms just not having paid off visibly so far.

Given these caveats, the survey should be repeated at regular time intervals. For example, a similar firm survey could be conducted again in a year's time or so to check whether perceptions of the effectiveness of structural reforms have evolved in the right direction.

Box 1. How Effective were Structural Reforms? A Firm-Level Perspective (concluded) 1/

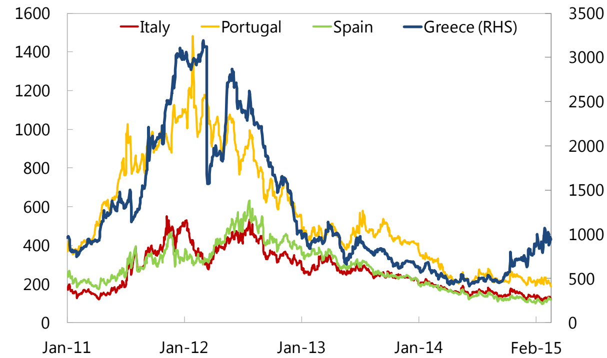
	Perceived impact of reforms		Perceived urgency of more reforms	
Product market reforms	**Exporters**	**Non-exporters**	**Exporters**	**Non-exporters**
Licensing environment	-0.02	0.00	-0.33	-0.05
Energy costs	0.06	-0.14	-0.41	-0.14
Cost of telecommunication and postal services	-0.11	-0.14	-0.06	0.21
Cost of road use	-0.16	0.19	-0.46	-0.23
Cost of using railways	-0.23	-0.50	-0.42	0.00
Cost of using ports	0.06	-0.24	-0.27	-0.29
Cost of professional services	-0.26	-0.30	0.00	0.11
Cost of other services	-0.38	-0.30	0.15	0.00
Enforcement of competition	-0.22	-0.24	-0.38	-0.08
Labor market reforms	**Exporters**	**Non-exporters**	**Exporters**	**Non-exporters**
Increases in work time	0.24	0.00	0.11	0.45
Increases in work time flexibility	0.54	0.24	-0.31	-0.10
Collective bargaining	0.15	-0.18	-0.30	0.19
Hiring and firing costs	0.38	0.29	-0.42	-0.26
Active labor market policies	0.27	0.19	-0.33	-0.13
Effectiveness of employment agencies	0.13	0.08	-0.37	-0.08
Public sector reforms	**Exporters**	**Non-exporters**	**Exporters**	**Non-exporters**
Effectiveness of central administration	0.21	0.07	-0.62	-0.50
Effectiveness of local administrations	0.08	0.04	-0.47	-0.56
Cost of paying taxes	0.55	0.50	-0.42	-0.04
Effectiveness of VAT refund	0.28	-0.04	-0.33	0.04
Investment incentives	0.45	0.00	-0.53	-0.26
Payment on time by central administration	0.10	0.15	-0.58	-0.52
Payment on time by local administrations	0.15	-0.04	-0.62	-0.56
Payment on time by SOEs	0.07	0.09	-0.64	-0.75
Quality of services provided by SOEs	0.00	-0.10	-0.54	-0.39
Privatization program	0.11	0.04	-0.13	0.19
Effectiveness of labor courts	-0.08	-0.09	-0.62	-0.41
Effectivess of tax courts	0.06	-0.14	-0.63	-0.30
Effectiveness of civil and commercial courts	-0.02	0.17	-0.60	-0.35
Effectiveness of alternatives to litigation	0.11	-0.04	-0.63	-0.63
Financial sector and insolvency reforms	**Exporters**	**Non-exporters**	**Exporters**	**Non-exporters**
Efficiency of insolveny framework	0.15	-0.04	-0.56	-0.41
Debt restructuring framework (PER)	0.18	-0.17	-0.38	-0.29
Out-of-court debt restructuring framework (SIREVE)	-0.02	-0.27	-0.29	-0.21
Provision of alternative financing options	0.35	0.19	-0.39	-0.42
Efficiency of credit allocation by banks	0.30	0.31	-0.63	-0.54

Sources: Survey; and IMF staff estimates.
1/ Numbers indicate average scores across firms' responses, with scores standardized in the range -1 to +1. As regards perceived impact of reforms, firms had the choice between "no impact" (score = -1), "some impact" (score = 0), or "significant impact" (score = 1). As regards the perceived urgency of more reforms, firms had the choice between "no need" (score = 1), "some need" (score = 0), or "urgent need" (score = -1). Firms also had the option to use "no answer" in case they felt there was not enough information to assess the structural reform. Colors are assigned based on four uniformly spaced intervals as follows: red refers to a value below -0.5; orange to a value betwen -0.5 and 0; light green to a value between 0 and 0.5; and dark green to a value above 0.5.

Box 2. Portugal's Regained Market Access: Opportunities and Risks

Portuguese bond spreads have declined considerably since early 2012, mostly driven by global factors. In the winter of 2012 Portuguese spreads peaked at over 1,400 basis points, with spreads from stressed European economies under similar pressure through the summer of 2012. They have declined rapidly since that time with the turn-around widely credited to Mario Draghi's 'whatever it takes' statement on July 26. The correlation in spreads suggests perceptions of the establishment of a European backstop and rising global risk appetite have been a common force behind these developments. Yet many of the high-spread countries have also seen significant economic turnarounds. If fundamentals are driving the decline, policy makers can take market confidence as a sign that they have achieved their goals and are on a glide-path to stability. Which factors dominate in the case of Portugal?

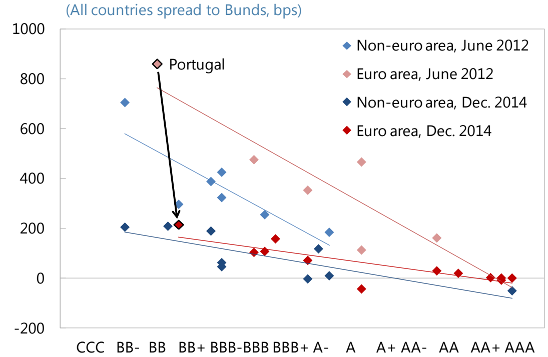
Sovereign Spreads
(10-year bond spread over Bunds)



Sources: Bloomberg; and IMF staff calculations.

Despite improved fundamentals, other factors seem to have been principally responsible for the decline in spreads. Plotting the average ratings of the three major agencies against 10 year bond spreads indicates a dramatic shift downward in spreads across the board. While average country ratings have improved modestly over this time period, Portugal would have required a significantly higher rating to have earned its current spread in the summer of 2012. Other indicators of economic fundamentals for Portugal such as the unemployment rate, GDP growth, public debt, and the current account balance support the same conclusion.

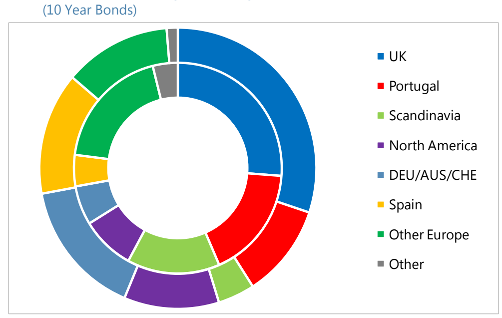
Credit Ratings and Spread Compression
(All countries spread to Bunds, bps)



Sources: Bloomberg; and IMF staff estimates.

Global factors have been the main drivers of spread compression. Both the VIX and the first principal component of periphery country spreads are positively associated with spreads, suggesting that they react strongly to these measures of global turbulence and risk aversion. Other global factors such as the ECB policy rate also help explain the low spreads. The investor base for Portuguese debt has diversified towards more risk-averse borrower types and residencies, as even insurers and pension funds hunt for yield in an environment of extremely low interest rates.

Investor Base by Country
(10 Year Bonds)



Note: Inside: Feb. 2014, Outside: January 2015.
Source: IGCP

Portugal's spreads are sensitive to changes in market sentiment. As global factors normalize, yields will likely exhibit an upward trend, pricing will become more sensitive to fundamentals, and debt service burdens will rise.

Box 3. Growth-Friendly Fiscal Adjustment

Recent fiscal adjustment has relied on revenue measures, with considerable scope to improve spending efficiency. Weak expenditure control played a key role in the build-up of fiscal imbalances prior to the crisis, as real primary spending growth outpaced real GDP growth for all levels of government, and particularly in the social security sector (Table 1). Since then, fiscal adjustment has been heavily revenue-based, with an increase in government revenue of 4.0 percent of GDP from 2010-2014. Going forward, the authorities should focus fiscal adjustment on rationalizing public expenditure, by implementing expenditure targets for all levels of government.

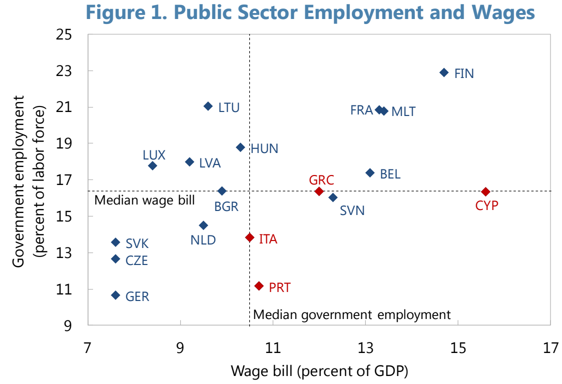
Table 1: Real Primary Spending and Real GDP Growth
(percent of GDP, real terms 2010)

	2000-2013	2010-2013
	Spending (change, percent of GDP)	
Central Government	3.0	-3.7
Local Government	0.6	-0.8
Social Security Funds	4.4	1.4
	Real Spending Growth	
Central Government	1.0%	-2.4%
Local Government	1.0%	-3.5%
Social Security Funds	3.1%	1.7%
Real GDP Growth	0.1%	-1.1%

Source: Eurostat and IMF staff estimates

Portugal can further improve expenditure management to enforce the expenditure targets. Spending targets could be set by levels of government, and the MTBF would need to cover all central government expenditure. Specific challenges are associated with the enforcement of the expenditure targets outside the central government. For local governments, while monitoring and reporting tools are being enhanced, the authorities could establish consolidated medium-term fiscal projections for each level of governments and introduce incentives for meeting the targets, such as additional government transfers. In the health sector, an alert mechanism could be created to ensure in-year corrective measures.

Figure 1. Public Sector Employment and Wages

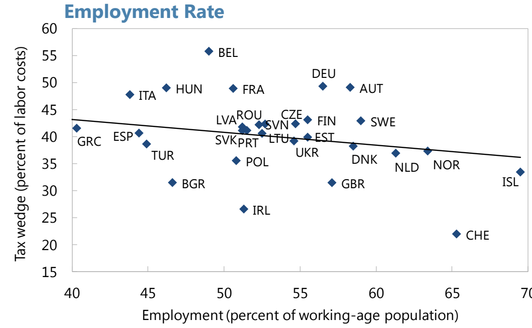


Sources: Eurostat; and IMF staff calculations.

Fiscal adjustment should aim at reducing unproductive spending, to make room for pro-growth fiscal measures. Public wage spending was contained under the program in part through temporary measures that will prove insufficient to ensure fiscal sustainability (Figure 1). Spending on pensions has increased at a slower pace under the adjustment program, and reforms have partially addressed long term sustainability issues. But spending is expected to increase in the short and medium term, particularly to finance the public sector pension scheme (CGA), due to the excessive back loading of pension savings. Structural high quality policy measures are therefore needed to alleviate spending pressures in these areas.

Fiscal targeted measures can support efforts to reduce corporate leveraging and unemployment. Tax policy could further contribute to reducing tax debt bias, by introducing a deduction for corporate equity under the CIT. Revenue cost (estimated to about 0.5 percent of GDP) could be mitigated by applying the deduction only to new investment. Fiscal policy can also help address labor market inefficiencies. In Portugal, the working-age population is significantly lower than in other countries with comparable tax wedge rates (Figure 2). Given fiscal constraints, targeted cuts in employers' social security contribution could address the high level of unemployment of low-skilled and youth workers, by lowering the labor costs of these specific populations, while limiting revenue costs.

Figure 2. Relationship Between the Tax Wedge and Employment Rate



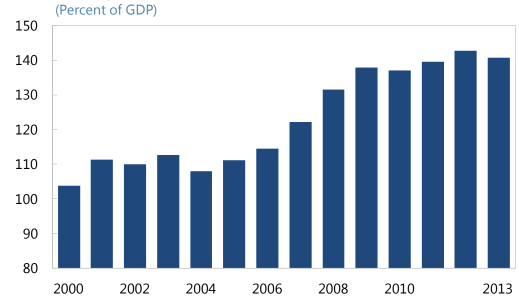
Sources: Institute for the Study of Labor; Organisation for Economic Co-operation and Development; and IMF staff estimates.

Box 4. Corporate and Bank Balance Sheet Repair: Recent Progress and Remaining Challenges

The corporate sector experienced rapid debt accumulation prior to the crisis. Following the adoption of the euro, large capital inflows and low funding costs fuelled the build-up of debt imbalances in the corporate sector, especially in the non tradable sector. Recently, the pace of corporate deleveraging picked up, but the stock of corporate debt remains among the highest in the EU.

Excessive corporate leverage continues to constrain business investment. A declining interest coverage ratio (from 3.9 in 2010 to 2.9 in 2014 for micro and SMEs and from 10.4 in 2010 to 4.3 in 2014 for large firms) and the high share of firms with overdue loans (31 percent as of January 2015), are indicative of the impact of the debt overhang on the corporate side, which in the short run impairs firms' ability to invest and in the long run renders firms unviable. On the bank side, the continued rise of non-performing loans impacts profitability and constrains new lending to viable firms.

Portugal: NFC Debt, 2000-2013
(Percent of GDP)



Note: Consolidated data including loans, securities other than shares and trade credits.
Source: Eurostat.

Corporates and banks face disincentives to speed up the deleveraging process. The corporate sector is dominated by SMEs where, due to weak corporate governance, firm owners typically distribute (rather than retain) earnings, shifting the risk from firms to banks. On the bank side, the reliance on lending that is collateralized, including by underlying assets for which there is no obvious valuation, creates an incentive for banks to postpone provisions and debt write-offs until the economic recovery takes hold, despite eroding profitability.

The authorities have taken steps to facilitate corporate debt restructuring. The institutional and legal framework was enhanced, including (i) introducing a less favorable tax treatment of debt financing, (ii) lowering the threshold for creditor approval in restructuring plans, (iii) streamlining and strengthening in and out-of-court workouts (PER, SIREVE), and (iv) developing an early warning system. However, these steps are not enough to significantly reduce the debt overhang, resulting in constrained credit amid rising NPLs.

The current economic and financial environment affords an opportunity to tackle the corporate debt overhang more ambitiously. A systemic approach, led by a body with sufficient resources and sway over banks, could move the restructuring process forward. A standardized bank-led, time-bound framework that calls on banks to raise more capital, increase provisioning, and accelerate the pace of write-offs to deal with debt restructuring would pave the way for restoring the flow of private credit to viable firms, and supporting economic growth. This would also help lower risks to financial stability by improving the overall asset quality of the banking system.

Box 5. Creating Jobs for Lower-Skilled Workers

Absorbing labor slack over the medium term by creating jobs poses two challenges. First, Portugal's post-crisis labor slack is very high. Second, much of the slack is concentrated in the lower-skilled segment of the labor market (Box figure). The first challenge can be met by faster output growth based on a more export-oriented economy. To meet the second challenge, labor market and other policies will need to address the special labor market integration needs of lower-skilled workers to achieve more inclusive growth.

A small, tractable model of the labor market is used to explore these issues. Labor demand is assumed to be based on a production function that nests a first-stage CES function aggregating skilled and lower-skilled labor into human capital within a Cobb-Douglas function that includes two types of capital goods. Labor supply is set exogenously based on projections of the working-age population and on extrapolating past trends in relative supplies of skilled and low-skilled workers. This model allows labor demand for skilled and lower-skilled labor to reflect both skill-capital complementarities as well as skill-biased technological progress.

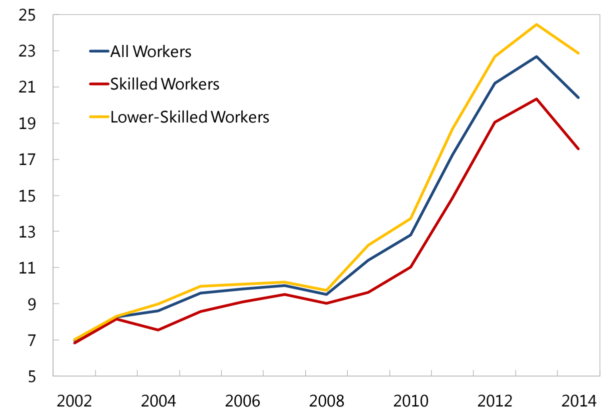
Assumptions for baseline scenario: In the baseline scenario, staff's medium-term outlook for output and investment is taken as given, the skill premium, defined as wages of skilled to low-skilled workers, is assumed to decline in line with longer-term trends, and the production function is used to determine the demand for skilled and low-skilled workers. On the labor supply side, to the extent that slack is not absorbed over the medium term, the assumption is that discouraged workers included in the slack measure will lose labor market attachment and involuntary part-time workers will be resigned to work shorter hours than they wish.

Assumptions for alternative absorption scenario: In the alternative scenario, medium-term targets are set for the absorption of skilled and low-skilled labor, roughly bringing the overall employment rate back to the pre-crisis (2008) levels. Migration flows are assumed to be unaffected by the higher rates of job creation, which may be unrealistic as some migrants would likely return to Portugal if more jobs become available. In this alternative scenario, the production function is used to determine the output and skill premium paths consistent with the labor absorption targets.

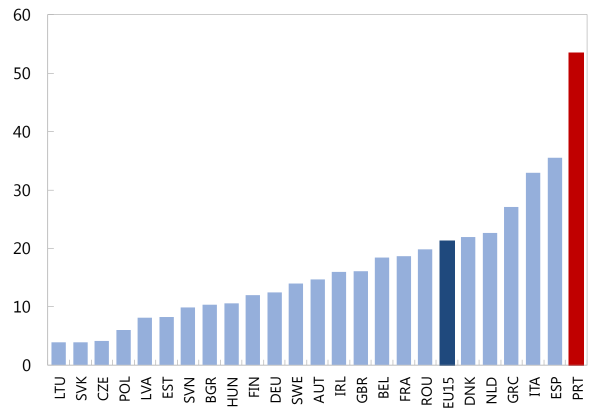
The scenarios illustrate that absorbing lower-skilled workers by job creation requires faster growth and more policy support. Given the assumption on labor demand and supply under the two scenarios, overall labor slack will roughly fall to similar levels over the medium term. Therefore, comparing employment rates under the two scenarios is more insightful than comparing slack rates. In the baseline scenario, job creation would clearly be insufficient to bring employment rates back to pre-crisis levels, especially for low-skilled workers (Box figure). Under the alternative scenario, the overall employment rate target is already pre-set, and the simulation suggests that absorbing labor slack through job creation would not require unrealistically fast output growth since absorbing low-skilled labor is not as growth-intensive as absorbing skilled labor. Labor productivity growth is relatively low under the absorption scenario since employing more lower-skilled labor than in the baseline depresses average productivity levels. This result also suggests that if lower-skilled labor would be mainly absorbed through creating jobs in exporting firms, this would have to occur through increasing exports that are relatively low on the value-added ladder.

Box 5. Creating Jobs for Lower-Skilled Workers (concluded)

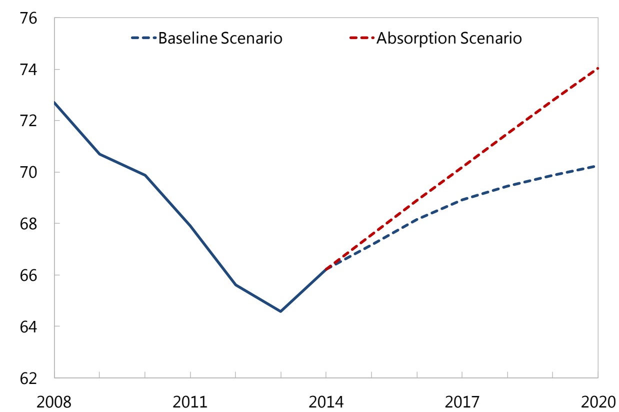
Labor Market Slack Rates



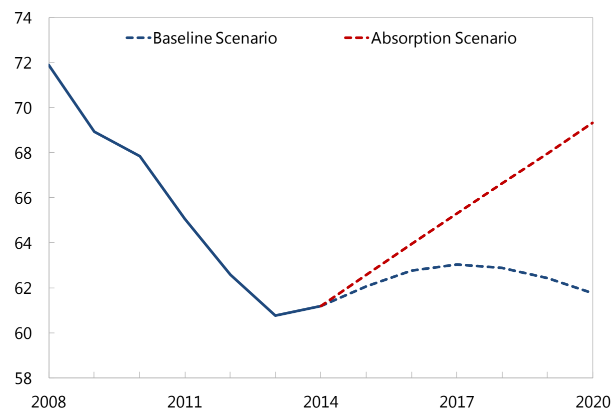
EU: Share of Lower-Skilled Workers, 2013



Employment Rate: All Labor

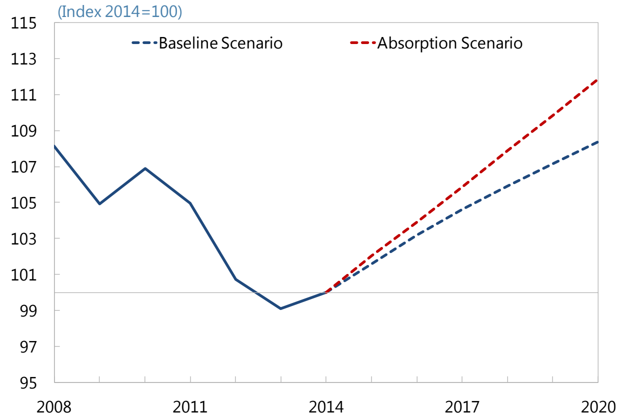


Employment Rate: Lower-Skilled Labor



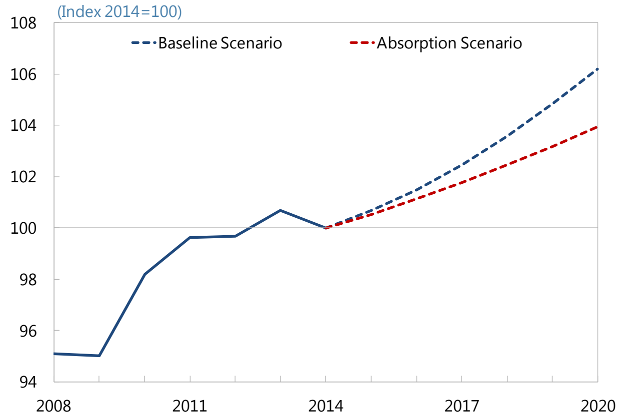
Real GDP, 2008-2020

(Index 2014=100)



Labor Productivity, 2008-2020

(Index 2014=100)



Sources: INE and staff calculations.

Box 6. Structural Reforms to Boost External Competitiveness

Portugal achieved impressive external adjustments in the past few years. Gross exports as share of GDP rose from just slightly above 30 percent in 2010 to over 40 percent in 2013. Such increase in gross exports led the country to the largest current account improvement during this period among all EU countries, from a deficit of 10½ percent of GDP to a half-percent-of-GDP surplus.

The improved external performance needs to be maintained on a sustainable basis in the future. This, over time, will help Portugal to reduce its still high external stock vulnerabilities, as indicated by both the large negative net IIP (close to 120 percent of GDP at end-2013) and huge amount of gross external debt (around 215 percent of GDP at end-2014).

The sustainability of the improved external performance, however, cannot be taken for granted. When the economy recovers, absent continued strengthening of external competitiveness, the picking up of domestic consumption and higher investment—needed to help re-absorb the labor slack through job creation—will create pressures that may lead to reopening of the external imbalances. Adding to the concern is the uncertainty on competitiveness gains associated with the observed gross exports increase. Growth of gross exports often reflects increases in both domestic-value added and imported intermediate inputs. In the latter case, the increase of growth exports is not necessarily a reflection of competitiveness gains.

Domestic-value added (DVA) exports, *as percent share of GDP*, are a better measure of competitiveness than gross exports and are closely linked to a small set of structural factors. With imported intermediated inputs excluded, DVA exports reflect the true external demand for domestic products. While estimates of DVA exports often come with significant time lags, historical information shows strong linkages between the levels of DVA exports and some structural indicators. In particular, countries with (i) more flexible labor markets; (ii) more developed manufacturing industries, relative to services sectors; (iii) more intense local competitions; and (iv) higher integration with the global value-chain, tend to export more domestic value-added.

EU Member States: DVA Exports and Structural Factors [1/]

Dependent variable: DVA exports (% of GDP)	(1)	(2)	(3)	(4)	(5)
Degree of employment protection	-8.858***				-4.078***
	(0.916)				(0.922)
Unit wage cost between services and manufacturing industries		0.974***			0.964***
		(0.125)			(0.183)
Intensity of local competition			5.295***		4.473***
			(1.367)		(1.253)
Degree of integration with global value chain				0.978***	0.587***
				(0.083)	(0.114)
Observations	170	214	168	216	134
R-squared	0.358	0.224	0.083	0.394	0.667

Data sources: Eurostat; Global Competitiveness Indicators, World Economic Forum; LAF database, European Commission; World Economic Outlook database, IMF; and IMF staff estimates. Standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1.

[1/] Cyprus, Malta and Luxeumberg are excluded from the sample. Croatia is not in the regressions because of missing DVA information. The sample covers the period 2003-11. The indicator of local competition intensity became available only in 2005. Information on employment protection is missing for Bulgaria, Latvia, Lithuania and Romania.

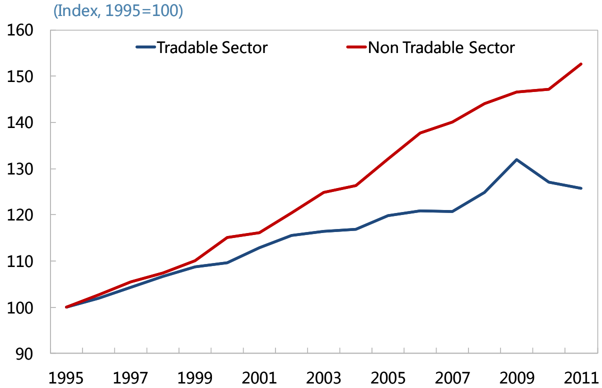
Going forward, Portugal should continue structural reforms in these key areas to boost external competitiveness. Cross-country comparisons based on the latest information suggest that, while Portugal might have come a long way in structural reforms, it still lags behind many of its peers, with rigid labor markets, high (relative to income) energy prices, a low degree of domestic competition, and bias of FDI towards the nontradable sectors.

Box 7. Further Structural Reforms and Institutional Transition

Portugal faces an acute growth challenge. Earlier boom episodes have largely been due to factor accumulation, while the productivity growth has been declining over the past half-century. Looking forward, Portugal's working-age population is projected to fall, and the country's capital stock is contracting because of underinvestment.

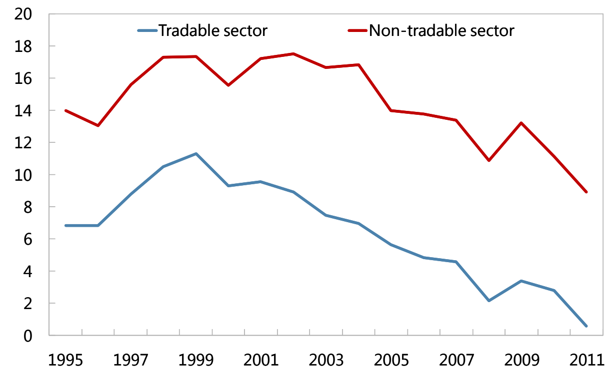
An institutional transition that minimizes rent-seeking is key for raising productivity, attracting investment, and jump-starting growth. While the nontradable sector is less productive than the tradable sector, it offers opportunities for rent-seeking. This results in higher mark-ups, which makes the nontradable sector an attractive investment destination and leads to misallocation of resources.

Unit Labor Cost in the Tradable and Non-Tradable Sectors
(Index, 1995=100)



Sources: Banco de Portugal; Eurostat; INE; OECD; and IMF staff calculations.

Tradable and Non-Tradable Sector Markups
(Percent)

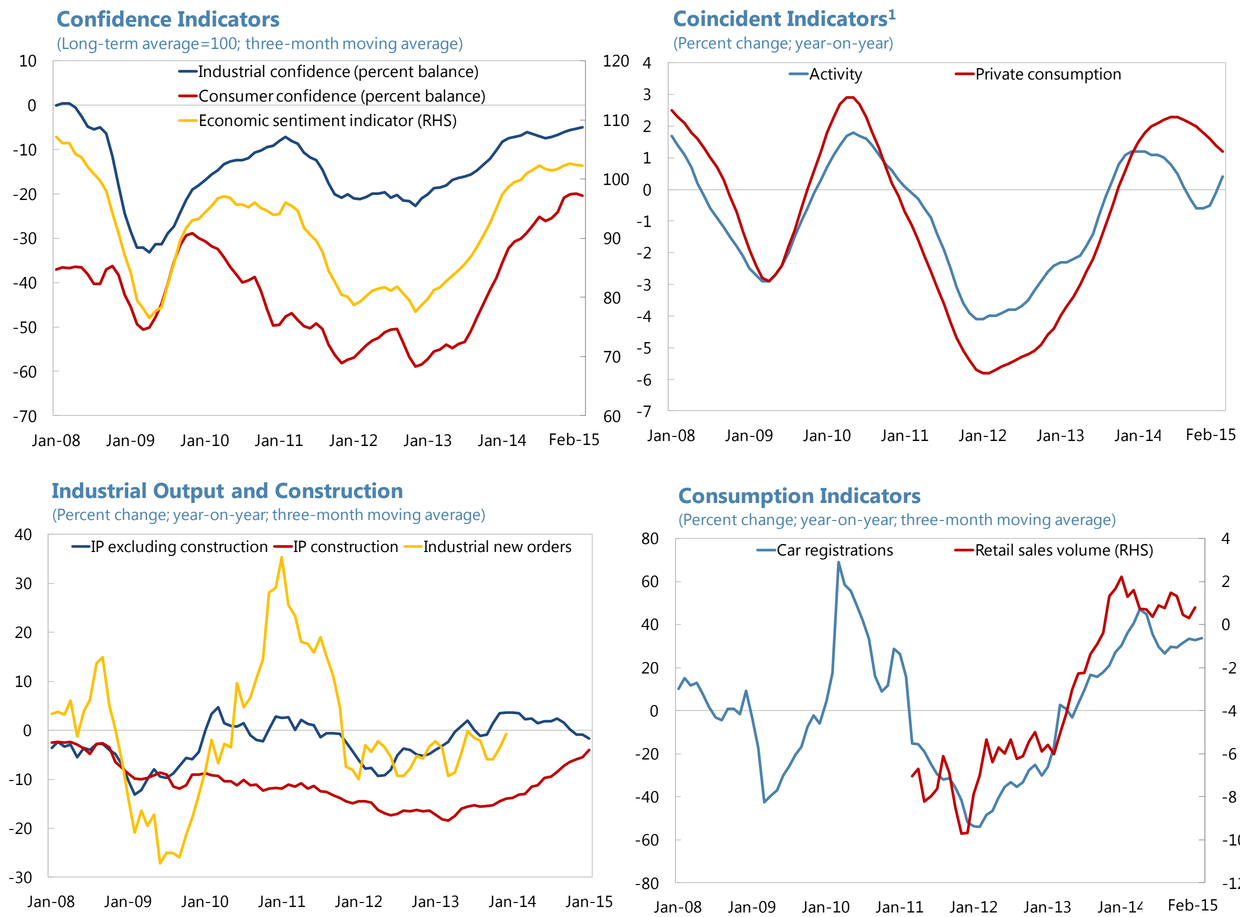


Sources: Banco de Portugal; Eurostat; INE; OECD; and IMF staff calculations.

Portugal is in an advantageous starting position. A cross-country study finds that institutional transitions are associated with trade openness, press freedom, "good" neighbors, and higher levels of education; aid, in contrast, makes institutional transitions less likely (IMF, "Building institutions." *World Economic Outlook*, September 2005, 125–160).

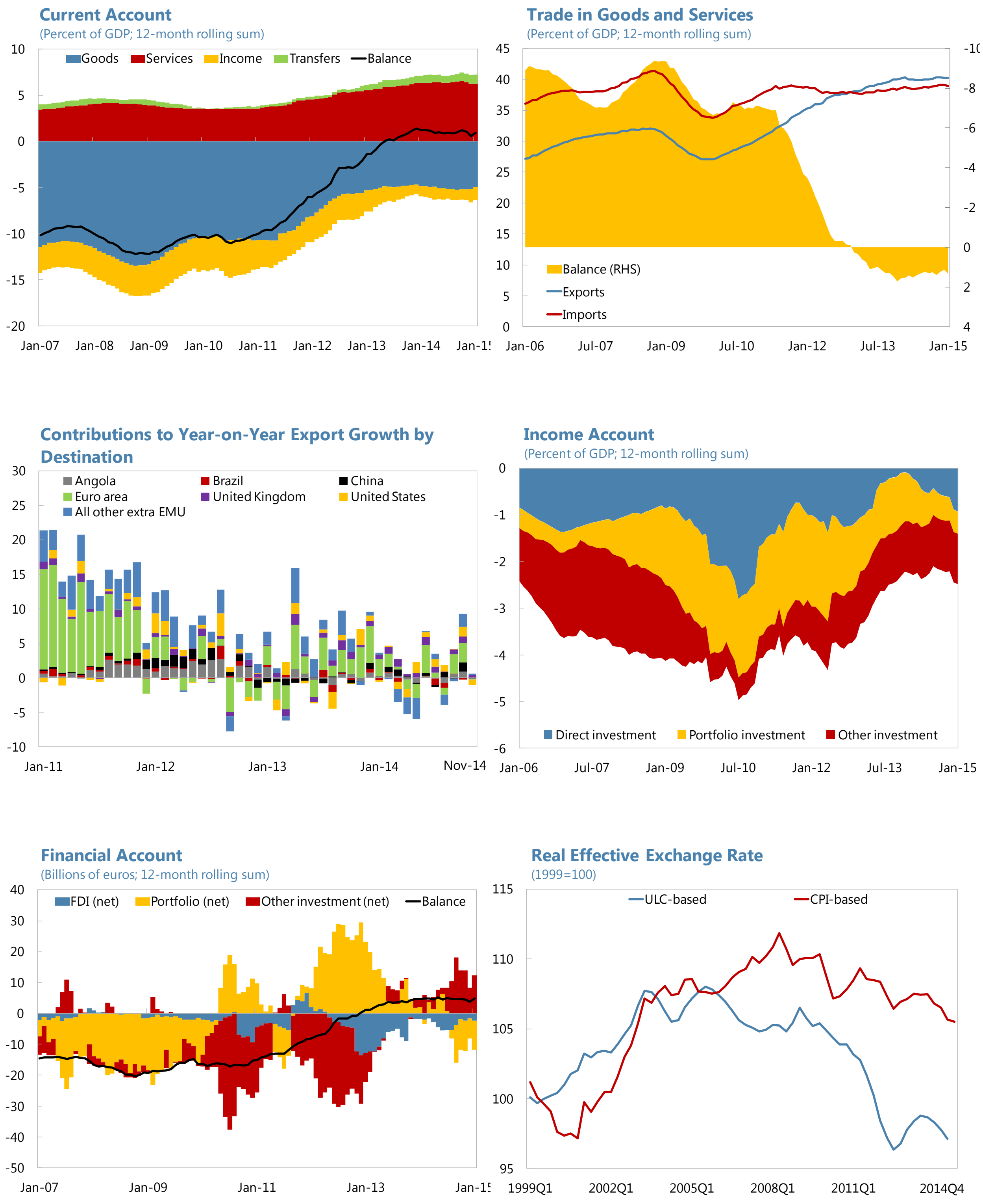
In the Portuguese context—with abundant press freedom, "good" EU neighbors, and little emphasis on aid—**the focus should be on minimizing rent-seeking, developing the tradable sector, and further investment in education.** Steps to minimize rent-seeking would ensure that the country's scarce resources are channeled to productive activities and strengthen the clout of the pro-reform tradable sector companies. Better education, with particular emphasis on vocational training, would allow the tradable sector companies to compete more successfully in the global economy.

Figure 5. Portugal: High Frequency Indicators



Sources: Eurostat; European Commission; Bank of Portugal; and IMF staff calculations.
[1]Calculated by the Bank of Portugal.

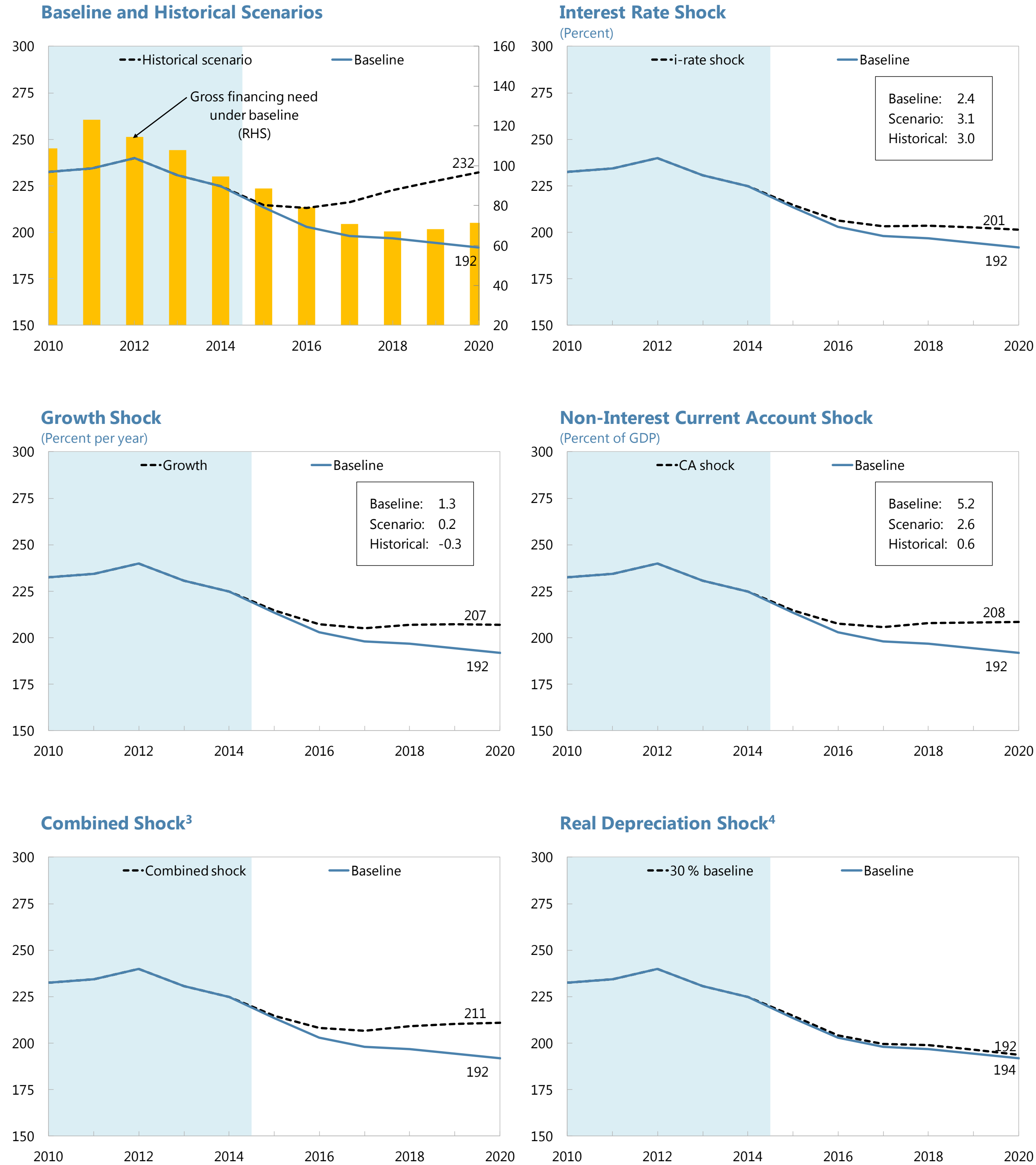
Figure 6. Portugal: Balance of Payments Developments



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

Figure 7. Portugal: External Debt Sustainability: Bound Tests, 2008–2020[1,2]

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and Fund 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)

	2012	2013	2014		2015		2016	2017	2018	2019	2020
					Projections 1/						
			1st PPM	Article IV	1st PPM	Article IV					
Real GDP	-4.0	-1.6	0.8	0.9	1.2	1.6	1.5	1.4	1.3	1.2	1.2
Total domestic demand	-7.3	-2.5	1.3	2.1	1.1	1.0	1.6	1.5	1.4	1.2	1.2
Private consumption	-5.5	-1.5	1.6	2.1	1.6	1.7	1.6	1.5	1.3	1.1	1.1
Public consumption	-3.3	-2.4	-0.6	-0.3	-0.5	-0.5	0.9	0.8	0.9	0.9	0.9
Gross fixed investment	-16.6	-6.7	1.4	2.5	1.8	3.1	2.6	2.4	2.4	2.4	2.4
Private	-13.6	-5.5	-0.5	3.6	2.1	0.0	2.4	2.6	2.6	2.6	2.6
Government	-29.4	-13.1	12.6	-3.4	0.5	21.7	3.7	1.4	1.2	1.2	1.2
Exports	3.4	6.4	3.5	3.4	4.5	5.5	4.8	4.5	4.4	4.4	4.3
Imports	-6.3	3.9	4.5	6.4	4.4	4.0	4.8	4.7	4.6	4.5	4.5
Contribution to Growth											
Total domestic demand	-7.6	-2.5	1.3	2.1	1.1	1.0	1.6	1.5	1.4	1.2	1.2
Private consumption	-3.6	-1.0	1.0	1.4	1.0	1.1	1.0	1.0	0.9	0.7	0.7
Public consumption	-0.7	-0.5	-0.1	-0.1	-0.1	-0.1	0.2	0.2	0.2	0.2	0.2
Gross fixed investment	-3.1	-1.1	0.2	0.4	0.3	0.5	0.4	0.4	0.4	0.4	0.4
Foreign balance	3.6	0.9	-0.4	-1.2	0.0	0.6	0.0	-0.1	-0.1	-0.1	-0.1
Savings-investment balance (percent of GDP)											
Gross national savings	14.1	15.0	16.3	15.5	16.1	15.9	15.9	15.8	15.8	16.1	16.3
Private	18.3	17.7	18.8	18.0	17.1	16.6	16.4	16.0	16.0	16.3	16.6
Public	-4.2	-2.7	-2.5	-2.5	-1.0	-0.7	-0.5	-0.3	-0.2	-0.2	-0.2
Gross domestic investment	15.7	14.5	15.7	14.9	15.9	14.6	15.0	15.2	15.3	15.6	15.9
Private	13.2	12.3	13.2	12.8	13.4	12.2	12.6	12.8	12.9	13.2	13.4
Public	2.5	2.2	2.5	2.1	2.5	2.5	2.4	2.4	2.4	2.5	2.5
Resource utilization											
Potential GDP	-0.9	-0.5	-0.5	-0.5	-0.2	-0.2	0.1	0.4	0.7	1.0	1.0
Output Gap (% of potential)	-5.2	-6.2	-3.6	-4.9	-2.3	-3.1	-1.8	-0.8	-0.3	-0.1	0.0
Employment	-4.1	-2.6	2.3	1.6	0.8	0.2	0.6	0.5	0.5	0.5	0.5
Unemployment rate (%)	15.5	16.2	13.8	13.9	12.7	13.1	12.6	12.1	11.7	11.2	10.8
Prices											
GDP deflator	-0.4	2.2	1.2	1.2	1.0	1.0	1.3	1.3	1.4	1.5	1.5
Consumer prices (harmonized index)	2.8	0.4	0.0	-0.2	0.4	0.6	1.3	1.5	1.6	1.7	1.7
Compensation per worker (whole economy	-2.0	3.5	-0.9	-0.9	1.0	1.8	1.5	1.5	1.5	1.5	1.5
Labor productivity	0.2	1.2	-1.4	-1.5	0.3	1.4	1.0	0.9	0.7	0.7	0.6
Unit labor costs (whole economy)	-2.2	2.2	0.6	0.6	0.7	0.3	0.6	0.6	0.7	0.8	0.8
Money and credit (end of period, percent change)											
Private sector credit	-6.5	-5.2	-3.2	-7.5	-0.4	-2.8	0.3	0.8	1.3	1.7	1.7
Broad money	-6.2	-0.2	2.0	0.0	2.2	2.1	2.4	2.2	2.2	2.2	2.2
Interest rates (percent)											
Short-term deposit rate	3.0	2.1	...	1.7	...	...	...	...	...	...	...
Government bond rate, 10-year	10.6	6.3	...	3.7	...	...	...	...	...	...	...
Fiscal indicators (percent of GDP)											
General government balance 2/	-5.6	-4.8	-5.0	-4.5	-3.4	-3.2	-2.8	-2.5	-2.4	-2.4	-2.4
Revenues	42.9	45.2	44.5	44.5	44.4	44.7	44.7	44.7	44.7	44.7	44.7
Expenditures	48.5	50.1	49.5	49.0	47.9	47.8	47.6	47.3	47.1	47.1	47.1
Primary government balance	-0.7	0.1	0.1	0.4	1.5	1.6	1.7	1.8	1.7	1.7	1.7
General government debt	125.8	129.7	127.8	130.2	125.7	126.3	124.3	122.7	122.2	121.7	120.9
External sector (percent of GDP)											
Trade balance (goods)	-5.6	-4.7	-4.2	-5.2	-4.0	-3.9	-4.5	-5.0	-5.4	-5.8	-6.2
Trade balance (G&S)	-0.1	1.7	2.3	1.1	2.7	2.6	2.2	2.0	1.7	1.5	1.3
Current account balance	-2.1	1.4	0.6	0.6	0.4	1.4	1.0	0.7	0.4	0.2	0.1
Net international investment position	-146.9	-157.5	-111.9	-111.6	-107.6	-105.9	-100.5	-95.8	-91.5	-87.7	-84.0
REER based on ULC (1999=100)	101.2	102.9	102.6	100.7	102.5	86.1	85.9	86.0	86.2	86.6	87.1
(rate of growth)	-4.8	1.7	-0.3	-2.1	-0.1	-14.5	-0.2	0.1	0.3	0.4	0.6
REER based on CPI (1999=100)	107.3	107.4	106.9	104.8	106.2	89.6	89.4	89.8	90.4	91.1	91.4
(rate of growth)	-1.3	0.1	-0.5	-2.4	-0.6	-14.5	-0.3	0.4	0.7	0.8	0.3
Nominal GDP (billions of euro)	168.4	169.4	174.6	173.1	178.5	177.6	182.7	187.6	192.6	197.7	203.0

Sources: Bank of Portugal; Ministry of Finance; National Statistics Office (INE); Eurostat; and IMF staff projections.
1/ Projections for 2016–2020 reflect current policies.
2/ In 2013, includes the increase in the share capital of Banif (0.4 percent of GDP). In 2014, includes SOEs (Carris and STCP) and banking support (BPN Credito) operations, as well as other one-off measures (CIT credit and upfront costs of mutual agreements) for a total of 1 percent of GDP.

Table 2a. Portugal: General Government Accounts 1/
(Billions of euros)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
				Projections 2/					
Revenue	72.2	76.6	77.0	79.3	81.7	83.9	86.1	88.3	90.7
Taxes	40.9	44.9	43.5	45.4	46.8	48.2	49.6	51.0	52.4
Taxes on production and imports	23.3	23.4	24.6	25.9	26.7	27.5	28.2	29.0	29.7
Current taxes on income, wealth, etc. and capital taxes	17.6	21.5	18.9	19.5	20.1	20.7	21.3	22.0	22.6
Current taxes on income, wealth, etc.	15.1	19.4	18.9	19.5	20.1	20.7	21.3	22.0	22.6
Capital taxes	2.4	2.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	19.1	20.1	20.5	21.0	21.6	22.0	22.5	22.9	23.5
Grants and other revenue	12.1	11.6	13.0	13.0	13.3	13.7	14.1	14.4	14.8
Property income	0.5	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.8
Sales of goods and services	6.5	6.7	6.8	6.9	7.1	7.3	7.5	7.7	7.9
Other current revenue	4.5	4.8	4.3	4.1	4.2	4.3	4.4	4.5	4.7
Capital transfers and investment grants	0.5	-0.5	1.3	1.3	1.4	1.4	1.4	1.5	1.5
Expenditure	81.6	84.8	84.8	84.9	86.9	88.7	90.7	93.1	95.6
Expense	78.8	82.2	82.3	81.8	83.8	85.6	87.6	90.0	92.5
Compensation of employees	19.7	21.1	20.5	19.6	20.4	20.9	21.5	22.2	22.9
Use of goods and services	9.7	9.7	10.2	10.5	10.6	10.9	11.2	11.5	11.8
Consumption of fixed capital	1.0	1.1	1.1	1.2	1.4	1.5	1.7	1.8	2.0
Interest	8.2	8.3	8.6	8.5	8.3	8.1	8.0	8.1	8.2
Subsidies	1.0	1.0	1.2	1.0	1.0	1.0	1.0	1.0	1.1
Social benefits	33.0	34.5	34.1	34.7	35.7	36.6	37.5	38.5	39.5
Grants and other expense	6.2	6.5	6.8	6.3	6.4	6.5	6.7	6.9	7.1
Other current expense	4.6	5.0	4.8	5.8	5.7	5.9	6.0	6.2	6.3
Capital transfers	1.6	1.5	2.0	0.4	0.7	0.7	0.7	0.7	0.7
Net acquisition of nonfinancial assets	2.8	2.6	2.5	3.2	3.1	3.1	3.1	3.1	3.0
Gross fixed capital formation	3.8	3.7	3.5	4.4	4.5	4.6	4.7	4.9	5.0
(-) Consumption of fixed capital	-1.0	-1.1	-1.1	-1.2	-1.4	-1.5	-1.7	-1.8	-2.0
Acquisitions less disposals of other nonfinancial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-5.6	-4.5	-4.3	-1.2	-0.7	-0.1	0.1	0.1	0.2
Net lending (+)/borrowing (–)	-9.5	-8.2	-7.8	-5.6	-5.2	-4.8	-4.6	-4.8	-4.8
Net acquisition of financial assets	4.8	-0.3	...	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	...	...	...	...	...	...	...
Currency and deposits	1.2	1.6	...	...	...	...	...	...	...
Debt securities	6.4	-0.6	...	...	...	...	...	...	...
Loans	1.2	0.0	...	...	...	...	...	...	...
Equity and investment fund shares	-1.2	0.0	...	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	...	...	...	...	...	...	...
Financial derivatives and employee stock options	-0.2	0.0	...	...	...	...	...	...	...
Other accounts receivable	-2.6	-1.3	...	...	...	...	...	...	...
Net incurrence of liabilities	15.5	7.9	...	...	...	...	...	...	...
SDRs	0.0	0.0	...	...	...	...	...	...	...
Currency and deposits	-1.4	1.1	...	...	...	...	...	...	...
Debt securities	-6.8	-1.4	...	...	...	...	...	...	...
Loans	27.4	10.3	...	...	...	...	...	...	...
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	-3.7	-2.1	...	...	...	...	...	...	...
Memorandum items:									
Primary balance	-1.2	0.1	0.8	2.9	3.1	3.3	3.4	3.3	3.4
Debt at face value (EDP notification)	211.8	219.6	225.3	224.4	227.1	230.2	235.3	240.6	245.4
Nominal GDP	168.4	169.4	173.1	177.6	182.7	187.6	192.6	197.7	203.0

Sources: Portuguese statistical authorities; and IMF staff projections.
1/ GFSM 2001 presentation.
2/ For 2014, the data include one-off measures from SOE (Carris and STCP) and banking operations (BPN Credito), CIT credit, and the upfront costs of mutual agreements for 1 percent of GDP. Projections reflect current policies after 2015.

Table 2b. Portugal: General Government Accounts 1/
(Percent of GDP)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
				Projections 2/					
Revenue	42.9	45.2	44.5	44.7	44.7	44.7	44.7	44.7	44.7
Taxes	24.3	26.5	25.2	25.6	25.6	25.7	25.7	25.8	25.8
Taxes on production and imports	13.9	13.8	14.2	14.6	14.6	14.6	14.7	14.7	14.7
Current taxes on income, wealth, etc. and capital taxes	10.4	12.7	10.9	11.0	11.0	11.0	11.1	11.1	11.1
Current taxes on income, wealth, etc.	9.0	11.4	10.9	11.0	11.0	11.0	11.1	11.1	11.1
Capital taxes	1.5	1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	11.4	11.8	11.9	11.8	11.8	11.7	11.7	11.6	11.6
Grants and other revenue	7.2	6.9	7.5	7.3	7.3	7.3	7.3	7.3	7.3
Property income	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Sales of goods and services	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9
Other current revenue	2.7	2.8	2.5	2.3	2.3	2.3	2.3	2.3	2.3
Capital transfers and investment grants	0.3	-0.3	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Expenditure	48.5	50.1	49.0	47.8	47.6	47.3	47.1	47.1	47.1
Expense	46.8	48.5	47.6	46.0	45.9	45.6	45.5	45.5	45.6
Compensation of employees	11.7	12.4	11.8	11.0	11.2	11.1	11.2	11.2	11.3
Use of goods and services	5.8	5.7	5.9	5.9	5.8	5.8	5.8	5.8	5.8
Consumption of fixed capital	0.6	0.6	0.6	0.7	0.7	0.8	0.9	0.9	1.0
Interest	4.9	4.9	5.0	4.8	4.6	4.3	4.1	4.1	4.1
Subsidies	0.6	0.6	0.7	0.5	0.5	0.5	0.5	0.5	0.5
Social benefits	19.6	20.4	19.7	19.5	19.5	19.5	19.5	19.5	19.5
Grants and other expense	3.7	3.8	3.9	3.5	3.5	3.5	3.5	3.5	3.5
Other current expense	2.7	2.9	2.8	3.3	3.1	3.1	3.1	3.1	3.1
Capital transfers	0.9	0.9	1.2	0.2	0.4	0.4	0.4	0.4	0.4
Net acquisition of nonfinancial assets	1.7	1.5	1.4	1.8	1.7	1.7	1.6	1.6	1.5
Gross fixed capital formation	2.3	2.2	2.0	2.5	2.5	2.5	2.5	2.5	2.5
(-) Consumption of fixed capital	-0.6	-0.6	-0.6	-0.7	-0.7	-0.8	-0.9	-0.9	-1.0
Acquisitions less disposals of other nonfinancial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-3.3	-2.7	-2.5	-0.7	-0.4	-0.1	0.1	0.1	0.1
Net lending (+)/borrowing (–)	-5.6	-4.8	-4.5	-3.2	-2.8	-2.5	-2.4	-2.4	-2.4
Net acquisition of financial assets	2.9	-0.2	...	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	...	...	...	...	...	...	...
Currency and deposits	0.7	0.9	...	...	...	...	...	...	...
Debt securities	3.8	-0.3	...	...	...	...	...	...	...
Loans	0.7	0.0	...	...	...	...	...	...	...
Equity and investment fund shares	-0.7	0.0	...	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	...	...	...	...	...	...	...
Financial derivatives and employee stock options	-0.1	0.0	...	...	...	...	...	...	...
Other accounts receivable	-1.6	-0.8	...	...	...	...	...	...	...
Net incurrence of liabilities	9.2	4.7	...	...	...	...	...	...	...
SDRs	0.0	0.0	...	...	...	...	...	...	...
Currency and deposits	-0.9	0.7	...	...	...	...	...	...	...
Debt securities	-4.0	-0.9	...	...	...	...	...	...	...
Loans	16.3	6.1	...	...	...	...	...	...	...
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	-2.2	-1.2	...	...	...	...	...	...	...
Memorandum items:									
Primary balance	-0.7	0.1	0.4	1.6	1.7	1.8	1.7	1.7	1.7
Structural balance (Percent of potential GDP)	-3.0	-2.0	-1.1	-1.8	-2.0	-2.2	-2.3	-2.4	-2.4
Structural primary balance (Percent of potential GDP)	1.6	2.6	3.6	2.9	2.5	2.1	1.8	1.7	1.7
Debt at face value (EDP notification)	125.8	129.7	130.2	126.3	124.3	122.7	122.2	121.7	120.9

Sources: Portuguese statistical authorities; and IMF staff projections.
1/ GFSM 2001 presentation.
2/ For 2014, the data include one-off measures from SOE (Carris and STCP) and banking operations (BPN Credito), CIT credit, and the upfront costs of mutual agreements for 1 percent of GDP. Projections reflect current policies after 2015.

Table 3. Portugal: Balance of Payments, 2012–20

			Est.	Projections					
	2012	2013	2014	2015	2016	2017	2018	2019	2020
				(Billions of euro)					
Current account	-3.5	2.4	1.0	2.5	1.8	1.3	0.8	0.4	0.2
Balance of goods and services	-0.2	3.0	2.0	4.6	4.1	3.7	3.4	2.9	2.6
Trade balance	-9.5	-8.0	-9.0	-6.9	-8.2	-9.3	-10.3	-11.5	-12.7
Exports fob	44.3	46.6	47.4	56.1	60.4	64.1	67.2	70.2	72.8
Imports fob	53.8	54.6	56.4	62.9	68.6	73.4	77.6	81.7	85.5
Services, net	9.3	10.9	10.9	11.4	12.3	13.0	13.7	14.5	15.3
Exports	19.9	21.9	22.8	24.2	25.8	27.2	28.8	30.5	32.2
Imports	10.6	11.0	11.9	12.8	13.5	14.2	15.1	16.0	16.9
Of which:									
Tourism	5.7	6.1	7.1	7.4	8.0	8.4	8.9	9.4	10.0
Exports	8.6	9.2	10.4	11.0	11.7	12.4	13.1	13.9	14.7
Imports	2.9	3.1	3.3	3.6	3.8	4.0	4.2	4.5	4.7
Primary income, net	-4.3	-1.8	-2.5	-3.6	-3.9	-4.0	-4.3	-4.3	-4.1
Secondary income, net	1.0	1.3	1.6	1.6	1.6	1.6	1.7	1.7	1.7
Capital account	3.5	2.8	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Financial account	28.0	16.4	9.0	5.1	4.4	3.9	3.3	2.9	2.8
Direct investment	-13.5	-1.7	-1.6	-1.5	-1.4	-1.2	-1.1	-0.8	-0.6
Direct investment assets	3.8	5.8	6.8	7.0	7.2	7.5	7.8	8.1	8.5
Direct investment liabilities	17.3	7.5	8.4	8.5	8.6	8.8	8.9	9.0	9.1
Portfolio investment, net	29.5	1.8	-6.5	-6.7	-6.9	-7.1	-7.3	-7.5	-7.7
Financial derivatives	-0.1	1.0	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Other investment, net	11.9	14.8	13.7	10.7	10.5	10.3	9.8	9.5	9.4
Reserve assets	0.2	0.4	1.7	0.9	0.4	0.2	0.1	0.1	0.0
Errors and omissions	0.3	-0.5	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	27.7	11.7	5.2	…	…	…	…	…	…
European Union	19.4	8.2	3.5	…	…	…	…	…	…
IMF	8.2	3.4	1.8	…	…	…	…	…	…
Memorandum items:									
Net international investment position 1/	-192.4	-200.9	-193.1	-188.0	-183.6	-179.6	-176.3	-173.4	-170.5
Direct investment, net	-42.1	-44.8	-41.3	-42.8	-44.3	-45.5	-46.5	-47.4	-48.0
Portfolio investment, net	-16.9	-23.6	-28.1	-34.7	-41.6	-48.6	-55.9	-63.4	-71.1
Financial derivatives	-3.6	-3.1	-1.9	-0.1	1.6	3.3	5.0	6.7	8.4
Other investment, net	-146.9	-142.1	-138.0	-127.3	-116.7	-106.4	-96.6	-87.1	-77.7
Reserve assets	17.2	12.7	16.2	17.0	17.4	17.7	17.8	17.8	17.8
Nominal GDP	168.4	169.4	173.1	177.6	182.7	187.6	192.6	197.7	203.0
				(Percentage of GDP)					
Current account	-2.1	1.4	0.6	1.4	1.0	0.7	0.4	0.2	0.1
Current account (including capital transfers)	0.0	3.1	2.1	2.9	2.4	2.1	1.7	1.5	1.4
Of which: Balance of goods and services	-0.1	1.7	1.1	2.6	2.2	2.0	1.7	1.5	1.3
Net international investment position 1/	-114.2	-118.6	-111.6	-105.9	-100.5	-95.8	-91.5	-87.7	-84.0
Direct investment, net	-25.0	-26.4	-23.9	-24.1	-24.2	-24.3	-24.2	-24.0	-23.7
Portfolio investment, net	-10.0	-14.0	-16.2	-19.5	-22.8	-25.9	-29.0	-32.0	-35.0
Financial derivatives	-2.2	-1.8	-1.1	-0.1	0.9	1.7	2.6	3.4	4.1
Other investment, net	-87.2	-83.9	-79.7	-71.7	-63.9	-56.7	-50.2	-44.1	-38.3
Reserve assets	10.2	7.5	9.3	9.6	9.5	9.4	9.2	9.0	8.8

Sources: Bank of Portugal; and IMF staff estimates.

1/ End-of-period data.

Table 4. Portugal: Selected Financial Indicators of the Banking System, 2008–2014 1/
(Percent)

	2008	2009	2010	2011	2012				2013				2014			
					Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.
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	13.4	13.3	12.3	12.0	13.0	12.3
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	12.0	11.9	11.1	10.7	12.1	11.4
Capital to assets[2]	5.8	6.5	6.7	5.3	5.8	6.2	6.6	6.7	6.9	6.7	6.9	6.9	7.4	7.2	8.1	7.7
Asset composition and quality																
Nonperforming loans to total gross loans[3]	3.6	4.8	5.2	7.5	8.0	9.2	9.8	9.8	10.4	10.6	11.2	10.6	10.8	11.2	12.0	12.0
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	86.7	86.8	86.1	85.8	84.8	85.6
Deposit-takers	6.2	5.8	5.3	6.5	6.8	7.3	6.3	7.7	7.2	6.2	6.6	7.6	5.5	5.4	4.4	3.8
Central bank	1.3	1.2	0.5	0.9	0.4	0.4	0.7	1.1	0.8	0.5	0.4	0.8	0.8	0.8	1.0	1.2
Other financial corporations	3.6	3.7	3.9	2.9	2.7	2.7	2.7	2.4	2.3	2.3	2.3	2.2	2.3	2.3	2.3	3.3
General government	1.6	1.7	2.9	2.6	3.2	2.7	2.7	2.2	2.2	2.3	2.4	2.3	2.4	2.3	2.5	3.2
Nonfinancial corporations	31.6	31.5	30.7	31.0	30.6	30.0	30.3	30.2	30.5	31.5	32.2	31.6	32.1	31.7	31.2	29.4
Other domestic sectors	39.5	39.6	39.9	40.1	39.6	39.2	39.8	39.8	40.1	41.1	42.9	42.3	43.0	43.3	43.4	44.6
Nonresidents	16.3	16.4	16.7	16.0	16.8	17.6	17.5	16.7	16.8	16.1	13.3	13.2	13.9	14.2	15.2	14.4
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	-0.5	-0.7	0.0	-1.8	-1.5	-1.3
Return on equity	5.7	7.3	7.5	-5.5	8.2	2.5	0.3	-5.4	-3.7	-8.0	-7.5	-11.0	-0.4	-24.8	-19.8	-17.9
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	46.0	47.7	46.3	47.9	49.1	50.1
Noninterest expenses to gross income	58.0	58.3	58.9	63.9	58.2	55.0	57.0	59.6	66.2	66.6	68.5	70.4	59.5	66.9	67.0	67.4
Liquidity																
Liquid assets to total assets[4]	12.8	13.2	19.0	13.8	11.2	12.7	13.7	14.8	15.4	16.0	15.7	16.9	16.7	16.2	17.2	22.0
Liquid assets to short-term liabilities[4]	67.7	84.5	86.2	85.4	90.5	101.5	123.2	140.0	145.9	150.7	155.1	170.3	155.6	157.3	146.8	154.2
Loans to deposits[5]	...	161.5	157.8	140.2	136.9	136.3	133.3	127.9	124.0	122.6	120.7	116.9	117.2	113.9	111.9	107.2
Foreign-currency-denominated liabilities to total liabilities[6]	5.8	5.1	5.1	4.1	3.9	3.9	4.0	4.2	4.5	4.4	4.4	4.3	4.3	4.7	4.8	4.5

Source: Bank of Portugal.
1/ The banking system data present a break in time series in 2014Q3 due to the resolution measure applied to Banco Espírito Santo (BES). The break in time series stems, in particular, from the fact that the assets/liabilities not transferred to the balance sheet of Novo Banco (NB) are not considered in the aggregate of the banking system from August 2014 onwards. In the absence of accounting information for BES on a consolidated basis for the period from 30 June 2014 to the day of implementation of the resolution measure (closing balance sheet and statement of profit or loss), the reporting of BES on an individual basis, with reference to 31 July 2014, was considered when determining the aggregate results of the banking system for 2014Q3. However, the adjustments stemming from the resolution measure applied to BES were also not considered.
2/ On accounting basis; consolidated.
3/ New NPL ratio in line with international practices. On a consolidated basis.
4/ Three-month residual maturity.
5/ Loans to customers (net of impairments) and securitized non-derecognized credit to customers divided by resources from customers and other loans.
6/ 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 5. Portugal: Monetary Survey, 2012–20
(Millions of euros, unless otherwise indicated; end of period)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
				Projections					
Aggregated Balance Sheet of Monetary Financial Institutions (MFIs)[1]									
Assets	457,434	427,726	407,595	400,306	404,088	405,255	408,570	412,128	414,597
Cash	1,605	1,622	1,150	815	578	410	291	206	146
Claims on Bank of Portugal	8,136	8,219	3,943	3,058	2,371	1,839	1,426	1,106	858
Claims on other FIs	46,870	46,693	44,215	42,424	44,215	42,424	43,015	42,866	42,717
Claims on non MFIs	296,043	282,510	266,560	259,505	260,415	262,434	265,182	268,769	272,403
General government	38,768	38,692	41,054	40,313	40,566	40,826	40,692	40,464	40,217
Central government (excluding SOEs)	27,109	27,678	29,447	29,044	29,828	30,153	30,085	30,053	30,088
loans	464	594	1,762	1,712	1,662	1,612	1,599	1,579	1,559
securities	26,645	27,084	27,685	27,332	28,166	28,541	28,485	28,474	28,530
Bonds	16,078	22,220	22,052	22,099	22,932	23,307	23,251	23,240	23,296
Tbills (up to 1 year maturity)	10,567	4,865	5,634	5,234	5,234	5,234	5,234	5,234	5,234
Regional and local government (excl SOEs)	5,592	5,496	6,070	6,070	6,099	6,099	6,160	6,167	6,167
SOEs	6,067	5,519	5,537	5,199	4,639	4,574	4,448	4,244	3,961
Private sector	257,275	243,818	225,506	219,192	219,849	221,608	224,489	228,305	232,187
Corporates	123,256	115,703	101,573	104,968	108,224	111,271	114,069	116,729	119,429
SOEs (non-consolidating)									
Households	134,019	128,115	123,933	112,771	109,482	107,669	107,403	108,339	109,299
Claims on non-residents	88,380	71,566	70,865	73,094	74,489	75,531	76,051	75,963	75,267
Other assets	16,400	17,116	20,862	21,409	22,019	22,616	22,606	23,219	23,206
Liabilities	457,434	427,726	407,595	403,565	404,088	405,255	408,570	412,128	414,597
Liabilities to Bank of Portugal	53,724	48,810	32,503	32,906	29,167	25,853	25,595	25,339	25,085
Liabilities to other FIs	46,542	43,761	40,742	41,275	42,156	40,287	40,690	41,504	42,334
Deposits of non MFIs	170,955	174,157	176,004	178,015	184,249	187,663	191,822	193,932	186,697
General government	13,218	12,429	12,672	8,679	8,679	8,679	8,679	8,679	8,679
Private sector	157,737	161,728	163,332	169,336	175,570	178,984	183,143	185,253	178,018
Securities other than capital	46,342	37,858	28,644	35,919	35,504	34,965	33,931	32,984	31,735
Liabilities to non-residents	89,483	70,135	67,620	74,219	77,187	80,352	83,646	87,109	90,681
Other	326	313	0	299	307	316	324	333	341
Capital and reserves	50,061	52,691	60,256	56,695	61,243	63,086	62,515	61,997	61,526
Money and Credit									
Broad Money (M3)	161,855	161,531	161,531	164,955	168,836	172,568	176,303	180,118	184,002
Intermediate money (M2)	156,877	156,563	156,563	159,882	163,643	167,260	170,880	174,579	178,343
Narrow money (M1)	65,785	65,653	65,653	67,045	68,622	70,139	71,657	73,208	74,786
Private sector credit	257,275	243,818	225,506	219,192	219,849	221,608	224,489	228,305	232,187
Public sector credit	38,768	38,692	41,054	40,313	40,566	40,826	40,692	40,464	40,217
(Percent of GDP)									
Broad Money	96.1	95.4	93.3	92.9	92.4	92.0	91.5	91.1	90.6
Private sector credit	152.8	143.9	130.3	123.4	120.4	118.1	116.6	115.5	114.4
Public sector credit	23.0	22.8	23.7	22.7	22.2	21.8	21.1	20.5	19.8
(Percentage change)									
Broad Money	-6.2	-0.2	0.0	2.1	2.4	2.2	2.2	2.2	2.2
Private sector credit	-6.5	-5.2	-7.5	-2.8	0.3	0.8	1.3	1.7	1.7
Public sector credit	20.0	-0.2	6.1	-1.8	0.6	0.6	-0.3	-0.6	-0.6
Memorandum items:									
ECB access (percent of assets)	11.7	11.4	8.0	8.2	7.2	6.4	6.3	6.1	6.1
Credit to deposits (percent)[2]	148.9	141.4	132.2	124.2	121.3	120.4	119.5	119.6	124.8
Loan to deposits (percent)[2]	145.0	130.5	120.6	116.1	112.5	112.5	111.3	111.4	115.7
Wholesale market funding (percent of assets)[3]	26.0	21.3	19.5	23.9	24.2	24.6	24.8	25.0	25.3

Sources: Bank of Portugal and IMF 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 6. Portugal: External Debt Sustainability Framework, 2010–2020
(Percent of GDP, unless otherwise indicated)

					Est.	Projections						
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Debt-stabilizing non-interest current account 6/
Baseline: External debt	232.4	234.2	239.8	230.8	224.7	213.5	203.0	197.9	196.7	194.4	191.9	0.1
Change in external debt	6.4	1.9	5.6	-9.0	-6.1	-11.2	-10.5	-5.1	-1.2	-2.3	-2.5	
Identified external debt-creating flows (4+8+9)	8.2	6.1	16.7	-3.0	-4.9	-5.5	-4.7	-3.8	-3.0	-2.5	-2.3	
Current account deficit, excluding interest payments	5.0	-0.5	-5.0	-7.2	-5.4	-6.1	-5.5	-5.2	-5.1	-5.1	-5.3	
Deficit in balance of goods and services	7.1	3.7	0.1	-1.7	-1.1	-2.6	-2.2	-2.0	-1.7	-1.5	-1.3	
Exports	30.1	35.0	38.2	40.4	40.6	45.2	47.2	48.7	49.8	50.9	51.8	
Imports	37.2	38.6	38.3	38.7	39.4	42.6	44.9	46.7	48.1	49.4	50.5	
Net non-debt creating capital inflows (negative)	3.6	-4.9	3.8	-0.2	0.6	-0.5	-0.4	-0.3	-0.2	-0.1	0.0	
Automatic debt dynamics 1/	-0.5	11.5	17.9	4.3	-0.1	1.2	1.3	1.7	2.3	2.7	3.0	
Contribution from nominal interest rate	5.1	6.5	7.1	5.7	4.8	4.7	4.5	4.5	4.7	4.9	5.1	
Contribution from real GDP growth	-4.2	4.3	9.9	3.8	-2.0	-3.5	-3.2	-2.8	-2.4	-2.2	-2.2	
Contribution from price and exchange rate changes 2/	-1.4	0.6	0.9	-5.2	-2.8	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-1.8	-4.3	-11.1	-5.9	-1.2	-5.7	-5.9	-1.2	1.9	0.2	-0.2	
External debt-to-exports ratio (in percent)	772.3	669.9	628.4	570.6	553.9	472.4	430.3	406.7	394.7	381.9	370.6	
Gross external financing need (in billions of Euros) 4/				182.5	164.0	157.5	144.3	133.0	129.0	135.0	144.8	
in percent of GDP				107.7	94.8	88.7	79.0	70.9	67.0	68.3	71.4	
Scenario with key variables at their historical averages 5/						214.6	213.0	216.0	222.5	227.5	232.2	2.5
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (percent)	1.9	-1.8	-4.0	-1.6	0.9	1.6	1.5	1.4	1.3	1.2	1.1	
GDP deflator in Euros (percent)	0.6	-0.3	-0.4	2.2	1.2	1.0	1.3	1.3	1.4	1.5	1.5	
Nominal external interest rate (percent)	2.3	2.8	2.9	2.4	2.1	2.1	2.2	2.3	2.4	2.6	2.7	
Growth of exports (Euros, percent)	13.8	13.8	4.3	6.6	2.5	14.3	7.3	6.0	5.2	4.8	4.4	
Growth of imports (Euros, percent)	12.6	1.7	-5.3	1.7	4.1	11.0	8.4	6.7	5.8	5.5	4.9	
Current account balance, excluding interest payments	-5.0	0.5	5.0	7.2	5.4	6.1	5.5	5.2	5.1	5.1	5.3	
Net non-debt creating capital inflows	-3.6	4.9	-3.8	0.2	-0.6	0.5	0.4	0.3	0.2	0.1	0.0	

Source: Fund staff estimates.

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 7. Portugal: Indicators of Fund Credit, 2011–20 1/
(Millions of euros, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Disbursements	13,052	8,220	3,407	1,787	...	...	...	...	...	...
(percent of quota)	1,117	670	289	152	...	...	...	...	...	...
(Projected debt service to the Fund, based on existing and prospective drawings)										
Total	14	152	171	241	7,272	6,099	3,160	457	2,806	4,983
Interest and charges	14	152	171	241	647	713	530	457	449	305
Repayments	0	0	0	0	6,625	5,386	2,630	0	2,357	4,678
Total debt service, in percent of										
Exports of goods and services	0.0	0.2	0.2	0.3	9.1	7.1	3.5	0.5	2.8	4.7
GDP	0.0	0.1	0.1	0.1	4.1	3.3	1.7	0.2	1.4	2.5
(Projected level of credit outstanding based on existing and prospective drawings)										
Outstanding stock	13,052	21,926	24,464	26,232	23,130	16,880	14,194	14,123	11,704	6,938
percent of quota	1,117.1	1,787.1	2,076.2	2,228.0	1,732.0	1,313.1	1,107.8	1,107.8	922.1	550.8
percent of GDP	7.4	13.0	14.4	15.2	13.0	9.2	7.6	7.3	5.9	3.4
Memorandum Items (billions of euros)										
Exports of goods and services	62	64	69	70	80	86	91	96	101	105
GDP	176	168	169	173	178	183	188	193	198	203

Source: IMF staff estimates.
1/ Exchange rate forecasts against the SDR as per WEO assumptions.

Annex I. Main Recommendations of the 2012 Article IV Consultation and Authorities' Response

Fund policy recommendations	Policy actions
1. Address accumulated financial imbalances	
1.1 Fiscal (public sector imbalance)	
(a) Rebalance the mix of revenue and expenditure adjustments and bring it closer to one third revenue and two thirds expenditure.	Consolidation continued to rely heavily on revenue measures (accounting for half of the adjustment effort from 2011–2014), as Constitutional Court rulings cancelled spending cuts, and required offsetting revenue measures.
(a.1) The core of spending reforms should focus on social transfers and public wages, which account for about two thirds of the total spending.	Adjustment efforts were geared toward the wage bill and pension spending. However, some of these measures were later reversed, especially nominal cuts in wages and pension benefits.
(a.2) Spending cuts could be implemented while increasing efficiency and equity, given the relatively high public employment, high wage premium in comparison to the private sector, and more generous pensions than in peer countries alongside limited old-age poverty alleviation.	Public employment was reduced by about 10 percent from 2011–2014. However, the public wage premium proved difficult to reduce, with the wage cuts adopted in 2011 to be fully reversed by 2016. Public pensions were aligned with private pension in 2014, and the suspension of pensions' indexation excluded minimum pensions, helping to improve efficiency and equity.
(a.3) Implement a growth-oriented tax reform, which should reduce distortions through streamlining and targeting tax expenditures.	A comprehensive reform of the corporate income tax (CIT) was adopted in 2013 to gradually reduce the statutory CIT rate, and improve tax provisions to retain multinational companies. In 2014, a PIT reform improved incentives to work, and a green tax reform was introduced. The cost of tax expenditures has been sharply reduced, particularly under the CIT.
(a.4) Strengthen tax compliance, including through greater use of the anti-money laundering framework.	The authorities have implemented an ambitious tax compliance and anti-fraud strategy, and adopted a new strategy for 2015–2017. Key measures included an automatic VAT invoice system. Progress on improving compliance has been uneven for high wealth individuals and self-employed professionals.
(b) Anchor fiscal discipline over the medium and long term.	The medium-term budget framework has been partially improved, with the formulation of a no-policy change baseline. A draft Budget Framework Law (BFL) is being finalized to expand the MTBF coverage to all central government spending.
(b.1) Reduce budget fragmentation.	The draft BFL is expected to reduce the number of budget appropriations, and reintegrate some autonomous entities into line ministries.
(b.2) Improve the medium-term fiscal framework, including by making it consistent with the EU fiscal compact.	The BFL is expected to revise the MTBF, and include all EU fiscal compact provisions in Portuguese legal framework.

Annex I. Main Recommendations of the 2012 Article IV Consultation and Authorities' Response (continued)

(b.3) Move towards accrual accounting.	Full accrual-based financial statements, including the general government balance sheet, would be produced by 2019-2020, in line with FAD recommendations.
(b.4) Continue to build up a stronger implementation capacity at the Ministry of Finance.	While key reforms improved fiscal reporting, capacity constraints in the Ministry of Finance continue to impede their ability to manage and implement fiscal reforms.
1.2 Corporate deleveraging (private sector imbalance)	
(c) Mitigate risks associated with corporate deleveraging.	The authorities took several steps to mitigate the risks associated with corporate deleveraging, including strengthening supervision and regulation, and legal and institutional frameworks.
(c.1) Apply regular supervisory inspections and stress test exercises to ensure banks have adequate capital under the baseline and are able to withstand adverse shocks.	Quarterly stress-testing, conducted during the EFF, allowed supervisors to assess the resilience of Portuguese banks on a forward-looking basis. In addition, three systemic banks took part in the ECB Comprehensive Assessment concluded in October 2014.
(c.2) Implement the new corporate and household debt restructuring frameworks.	Institutional and legal frameworks for debt restructuring were strengthened under the EFF. The authorities introduced, and subsequently refined, regimes for in-court (PER) and out-of-court (SIREVE) workouts. However, particularly in the case of PER, the new regime has had limited effect. A TA mission on corporate debt restructuring visited Lisbon in January 2014, and recommended a systemic approach to debt restructuring (especially for SMEs), which has not been implemented.
(c.3) Use supervision and regulatory frameworks to limit ever-greening and ensure that credit flows to the most dynamic enterprises.	Under the EFF, the Bank of Portugal strengthened the regulatory framework for non-performing loans and restructured credits. Recurrent impairment reviews have also contributed to bolstering loss recognition by banks. However, NPLs are high and still rising, reflecting the need for bank balance sheet repair.
(d) Counteract a renewed buildup of excessive leverage of bank balance sheets.	Given the credit crunch experienced under the crisis, consideration of macro-prudential policy tools was largely deferred until 2014.
(d.1) Use macro-prudential policy tools, such as net stable funding and leverage ratios (consistent with Basel III requirements).	In December 2014, the Bank of Portugal issued its first description of the objectives and instruments that would comprise its macro-prudential toolkit (in line with ESRB recommendations). Two instruments (systemic risk buffer and sectoral capital requirements) are already available but have not yet been applied, and two others (countercyclical policy buffer and the buffer for systemically important institutions) will be available from January 1, 2016 onwards.

Annex I. Main Recommendations of the 2012 Article IV Consultation and Authorities' Response (concluded)

2. Restore competitiveness and growth	
(e) Increase incentives towards tradable sectors by reducing excessive rent of the nontradable sectors.	A wide range of structural reform measures were introduced, or continued, under the EFF, aiming to: (i) reduce labor market rigidity; (ii) cut excessive rent of the nontradable sectors; (iii) strengthen market competitions, and (iv) enhance external competitiveness.[1/] Most notably: i. Severance pay was further reduced to 12 days per year of service and is now closer to the EU average. ii. Survival period of collective agreements was shortened from 5 to 3 years, and the possibility of temporary suspension of collective agreements in the face of economic crises or natural disasters was introduced. iii. A 3rd package of energy reform measures was adopted, and a new special levy to tackle the windfall profits of the natural gas providers is now under consideration.[2/] iv. Formal renegotiations of existing port concession contracts were launched and are expected to be completed soon. v. The Competition Authority's resources were improved by a newly established funding model. vi. Several national regulatory authorities adopted, or are in the process of adopting, new bylaws. vii. 18 services and regulated professions are in the final legislation stages of adopting new bylaws.
(f) Close human capital and structural policy gaps between tradable and nontradable sectors.	

1/ Please refer to the Selected Issues Paper for an overall assessment on the impact of the structural reform measures.
2/ A key component of the 3rd package, renegotiation of the long-term natural gas sale and purchase agreements, is not implemented.

Annex II. Risk Assessment Matrix

Source of Risks	Relative Likelihood	Impact	Policy response
I. A surge in financial volatility, with investors re-assessing underlying risk and moving to safe-haven assets.	H	H Given its high corporate and private debt levels, Portugal would be highly susceptible to financial contagion. **The result would be a** heightened financial stress in the Portuguese banking system, as balance sheet fragilities in both banking and corporate sectors are still significant.	Shore up liquidity and capital buffers; encourage private savings.
II. Protracted period of slower growth in advanced economies, especially in the euro area. Weak demand and persistently low inflation from a failure to fully address crisis legacies and appropriately calibrate macro policies, leading to "new mediocre" rate of growth.	H	H With the euro area accounting for 60 percent of total exports, the trade balance would deteriorate, possibly pushing the current account back into deficit and derailing the downward path for Portugal's sizable net foreign liabilities. In addition, lower growth would weaken debt dynamics.	Step up structural reforms to improve competitiveness and reduce debt overhang. ECB policy actions are expected to support exports to trade partners outside the euro area.
III. Political and legal setbacks that delay policy implementation. These may become more acute in the wake of QE and in the run up to the elections in the Fall.	H	M QE, by temporarily removing sovereign financing concerns reduces the sense of urgency in implementing reforms.	Step up structural reforms to improve competitiveness.
IV. Political fragmentation including involving Russia/Ukraine, the Middle East, and Africa. The mounting conflict in the Ukraine depresses business confidence, heightens risk aversion, amid disturbances in global financial, trade, and commodity markets. Heightened risk of fragmentation/ state failure/security dislocation in the Middle east and some countries in Africa lead to a sharp rise in oil prices, with negative global spillovers.	M	M As a net oil importer (oil trade deficit of about 3½ percent of GDP), Portugal's trade balance would weaken. Inflation would pick up from low levels, with a high pass-through in energy and pump prices and second-round effects. A supply-driven increase in oil prices is likely to depress domestic and external demand. However, given the current low base, the overall impact is expected to be subdued.	Step up structural reforms to improve competitiveness.

Annex II. Risk Assessment Matrix (concluded)

V. Excessively low inflation.	M	M Portugal's high debt levels and tepid growth make this eventuality troublesome. Further compression of interest margins, which in turn reduces interest income and undermines already weak profitability. Higher real debt burden for firms and households. Lower domestic demand.	Shore up liquidity and capital buffers. Step up structural reforms to improve competitiveness and reduce debt overhang.
VI. Bond market stress from a reassessment of sovereign risk in the euro area. Sovereign stress re-emerges due to policy uncertainty, faltering reforms, and political and social upheaval, particularly in Greece.	M	H Given its high public debt, Portugal would be highly susceptible to sovereign stress, although the recent ECB policy action makes its re-emergence unlikely in the short term. Although Portugal has been able to build a cash buffer sufficient to cover a large share of its financing needs for 2015, those needs remain substantial. In addition, while the short-term financing needs are largely covered, medium-term debt dynamics remains fragile and is heavily dependent on retaining market access on favorable terms. Debt sustainability concerns would quickly re-emerge in the event of a reversal of the current favorable financing conditions.	High-quality fiscal adjustment and fiscal structural reforms to rein in financing needs. Continue pre-financing efforts to build cash buffers on favorable financing terms in current market conditions.

Note: The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relatively likelihoods of risks listed is the staff' subjective assessment of the risks surrounding the baseline (with L, M, H, denote low, medium, and high, respectively). The RAM reflects staff views on the sources of risk and overall level of concern as of the time of discussions with the authorities.

Annex III. External Stability Assessment

1. After a short-lived interruption, the real effective exchange rate continued its trend depreciation. Depreciation of the euro following the ECB's policy actions, lower oil prices, persistent labor market slack, and low capacity utilization are expected to put downward pressure on the ULC-based and CPI-based REER this year. These factors will be partially offset by the increase in labor costs following increases in the minimum wage and in the non-subsidized electricity tariffs. Short of additional actions to improve cost competitiveness, the factors driving up costs are expected to reverse the trend depreciation over the medium term.

Table 1. Portugal's External Balance Assessment Results[1]

	CA gap Percent of GDP		REER gap[2] Percent	
Current account approach	1.9	*0.7*	-5	...
ES approach	1.2	*-2.6*	-3	...
Index REER approach	...		2.9	6
Level REER approach	...		8.5	...

[1] Estimates based on data available in January 2015. The figures in italic represent the EBA estimates at the time of the 2012 Article IV Consulation.

[2] A positive REER gap indicates overvaluation.

Source: IMF staff estimates.

2. While the EBA estimates (based on data through 2014) broadly reflect external balance, large debt overhand and ongoing structural challenges lead staff to assess the external position as slightly weaker than implied by medium term fundamentals and desirable policy settings. The current account and external sustainability approaches suggests that the exchange rate is undervalued, while the REER approaches suggest it is overvalued by as much as eight percent (table 1). Given Portugal's sizeable net foreign liabilities (110 percent of GDP in 2014), the ES and the REER approaches—which give more weight to external indebtedness—are more appropriate.

- *Under the CA approach* the exchange rate is slightly undervalued. The CA surplus was 0.6 percent of GDP in 2014, corresponding to an estimated cyclically adjusted surplus of around -0.1 percent of GDP. A model-based analysis indicates a norm of -2.0 percent of GDP for the cyclically adjusted CA balance which would suggest a 5 percent undervaluation. The empirical model contains a large regression residual which is not explained by policy gaps. Indeed, part of the residual also likely reflects structural determinants not fully captured by the EBA model. Reflecting these factors, staff assesses the norm at about -0.5 percent of GDP. Thus, the cyclically adjusted CA would be around 0.4 percent of GDP stronger than that implied by fundamentals and desirable policies.

- *Under the ES approach*, the current account surplus needed to stabilize NFA at just above -60 percent of GDP is estimated at 0.2 percent of GDP. Staff now projects a medium-term current account surplus of 0.1 percent (compared with 1.7 used in EBA calculations), implying broad exchange rate alignment by this metric. Yet, reaching the target NFA level at the debt-stabilizing surplus would take many years. A more rapid increase in NFA is needed to mitigate Portugal's vulnerability to external shocks. A current account surplus of 1 percent would bring NIIP down to 80 percent of GDP by 2020 reducing outstanding risks.

- *The REER approaches* indicate an overvaluation of between 2.9 and 8.5 percent. The REER level approach reflects an updated methodology which is independent of the year of normalization for the REER and likely more accurately reflects underlying fundamentals.

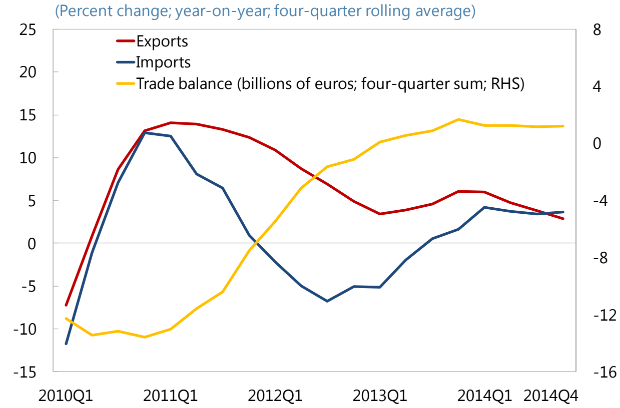
Taken together, including updated staff forecasts, the estimates suggest a slight overvaluation relative to medium term fundamentals. Recent euro depreciation against major currencies, associated with QE, has caused a real effective depreciation of 3 percent since end-2014. This will likely delay the effects of the overvaluation in the short term. Nevertheless policy action to improve fundamentals will be needed to ensure competitiveness when the forces behind Euro-area-wide depreciation unwind and to reduce risks from a high debt burden.

3. Portfolio inflows have returned and risks of a sudden reversal are limited, but external debt remains vulnerable to shocks. Portfolio inflows—primarily public, but also private—have resumed and accelerated in 2014 on the back of regained sovereign market access, increasing from close to zero in 2013 to 7 percent of GDP in 2014. Regarding public external debt, a more diversified investor base, in terms of geography and investor class, and the issuance of debt securities at maturities of up to 30 years mitigate the risks of a sudden reversal of these flows. The recovery of portfolio inflows mirrors a reduction in other investment inflows, in part reflecting the end of program financing. FDI inflows picked up slightly from 2013 to 4.8 percent of GDP in 2014, including some large-scale inflows mostly related to investments in the auto industry but are down significantly from their 2012 peak of 11 percent of GDP. Notwithstanding restored access to international capital markets at sustainable rates and the reduction in external financing needs, the small external surplus and sizeable external debt render Portugal vulnerable to shocks, as confirmed by the external DSA (Figure 5).

4. Export performance and market share. While Portugal's exports held up during the crisis, benefitting from diversification away from the euro area to the rapidly growing emerging markets (notably Angola, Brazil, and China), export growth slowed down in 2014. Goods exports declined in part as a result of production stoppages at an oil refinery in early 2014, while services exports maintained consistent growth. As a result, with external demand growth from trade partners outpacing export growth, Portugal lost market share in 2014. Looking forward, notwithstanding a temporary—and possibly significant—boost to exports from the euro depreciation and lower oil prices, exports are expected to remain subdued in absence of further reforms to alleviate bottlenecks to growth and competitiveness.

Exports and Imports of Goods and Services

(Percent change; year-on-year; four-quarter rolling average)



Source: INE

Annex IV. Public Debt Sustainability Analysis (DSA)

Staff's analysis, applying the [Public DSA framework for Market-Access Countries](), suggests that Portugal's gross debt trajectory is subject to significant risks, in the context of a sizable debt burden and gross financing needs. Debt dynamics continue to hinge on additional growth-supporting structural effort over the medium term and remain highly vulnerable to adverse yet plausible macro-fiscal and contingent liabilities shocks. Moreover, while staff's baseline projections reflect the authorities' current fiscal policies, additional fiscal consolidation in 2015 and the outer years remains critical to anchor debt safely on a downward-sloping path, boosting policy credibility and strengthening the country's resilience to reversals in market sentiment.

A. Baseline Scenario

1. **Public debt continued to increase in 2014 despite further progress on fiscal adjustment.** (Figure 3 and 4). This primarily reflected several large one-off transactions related to SOE support, but was also higher relative to previous projections as a result of the adverse valuation effects of euro depreciation[1], and a downward revision to nominal GDP. As a result, the debt ratio did not peak in 2013 as previously envisaged, but rather increased from 129.7 to 130.2 percent of GDP in 2014. Debt is projected to decline steadily beginning in 2015, as the headline fiscal deficit continues to fall -- with Portugal benefitting from a sizable reduction in interest costs as yields have declined -- but would still remain at nearly 121 percent of GDP at the end of 2020, in the absence of further consolidation efforts. Staff's estimate of potential growth has been lowered relative to earlier projections, with growth expecting to slow as cyclical momentum fades after 2016 – but the baseline debt projections still hinge on sustained structural reform efforts over the medium term, as well as further drawdown of cash deposits in 2015-17 and the ongoing reallocation of the Social Security portfolio from foreign assets to government securities. Portugal's debt net of government deposits amounted to 120 percent of GDP at end–2014, reflecting the accumulation of sizable cash reserves in recent years.

B. Risk Assessment

2. **Portugal's sizable debt burden and gross financing needs continue to pose significant risks to debt sustainability and leave debt dynamics very sensitive to macro shocks.** As shown in Figure 1, Portugal's debt ratio already exceeds the debt burden benchmark for advanced

[1] The majority of Portugal's foreign-currency denominated debt is hedged through currency swaps; unhedged foreign-currency denominated debt is around 3 percent of GDP. The chart in Figure 4 shows total foreign-currency debt, not accounting for hedging operations.

economies of 85 percent of GDP under the baseline scenario. The same applies to Portugal's public financing needs which are above the relevant benchmark of 20 percent of GDP. However, the debt profile is subject to medium to low risks in terms of market perception, projected change in short-term debt, and the share of public debt held by nonresidents.[2] Moreover, in the case of Portugal, since bank vulnerabilities are below the relevant thresholds identified by the MAC DSA template, the standardized contingent liabilities shock does not apply. Nevertheless, this is replaced by a customized shock given the risks posed by the materialization of contingent liabilities from SOEs and PPPs (please refer to the stress test customized scenario).

C. Realism of Baseline Assumptions and Alternative Scenarios

3. **Realizing the potential growth rate assumed in the current projection has important implications for the debt adjustment path.** Portugal's growth forecast track record shows a relatively large median error compared with other countries with Fund-supported programs, especially during the pre-crisis period (Figure 2). The achievement of a growth rate of 1¼ percent over the medium term, as per staff's updated projection, is consistent with moderate growth convergence, but remains subject to sustained structural effort and a successful rebalancing of the economy from the nontradable to the tradable sectors. If growth were to turn out lower than currently projected—for instance as a result of stalling or reversal of the reform effort—the rate of debt decline would significantly slow down, as also shown in Figure 4 and AI.5. Similarly, risks from a protracted period of negative inflation in Portugal could further impede the repair of already-weak private and public balance sheets, as highlighted by the customized deflation scenario in Figure 5.

4. **Given Portugal's sizable debt burden and financing needs, the primary balance is expected to exceed its debt-stabilizing threshold over the projection period.** Under staff's baseline scenario,[3] the fiscal primary balance is expected to reach nearly 2 percent of GDP over the medium term. As estimated in Figure 2, the 3-year change in the cyclically-adjusted primary balance identified for Portugal is in the top third of the fiscal adjustments observed in other countries with debt greater than 60 percent of GDP. However, due to the 3-year rolling nature of the estimate, this largely reflects the country's fiscal efforts already achieved over 2011–14. Nevertheless, Portugal's debt profile remains highly vulnerable to a primary balance shock (Figure 4 and 5), as also highlighted by the asymmetric fan chart analysis in Figure 1, which shows the risks to the debt

[2] The total (public and private) external financing requirements exceed significantly the relevant benchmark under the baseline. However, in the case of Portugal, the figure includes, among others, non-residents bank deposits, accounting for about 45 percent of GDP.

[3] In line with the WEO guidelines, medium-term assumptions that are not backed up by well-defined fiscal measures are not incorporated by the team under the baseline scenario.

outlook if only negative shocks to the primary balance were to materialize. Moreover, the authorities' medium-term fiscal strategy is expected to target a more ambitious adjustment path than staff's current-policies baseline, consistent with the European Treaty on Stability, Coordination, and Governance framework which establishes a minimum structural adjustment effort of ½ percent of GDP per year, until the medium term objective is achieved.

D. Stress Tests

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

- Under a *growth shock* that lowers output by nearly 4.5 percentage points in 2016–17 (and in turn inflation by a cumulative 1 percentage point), debt would peak at about 134 percent of GDP in 2017, over 10 percentage points higher compared with the 2016 baseline. However, debt dynamics would be severely compromised under a *deflation scenario* where a sharper growth shock (that lowers output by 5½ percentage points in 2016–17) is associated with deflationary pressures (with inflation lower by cumulative 4 percentage points), in the context of a widening output gap and high unemployment. Under this scenario, debt would rise to 142 percent of GDP by 2017and remain at this level over the medium-term.

- A sustained interest rate shock of 200 bps throughout the projection period 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 2020 the debt-to-GDP ratio is about 3 points higher compared with the baseline.

- Further materialization of contingent liabilities would also have implications for Portugal's debt dynamics. While the recent debt management operation for SOEs has significantly addressed fiscal risks from the transport and infrastructure sectors, staff's assessment suggests that, under a severe scenario, further contingent liabilities could potentially materialize for about 5 percent of GDP, due to SOEs, PPPs, and State guarantees.[4] A contingent liabilities shock of this magnitude would push the 2015 debt ratio to about 131 percent of GDP.

[4] Staff's assumptions for the adverse contingent liabilities scenario include (i) staff's estimate of potential contingent liabilities from PPPs based on financial rebalancing requests by concessionaires; (ii) the hypothetical settlement of the outstanding stock of arrears; (iii) staff's estimate of potential contingent liabilities from other non-bank debt directly guaranteed by the State and/or classified outside the general government perimeter.

- A severe combined shock that incorporates the macro-fiscal and contingent liabilities adverse scenarios mentioned above would significantly affect the country's debt dynamics, with debt rising to 135 percent of GDP in 2017 and then continuing to rise gradually over the medium term.

6. **The authorities took note of the risks highlighted by staff, but also stressed their divergence from staff's baseline scenario.** The authorities were more optimistic about the growth outlook, and foresee a larger improvement in medium-term debt dynamics than projected by staff. In addition, the authorities emphasized the significant progress on fiscal adjustment in recent years and the resulting improvement in investor confidence, which has allowed a return to market borrowing on favorable terms and facilitated the prepayment of nearly one-fourth of their outstanding borrowing from the Fund in March 2015. They also noted that recent increases in gross debt have been largely due to the sustained build-up of central government cash balances and that the SOE debt management operation in 2014 aimed at restoring the financial viability of these companies, thus significantly reducing fiscal risks and future borrowing needs. Finally, they stressed their confidence that the 2015 fiscal deficit target will be achieved, resulting in a larger reduction of the debt-to-GDP ratio by the end of the year, and putting debt dynamics on a trajectory to improve at a faster pace than envisaged under staff's baseline scenario. As foreseen in the EU framework, the authorities will present revised macroeconomic and fiscal projections for the medium-term in their Stability Program by end-April.

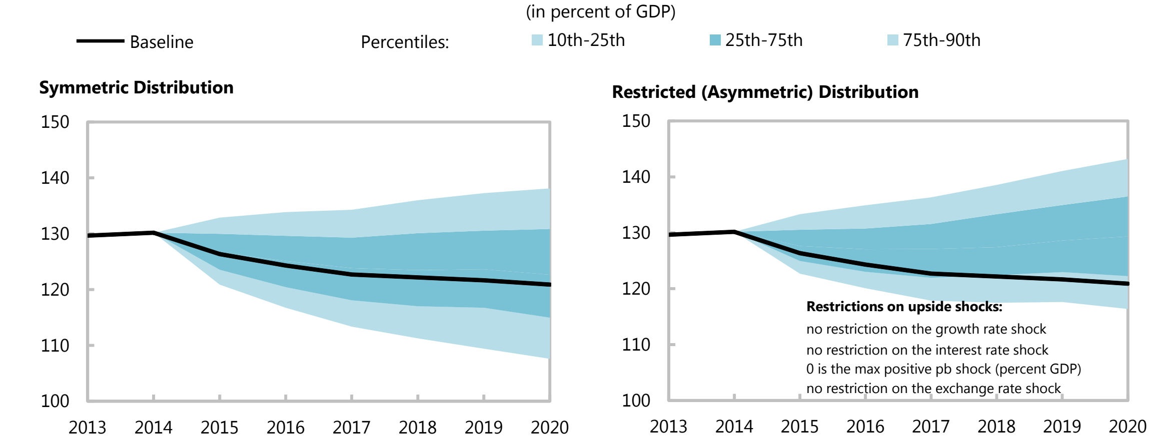
Figure 1. Portugal: Public DSA Risk Assessment, 2013–20

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

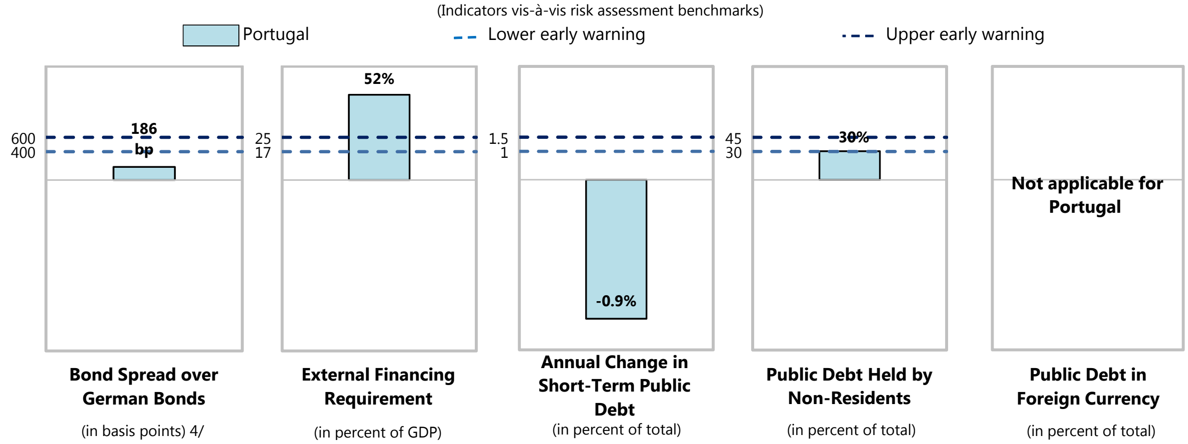
Evolution of Predictive Densities of Gross Nominal Public Debt

(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, the benchmark is already exceeded under the baseline (implying that any specific shock, regardless of its size, is reported as red). Moreover, the standardized contingent liabilities shock of the MAC DSA template (based on bank vulnerabilities and below the relevant threshold for Portugal) is replaced by a customized shock based on contingent liabilities risks from SOEs and PPPs.

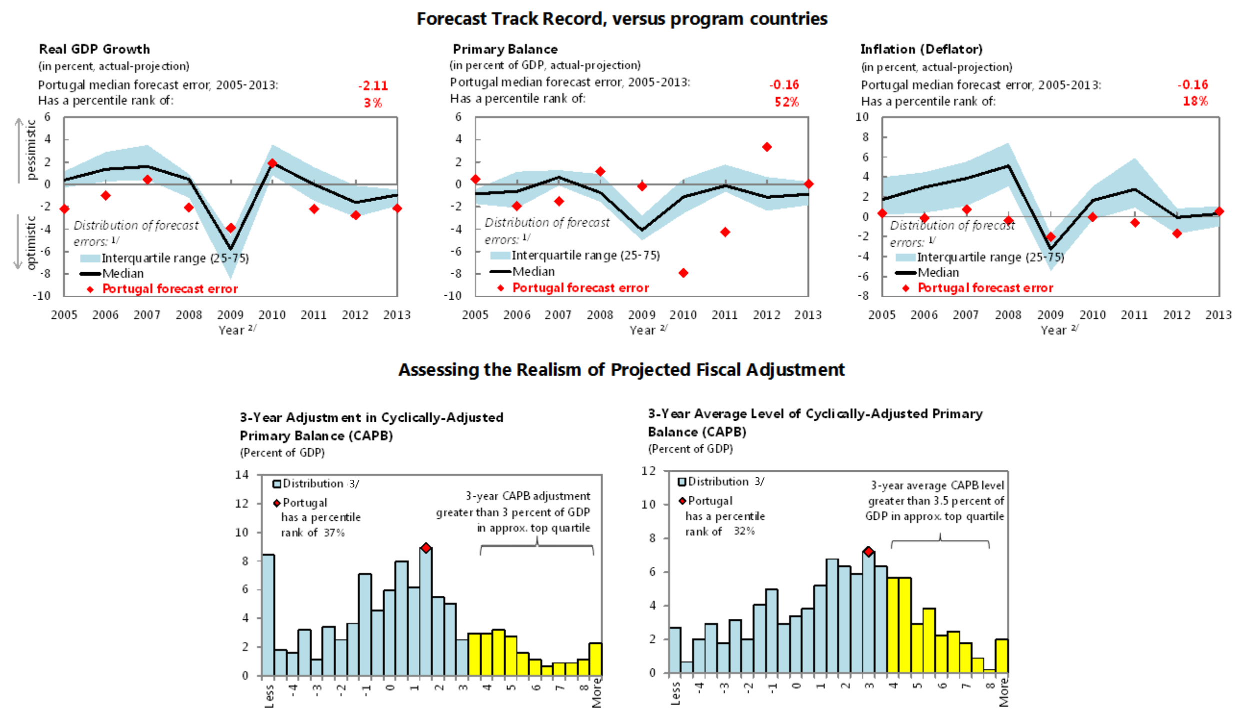
2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

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/ Ten-year maturity, average over the last 3 months, 31-Dec-14 through 31-Mar-15.

Figure 2. Portugal: Public DSA - Realism of Baseline Assumptions



Source: IMF staff.

1/ Plotted distribution includes program countries; percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 3. Portugal: Public Sector Debt Sustainability Analysis (DSA) Baseline Scenario, 2004–2020

(in percent of GDP unless otherwise indicated)

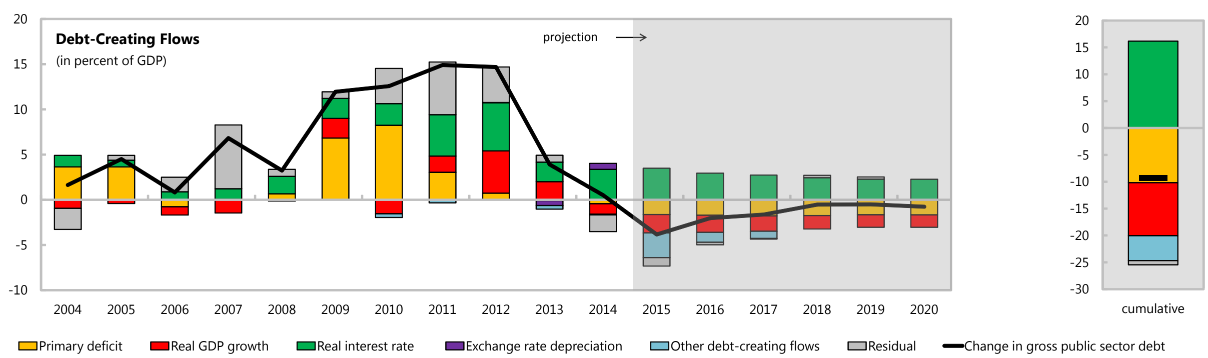
Debt, Economic and Market Indicators [1/]

	Actual		Prel.	Projections					
	2004-2012 [2/]	2013	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	81.7	129.7	130.2	126.3	124.3	122.7	122.2	121.7	120.9
Public gross financing needs	...	23.5	22.9	20.1	17.5	16.7	18.1	18.3	21.1
Real GDP growth (in percent)	0.0	-1.6	0.9	1.6	1.5	1.4	1.3	1.2	1.2
Inflation (GDP deflator, in percent)	1.6	2.2	1.2	1.0	1.3	1.3	1.4	1.5	1.5
Nominal GDP growth (in percent)	1.6	0.6	2.2	2.6	2.9	2.7	2.7	2.7	2.7
Effective interest rate (in percent) [4/]	4.5	3.9	3.9	3.8	3.7	3.6	3.5	3.4	3.4

As of March 31, 2015		
Sovereign Spreads		
Spread (bp) 3/		151
CDS (bp)		128
Ratings	Foreign	Local
Moody's	Ba1	Ba1
S&Ps	BB	BB
Fitch	BB+	BB+

Contribution to Changes in Public Debt

	Actual		Prel.	Projections							
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	7.9	3.9	0.5	-3.8	-2.0	-1.6	-0.5	-0.5	-0.8	-9.3	
Identified debt-creating flows	5.5	3.1	2.4	-2.9	-1.8	-1.5	-0.8	-0.8	-0.8	-8.5	
Primary deficit	2.9	-0.1	-0.4	-1.6	-1.7	-1.8	-1.7	-1.7	-1.7	-10.2	0.9
Primary (noninterest) revenue and grants	41.2	45.2	44.5	44.7	44.7	44.7	44.7	44.7	44.7	268.2	
Primary (noninterest) expenditure	44.1	45.2	44.1	43.0	43.0	42.9	43.0	43.0	43.0	258.0	
Automatic debt dynamics [5/]	2.6	3.6	2.9	1.5	1.0	1.0	1.0	0.9	0.9	6.3	
Interest rate/growth differential [6/]	2.6	4.2	2.2	1.5	1.0	1.0	1.0	0.9	0.9	6.3	
Of which: real interest rate	2.3	2.2	3.4	3.5	2.9	2.7	2.4	2.3	2.3	16.2	
Of which: real GDP growth	0.4	2.0	-1.1	-2.0	-1.9	-1.7	-1.5	-1.4	-1.4	-9.9	
Exchange rate depreciation [7/]	0.0	-0.6	0.7	...	...	...	...	...	...	...	
Other identified debt-creating flows	-0.1	-0.4	-0.1	-2.7	-1.1	-0.8	0.0	0.0	0.0	-4.6	
Privatization Revenue (negative)	-0.2	-0.8	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Increase in deposits and other (- means drawn down of deposits)	0.1	0.4	0.1	-2.7	-1.1	-0.8	0.0	0.0	0.0	-4.6	
Residual, including asset changes [8/]	2.4	0.8	-1.8	-0.9	-0.3	-0.1	0.3	0.3	0.0	-0.8	



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.

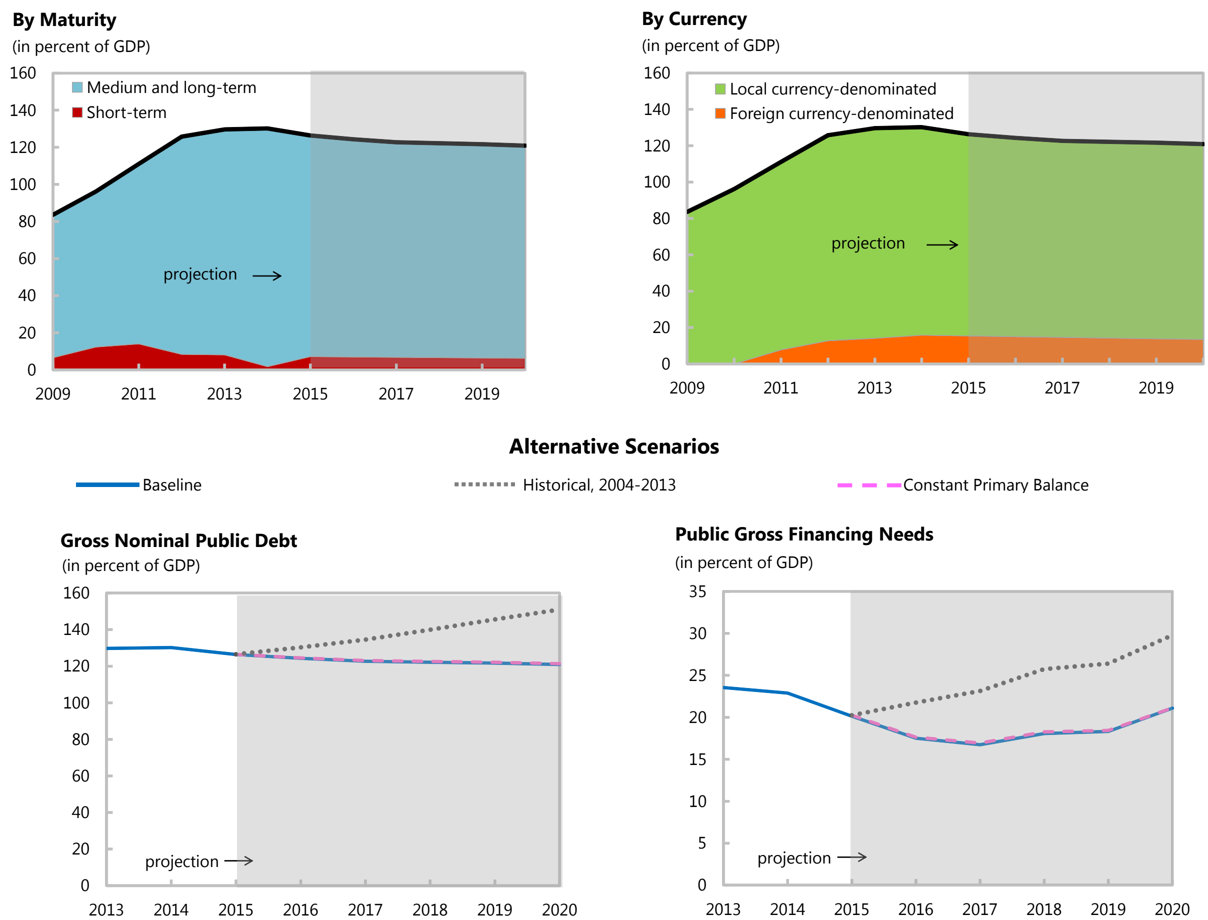
7/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

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 4. Portugal: Public DSA - Composition of Public Debt and Alternative Scenarios, 2009–2020

Composition of Public Debt



Underlying Assumptions

(in percent)

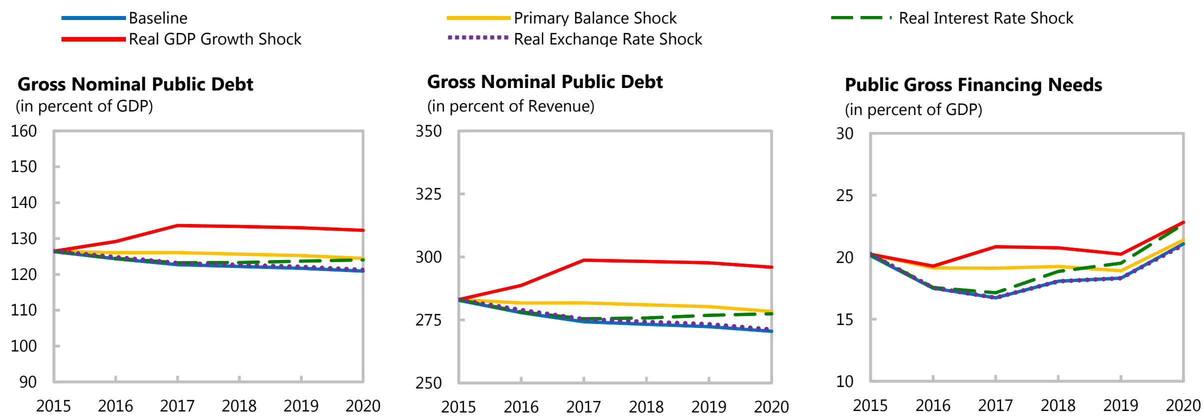
Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	1.6	1.5	1.4	1.3	1.2	1.2
Inflation	1.0	1.3	1.3	1.4	1.5	1.5
Primary Balance	1.6	1.7	1.8	1.7	1.7	1.7
Effective interest rate	3.8	3.7	3.6	3.5	3.4	3.4
Constant Primary Balance Scenario						
Real GDP growth	1.6	1.5	1.4	1.3	1.2	1.2
Inflation	1.0	1.3	1.3	1.4	1.5	1.5
Primary Balance	1.6	1.6	1.6	1.6	1.6	1.6
Effective interest rate	3.8	3.7	3.6	3.5	3.4	3.3

Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	1.6	-0.3	-0.3	-0.3	-0.3	-0.3
Inflation	1.0	1.6	1.6	1.6	1.6	1.6
Primary Balance	1.6	-2.2	-2.2	-2.2	-2.2	-2.2
Effective interest rate	3.8	3.7	3.6	3.6	3.6	3.6

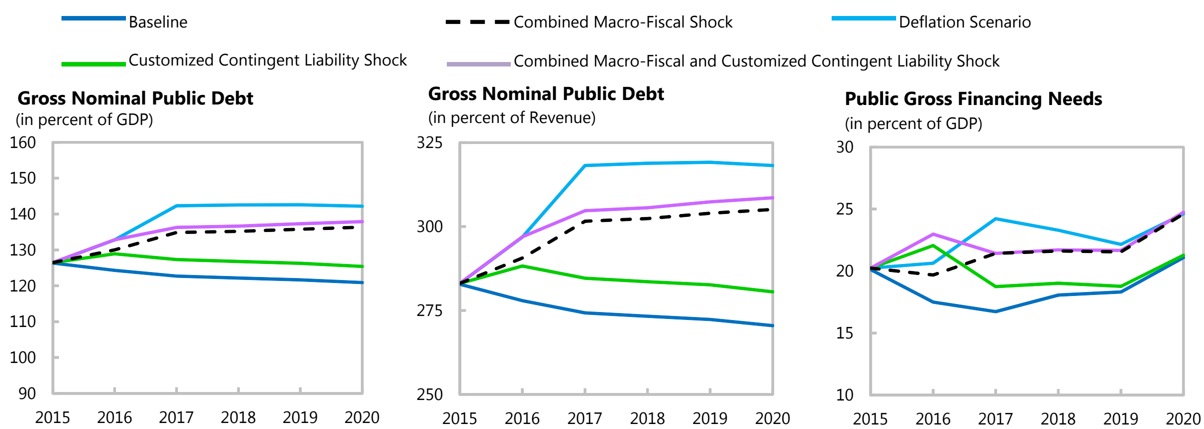
Source: IMF staff.

Figure 5. Portugal: Public DSA - Stress Tests, 2015–20

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	1.6	1.5	1.4	1.3	1.2	1.2
Inflation	1.0	1.3	1.3	1.4	1.5	1.5
Primary balance	1.6	0.1	0.2	1.7	1.7	1.7
Effective interest rate	3.8	3.7	3.6	3.5	3.5	3.4
Real Interest Rate Shock						
Real GDP growth	1.6	1.5	1.4	1.3	1.2	1.2
Inflation	1.0	1.3	1.3	1.4	1.5	1.5
Primary balance	1.6	1.7	1.8	1.7	1.7	1.7
Effective interest rate	3.8	3.7	3.9	4.0	4.2	4.3
Combined Shock						
Real GDP growth	1.6	-0.7	-0.8	1.3	1.2	1.2
Inflation	1.0	0.7	0.7	1.4	1.5	1.5
Primary balance	1.6	0.1	-0.6	1.7	1.7	1.7
Effective interest rate	3.8	3.7	3.9	4.0	4.2	4.3
Customized Contingent Liability Shock						
Real GDP growth	1.6	1.5	1.4	1.3	1.2	1.2
Inflation	1.0	1.3	1.3	1.4	1.5	1.5
Primary balance	1.6	-2.8	1.8	1.7	1.7	1.7
Effective interest rate	3.8	3.7	3.5	3.4	3.4	3.3

Real GDP Growth Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	1.6	-0.7	-0.8	1.3	1.2	1.2
Inflation	1.0	0.7	0.7	1.4	1.5	1.5
Primary balance	1.6	0.5	-0.6	1.7	1.7	1.7
Effective interest rate	3.8	3.7	3.6	3.6	3.5	3.4
Real Exchange Rate Shock						
Real GDP growth	1.6	1.5	1.4	1.3	1.2	1.2
Inflation	1.0	1.4	1.3	1.4	1.5	1.5
Primary balance	1.6	1.7	1.8	1.7	1.7	1.7
Effective interest rate	3.8	3.7	3.6	3.4	3.4	3.3
Deflation Scenario						
Real GDP growth	1.6	-1.2	-1.4	1.3	1.2	1.2
Inflation	1.0	-0.8	-0.8	1.4	1.5	1.5
Primary balance	1.6	-0.4	-2.6	1.7	1.7	1.7
Effective interest rate	3.8	3.7	3.7	3.9	3.7	3.6
Combined Macro-Fiscal and Customized Contingent Liability Shock						
Real GDP growth	1.6	-0.7	-0.8	1.3	1.2	1.2
Inflation	1.0	0.7	0.7	1.4	1.5	1.5
Primary balance	1.6	-3.2	0.9	1.7	1.7	1.7
Effective interest rate	3.8	3.7	3.9	4.0	4.2	4.4

Source: IMF staff.

INTERNATIONAL MONETARY FUND

PORTUGAL

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

April 15, 2015

Prepared By

European Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of March 31, 2015)

Membership Status
Joined: March 29, 1961; Article VIII

General Resources Account	**SDR Million**	**Percent Quota**
Quota	1,029.70	100.00
Fund holdings of currency	18,656.12	1,811.80
Reserve position in Fund	207.85	20.19

SDR Department	**SDR Million**	**Percent Allocation**
Net cumulative allocation	806.48	100.00
Holdings	792.95	98.32

Outstanding Purchase and Loans	**SDR Million**	**Percent Quota**
Extended Arrangements	17,834.25	1,731.99

Latest Financial Arrangement

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
EFF	May 20, 2011	June 30, 2014	23,742.00	22,942.00
Stand-By	Oct 07, 1983	Feb 28, 1985	445.00	259.30

Projected Payments to Fund[1]
(SDR Million; based on existing use of resources and present holdings of SDRs)

			Forthcoming		
	2015[2]	**2016**	**2017**	**2018**	**2019**
Principal	0	0	822.42	3,693.42	3,823.67
Charges/Interest	495.08	629.91	629.34	556.97	404.21
Total	**495.08**	**629.91**	**1,451.76**	4,250.**39**	**4,227.88**

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section. Projections do not reflect intended early repurchases.
[2] Does not include SDR 5.1 billion early repurchase and SDR 0.42 billion in interest payments through March 2015.

Exchange Rate Arrangement

Portugal's currency is the euro, which floats freely and independently against other currencies. Portugal has accepted the obligations of Article VIII, Section 2, 3, and 4, and maintains an exchange system free of restrictions on payments and transfers for current international transactions, other than restrictions notified to the Fund under Decision No. 144 (52/51).

Article IV Consultations

Portugal has been on a 24-month consultation cycle since the beginning of the Extended Arrangement in 2011. Staff discussions for the 2012 Article IV consultation were conducted on a mission to Lisbon during November 8–11, 2012. The 2012 Article IV consultation was concluded by the Executive Board on December 26, 2012.

First Post-Program Monitoring Discussions

Discussions were held in Lisbon during October 28 – November 4, 2014.

Technical Assistance:

Department	Purpose	Date
FAD	Fiscal Transparency Evaluation	April 2014
FAD	Taxpayer Compliance Management	April 2014
FAD	Value-Added Tax Gap Analysis	February 2014
FAD	Reforms of Accounting and Reporting Framework	February 2014
FAD	Expenditure Arrears and Commitment Control	December 2013
FAD	Reforming the Budget Framework Law	December 2013, July 2013,
FAD	Tax Administration	November 2013
FAD	Tax Policy	June 2013
FAD	Accelerating Measures to Strengthen Tax Payer Compliance	March 2013
FAD	Expenditure Review and Installation of Resident PFM Advisor	December 2012
FAD	Revenue Administration	November 2012
MCM/LEG	Corporate Debt Restructuring	January 2014

Resident Representative:

Mr. Albert Jaeger assumed his position in October 2011.

STATISTICAL ISSUES

As of April 7, 2015

I. Assessment of Data Adequacy for Surveillance
General. Data provision to the Fund is adequate for surveillance purposes.
Real sector. Since 2000, and until August 2014, INE published a full set of national accounts based on the *ESA 1995* methodology, including quarterly GDP estimates. Since September 2014, all information regarding National Accounts follows the *ESA 2010*.
Fiscal sector. Data have undergone a number of revisions during the transition to the *ESA 2010*, sizably altering revenue and expenditure and hampering comparisons across years. From 2001 onward, budgets have been presented in a manner consistent with recent changes in national and fiscal accounting methodology. Quarterly general government statistics on an accrual basis are available as derived from the national accounts statistics.
Trade and balance of payments. Data are provided according to the IMF's sixth edition of the *Balance of Payments Manual*. The external trade data meet the timeliness standards. The portfolio investment collection system has a simplified threshold of €500 million, which is relatively high in comparison with many EU countries. The authorities estimate however, that only about 1.5 percent of transactions are not captured on a monthly basis by this threshold, and that this reporting simplification does not significantly hamper the quality of the monthly balance of payments. Moreover, they indicate that all transactions below this threshold are included in the first release of the annual balance of payments data, and the monthly numbers are revised accordingly.

II. Data Standards and Quality	
Portugal is subject to the statistical requirements and timeliness and reporting standards of Eurostat and the European Central Bank (ECB). Portugal subscribes to the Special Data Dissemination Standard Plus (SDDS+), and the relevant metadata have been posted on the Dissemination Standards Bulletin Board.	No data ROSC is available.

Portugal: Table of Common Indicators Required for Surveillance
(As of April 7, 2015)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	4/07/15	4/07/15	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	2/15	3/15	M	M	M
Reserve/Base Money	1/15	3/15	M	M	M
Broad Money	1/15	3/15	M	M	M
Central Bank Balance Sheet	2/15	3/15	M	M	M
Consolidated Balance Sheet of the Banking System	1/15	3/15	M	M	M
Interest Rates[2]	2/15	3/15	M	M	M
Consumer Price Index	2/15	3/15	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2/15	3/15	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	2/15	3/15	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2/15	3/15	M	M	M
External Current Account Balance	1/15	3/15	M	M	M
Exports and Imports of Goods and Services	1/15	3/15	M	M	M
GDP/GNP	2014:Q4	3/15	Q	Q	Q
Gross External Debt	2014:Q4	2/15	Q	Q	Q
International Investment Position	2014:Q4	2/15	Q	Q	Q

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I); and not available (NA).

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FOR IMMEDIATE RELEASE
May 8, 2015

International Monetary Fund
700 19th Street, NW
Washington, D.C. 20431 USA

IMF Executive Board Concludes the Article IV Consultation with Portugal[1]

On May 6, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation with Portugal.

Portugal's significant flow imbalances have largely been corrected in the wake of the sovereign debt crisis, with employment increasing, output expanding, and the current account balance posting surpluses for the first time in decades. Nevertheless, the stock vulnerabilities that had accumulated over time—most notably public and nonfinancial corporate debt, and a large negative international investment position—remain pronounced.

The economy has expanded at close to 1 percent per year on average since early 2013, with growth driven largely by consumption. The 2014 fiscal deficit objective of 4.0 percent of GDP (excluding one-off operations) has been achieved, implying a structural primary adjustment of 1 percent. The trend of downward inflation pressures, exacerbated more recently by falling energy prices, appears to have been arrested. The banking system is reducing its reliance on Eurosystem financing, although it remains unprofitable and saddled with a rising stock of non-performing loans.

The near-term outlook is benefiting from the trifecta of record-low interest rates, a weakening euro, and low oil prices. Output is expected to increase by 1.6 percent in 2015 and by 1.5 percent in 2016, with outlook for inflation improving as well. As the boost from short-

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

term factors fades, however, growth is projected to moderate over the medium term, as Portugal continues to lag behind its peers in key structural indicators. The risks to the outlook are mostly on the upside, as the impact of ECB's expanded asset purchase program may turn out to be stronger than anticipated. At the same time, there are low-probability but potentially disruptive downside possibilities, most notably any volatility associated with turmoil at the euro-area level.

Executive Board Assessment[2]

Executive Directors commended the Portuguese authorities for their achievements over the past few years in improving the fiscal and current account balances, safeguarding financial stability, and regaining market access. Directors also welcomed the authorities' decision to begin early repayment of outstanding Fund credit. Directors observed, however, that the ongoing recovery is still too modest to bring output and employment back to pre-crisis levels in the period ahead. Restoring internal balance without undermining Portugal's external position thus remains the most important policy priority.

Directors agreed that, while the near-term economic outlook has improved significantly, medium-term prospects are still clouded by legacy problems—weak investment, large stocks of public and private debt, excessive leverage in the corporate sector, and labor market slack. Noting that Portugal is benefitting from low sovereign yields, a depreciated euro exchange rate, and low oil prices, Directors encouraged the authorities to tackle the remaining vulnerabilities, rebuild fiscal buffers, and accelerate key structural reforms to enhance potential growth.

Directors welcomed the progress on fiscal consolidation and the authorities' commitment to exit the EU's Excessive Deficit Procedure this year. They encouraged further efforts to reduce the debt-to-GDP ratio to more sustainable levels. Directors generally noted the benefits of setting multi-year expenditure targets to anchor the fiscal structural adjustment, given Portugal's elevated tax burden. In this regard, it will also be important to further rationalize public spending through a comprehensive reform of wages and pensions, and broader fiscal reforms to improve public administration and mitigate risks from state-owned entities.

Directors considered that Portugal's economic recovery depends crucially on progress in addressing nonperforming loans and the corporate debt overhang in a timely and systematic manner. Actions are needed to ensure that banks maintain adequate capital and provisioning,

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

and speed up debt write-offs. Directors recommended further efforts to improve the efficiency of the insolvency framework and promote equity-based financing for corporations.

Directors stressed the need to continue structural reforms to enhance external competitiveness and labor market flexibility, building on recent achievements. They saw as priorities reforms to support job creation, enhance local competition, and upgrade public services. Directors also recommended measures to improve vocational training, upgrade managerial skills, reduce disincentives to work, and make the social dialogue more inclusive.

Portugal: Selected Economic Indicators, 2014–17 1/

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

		Projections 1/		
	2014	2015	2016	2017
Real GDP	0.9	1.6	1.5	1.4
Private consumption	2.1	1.7	1.6	1.5
Public consumption	-0.3	-0.5	0.9	0.8
Gross fixed capital formation	2.5	3.1	2.6	2.4
Exports	3.4	5.5	4.8	4.5
Imports	6.4	4.0	4.8	4.7
Contribution to growth (percentage points)				
Total domestic demand	2.1	1.0	1.6	1.5
Foreign balance	-1.2	0.6	0.0	-0.1
Resource utilization				
Employment	1.6	0.2	0.6	0.5
Unemployment rate (percent)	13.9	13.1	12.6	12.1
Prices				
GDP deflator	1.2	1.0	1.3	1.3
Consumer prices (harmonized index)	-0.2	0.6	1.3	1.5
Money and credit (end of period, percent change)				
Private sector credit	-7.5	-2.8	0.3	0.8
Broad money	0.0	2.1	2.4	2.2
Fiscal indicators (percent of GDP)				
General government balance 2/	-4.5	-3.2	-2.8	-2.5
Primary government balance	0.4	1.6	1.7	1.8
Structural primary balance (percent of potential GDP)	3.6	2.9	2.5	2.1
General government debt	130.2	126.3	124.3	122.7
Current account balance (percent of GDP)	0.6	1.4	1.0	0.7
Nominal GDP (billions of euros)	173.1	177.6	182.7	187.6

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

1/ Projections for 2016 and 2017 reflect current policies.

2/ Includes one-off measures from SOE and banking sector support operations, CIT credit, and the upfront costs of mutual agreements for 1 percent of GDP.

Statement by Carlo Cottarelli, Executive Director for Portugal
and Ines Lopes, Advisor to the Executive Director
May 6, 2015

I. Overview

We welcome the IMF staff report on the 2015 Article IV Consultation, as it provides an updated assessment of the recovering Portuguese economy and draws attention to the challenges that remain to be addressed. However, we also feel that a staff report for an Art. IV consultation – there has not been one since over two years ago – could have focused more on the remarkable progress Portugal achieved in terms of fiscal consolidation, external adjustment, market access, financial stability and implementation of structural reforms. The staff report pays relatively limited attention to these results, focusing primarily on the remaining stock imbalances. Additionally, the policy proposals put forward by staff would have benefited from a more in-depth discussion of the reforms undertaken in 2013-2014 as well as of the challenges faced in their implementation.

The authorities feel that strong compliance with the Economic and Financial Adjustment Program and the continued implementation of sound policies following its completion have been decisive in stabilizing the economy and gradually building stronger foundations for growth in the medium and long term. The authorities also acknowledge that, given the magnitude of the stock imbalances accumulated since the mid-1990's – namely in terms of indebtedness – the adjustment process will have to continue, underpinned by the consolidation of recent results and renewed commitment for further reforms.

By their own nature, reducing stock imbalances will require time, something that the Fund has clearly recognized.[1] Steady adjustment and reform, at a pace that takes into account also the need to sustain the ongoing recovery of economic activity and employment, is critical to successfully reduce remaining imbalances. But the gradual reduction of stock imbalances, in the presence of a faster adjustment of flow imbalances, should not be taken as an example of absence of adjustment. Thus, we were somewhat surprised to see that according to the Table in paragraph 8 of the staff report, progress in achieving fiscal sustainability is assessed solely by looking at the public debt to GDP ratio. The remarkable improvements in terms of budget balance, structural balance or primary balance are not considered at all.

[1] For example, in the chapter devoted to dealing with public debt overhang of October 2012 World Economic Outlook, it was concluded that "*reducing public debt takes time, especially in the context of a weak external environment*".

The Government's commitment to this strategy was reaffirmed in late April, with the formal submission to the European Commission of two key strategy documents: the National Reform Program and the Stability Program.[2] In particular, these documents outline Portugal's strategy for the next four years, in terms of policy intentions for ensuring sustainable growth and on the design of the medium-term fiscal strategy.

II. Economic Activity

The economy continues to recover steadily. Portuguese GDP grew by 0.9 percent in 2014, confirming a turnaround after three years of negative growth. Domestic demand was underpinned by the recovery of private consumption (which grew by 2.1 percent, against -1.5 percent in 2013 and -5.5 percent in 2012) and also investment (as Gross Fixed Capital Formation increased by 2.5 percent, following -6.7 percent in 2013 and -16.6 percent in 2012). This led to an acceleration of import growth (+6.4 percent), which surpassed the sustained increase in exports (+3.4 percent).

While the strong pick-up in private consumption and imports led to a shift in growth composition in 2014, the updated macroeconomic scenario of the Stability Program projects this effect to be temporary and triggered by a relevant improvement in confidence following the most difficult period of the adjustment process. According to the Government's projections, GDP growth is expected to accelerate in 2015-2019, underpinned by positive contributions both from domestic demand and net exports, continued investment growth and a sustained improvement in the labor market.

The Government's macroeconomic scenario does not significantly diverge from the one in the staff report for 2015 (as staff's growth projections have been revised up since the previous PPM staff report), but prospects from 2016 onwards are more optimistic. In 2015, GDP is expected to grow by 1.6 percent. Growth should then accelerate to 2.0 percent in 2016 and 2.4 percent in 2017, maintaining a similar pace in 2018 and 2019. The unemployment rate is expected to reach 13.2 percent in 2015, down from 13.9 percent in 2014 and 16.2 percent in 2013. As this declining trend continues in outer years and employment growth is expected to remain steady, the Stability Program forecasts an unemployment rate of 11.1 percent in 2019.

The external adjustment is also expected to continue in tandem with economic recovery, with the net lending position of the Portuguese economy expected to reach 2.7 percent of GDP in 2019. In addition, the current account balance is forecast to remain in surplus, improving from 0.5 percent of GDP in 2015 to 1.4 percent of GDP in 2019.

[2] This submission occurs under the European Semester – a set of procedures aimed at enhancing policy coordination at EU levels, which is mandatory for all EU Member States which are not under an adjustment program.

III. Fiscal Policy

While taking note of staff's assessment, the Government reaffirms its firm commitment to respect the 2015 deadline for Portugal to exit the EU's Excessive Deficit Procedure (EDP). The 2.7 percent of GDP deficit target for this year is also maintained, and reinforced by the statistical authorities' assessment that the 2014 deficit was lower than forecast in the State Budget.

According to the figures released on April 17, the 2014 General Government deficit stood at 4.5 percent of GDP (EUR 7.717 billion), falling below the 2013 deficit of 4.8 percent of GDP (EUR 8.181 billion). This result was achieved in spite of one-off items, net of which the deficit falls to 3.3 percent of GDP (against 5.1 percent of GDP recorded in 2013). In 2014, Portugal recorded a primary surplus for the second consecutive year, amounting to 0.5 percent of GDP. This result places the total correction in the primary balance between 2010 and 2014 at 8.7 percentage points of GDP.

The fiscal strategy outlined in the Stability Program demonstrates that the Government is committed to pursuing sound policies in the medium-term, so as to ensure the sustainability of public finances and compliance with the EU fiscal framework. The medium-term objective – set for Portugal as a structural deficit of 0.5 percent – is expected to be achieved in 2016, one year earlier than foreseen in the 2014 Fiscal Strategy Document. The General Government balance is targeted to improve from a deficit of 2.7 percent of GDP in 2015 – thus complying with the 3 percent EDP limit – to a surplus of 0.2 percent of GDP in 2019.

Following a near-stabilization in 2014, General Government Gross Debt is set to decline by 6 percentage points in 2015 – reaching 124.2 percent of GDP by end-December – and to continue this trend in the following years, falling to 107.6 percent in 2019. Excluding Central Administration deposits, public debt is expected to decrease from 116.5 percent of GDP in 2015 to 103.8 percent of GDP in 2019.

The improvement in the fiscal accounts recorded over the last few years critically contributed to the recovery of market access and the decline in spreads. The latter reflects a mix of several factors, including the improvements in the fiscal balance and the current account, whose relevance is somewhat underplayed in the staff report, notably in Box 2.

IV. Financial Sector Policies

While important measures have been taken during the Program, the strengthening and stabilization of the financial sector continues to be one of the main objectives of Banco de Portugal. The liquidity position of the Portuguese banks improved quite significantly. The solvency position has also improved, and significant efforts continue to be made by the Portuguese banks in this area.

In line with other sectors of the economy, the banking sector continued to deleverage during 2014, with the loan-to-deposit ratio falling to 107 per cent in December 2014 from 117 percent at end 2013. Deposits remained resilient throughout the year and Central Banks' financing, mostly comprised of Eurosystem monetary policy operations, continued to decrease - reaching, at end 2014, minimum levels since the beginning of the Program. Credit granted by banks continued to decrease in the residential mortgage segment and in sectors most dependent on domestic demand (notably construction and real estate), while exporting firms continue to benefit from increasing positive (net) flows of credit. There is also evidence pointing to a strong competition across banks with respect to firms with a good risk profile - in 2014, the Portuguese banks have more clearly differentiated credit conditions (notably the interest rate charged) according to the risk profile of the firms. This also applies to loan volumes: the growth rate of loans granted to the firms with the lowest levels of risk increased during 2014, whereas the growth rate of loans underlying the riskiest firms continued to register significant negative values. Finally, the level of deposits and loans was not affected by the resolution measure applied to BES, thus confirming the improved resilience of the system.

In terms of solvency, the Common Equity Tier 1 reached 11.3 percent at end 2014, for the banking system as a whole – in line with average European levels. The decrease observed in the last quarter of 2014 reflected not only low profitability levels but also the revision of the actuarial assumptions followed by some banks' pension funds, as a consequence of the general decrease in interest rates. In fact, the main challenge faced by the banking sector at the current juncture is to regain profitability. Despite the recent improvement of both return on asset and return on equity ratios, profitability remains at low for most banks. The favorable dynamics in net interest income, the increase in profits underlying financial operations and the ongoing decline in operational costs, have had a positive impact during 2014. However, the still high level of impairments, to a large extent linked with the exposure of banks to non-financial firms, continue to weigh negatively on profits.

Nonetheless, banks' profitability recovery should not involve excessive risk-taking, nor excessive concentration levels in certain activities or markets. It will be important for institutions to adjust their business models to a macroeconomic context that may involve relatively moderate potential growth and low interest rates.

Also, the stock of NPLs is still high, especially in the non-financial corporate sector, a sector that despite the aforementioned adjustment is still characterized by high levels of indebtedness. Consequently, the stock of impairments as a percentage of gross loans is one of the highest in Europe (7.7 percent). Several horizontal inspections carried out by Banco de Portugal during the Program, as well as the ECB Comprehensive Assessment, led banks to recognize a significant amount of NPLs and to reinforce the level of impairments, contributing to safeguarding the correct assessment and accounting of credit risk.

Reconciling the need to further deleverage in a controlled way – given the still high level of debt in the economy – and the goal of promoting economic growth will be challenging. Banks will continue to have a key role in this scenario by continuing to promote the reallocation of resources towards the most productive sectors of the economy. Banco de Portugal is following this adjustment process very closely and has contributed to a strategic plan set up by the Portuguese authorities to address the still high levels of indebtedness in the non-financial corporate sector (for further details, please refer to the report of the First Post-Program Monitoring). Further measures to accelerate the deleveraging process in this sector, whose debt decreased quite significantly in 2014, and the cleaning up of banks' balance sheets, that was reinforced from 2011 onwards, need to be assessed against (i) the impact they will have on debt; (ii) the impact they will have on banks' profitability and, consequently, on banks' capital ratios; and, ultimately, (iii) the impact they will have in terms of financial stability and economic growth, taking also into account the credit demand constraints still faced. In this context, one should bear in mind that, at the end of 2014, about 50 percent of non-performing loans granted to firms on banks' balance sheet were under litigation, thus showing that the swiftness of the judicial system will be key to accelerate the cleaning up of banks' balance sheet.

V. Structural Reforms

Structural reforms are crucial for ensuring sustainable growth, as they play a central role in increasing external competitiveness and potential growth. The commitment to implementing structural reforms was visible during the Program, with several initiatives being launched in a wide range of sectors, and remained firm after the Program's completion, as reforms continued to be implemented and new milestones were achieved regularly, as highlighted in the staff report and thoroughly described in the National Reform Program. This medium-term strategy document includes the updated state of play of most ongoing reforms and also describes the Government's plans going forward.

Regarding product markets, a number of reforms is ongoing and expected to be completed in a near future. In the energy sector, only two measures from the Third Energy Package remain to be fully completed. In the transport infrastructure sector, concessions for urban transportation are proceeding at a good pace: in Porto, the concession was awarded to an international company; while in Lisbon the international tender procedure should be completed by July. The privatizations of CP Carga and EMEF were approved and the process for TAP was relaunched. The merger of Estradas de Portugal and REFER was also formalized, naming the new company Infraestruturas de Portugal. In Public Administration, reforms also continue to occur at a significant pace, namely in the areas of administrative reorganization, courts' efficiency and payment discipline. Regarding the labor market, the Government remains fully committed to implementing reforms in order to promote job creation and skills' upgrading, while reinforcing social cohesion.

While the payoff of many of these reforms is already evident and effective, the benefits from other reforms – and new reforms – take longer to materialize. This should not be considered as a failure nor insufficiency of reform, but as a reflection of the expected time lag in full effectiveness.