INTERNATIONAL MONETARY FUND

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PORTUGAL

August 2015

SECOND POST-PROGRAM MONITORING DISCUSSIONS—PRESS RELEASE; AND STAFF REPORT

In the context of the 2015 Second Post-Program discussions, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse of time basis, following discussions that ended on June 12, 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 July 16, 2015.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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August 6, 2015

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

IMF Executive Board Concludes Second Post-Program Monitoring with Portugal

On July 31, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Second Post-Program Monitoring with Portugal,[1] and endorsed the staff appraisal without a meeting on a lapse-of-time basis.[2]

Portugal's economic recovery remains on track in 2015, boosted by rising exports and consumption, together with a recent upturn in investment. Real GDP expanded by 1.5 percent (year-on-year) in the first quarter, and is projected to increase 1.6 percent for the full year. Fiscal adjustment has slowed, meanwhile, with a structural loosening likely this year. Employment has declined in recent quarters, after increasing sharply from early-2013 through mid-2014, and the unemployment rate was at 13.7 percent at the end of March.

The banking system as a whole remains adequately capitalized, with decreasing reliance on Eurosystem financing, but loan performance has continued to deteriorate. Non-performing loans increased to 12.3 percent at the end of March, putting further pressure on already weak profitability as banks absorb large impairment expenses and high operating costs.

Recent market volatility related to Greece has had limited impact on Portugal, reflecting the country's improving fundamentals in addition to the overall supportive external environment. Portugal has benefitted from favorable commodity prices, low interest rates and a weaker euro. Growth is projected to moderate over the medium term, however, as these supportive cyclical factors weaken and still high public and private debt constrain the pace of recovery.

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[1] The central objective of PPM is to provide for closer monitoring of the policies of members that have substantial Fund credit outstanding following the expiration of their arrangements. Under PPM, members undertake more frequent formal consultation with the Fund than is the case under surveillance, with a particular focus on macroeconomic and structural policies that have a bearing on external viability.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

Executive Board Assessment[3]

In concluding the Second Post-Program Monitoring Discussions with Portugal, Executive Directors endorsed the staff's appraisal, as follows:

The economic recovery remains on track, but the public and private debt overhang is likely to constrain medium-term growth prospects as favorable cyclical factors weaken. The pickup in investment in the first quarter is encouraging, but this will be difficult to sustain without greater efforts to reduce the corporate debt overhang and alleviate structural impediments to reallocating resources away from nonviable and low-productivity firms. Exports have benefitted from the strong recovery underway in Spain, but will need to be supported by faster progress on structural reforms to underpin external competitiveness and expand market share over the medium-term.

Maintaining policy credibility will be essential to ensure favorable financing conditions. With increased financial market volatility in the context of developments in Greece, it is crucial to ensure that investors retain confidence in the direction of economic policies. The authorities have made progress in improving the profile of public debt, but medium-term financing needs remain large, and rising bond market volatility implies significant risks around the baseline financing plan. The authorities should continue to retain a large cash buffer in order to maintain flexibility in implementing their borrowing program.

Further fiscal adjustment is needed to further reduce vulnerabilities from high public debt, particularly given the increased risk of financial market turbulence. The authorities' Stability Program sets appropriately ambitious targets for medium-term debt reduction, but this needs to be accompanied by credible measures to achieve the required fiscal adjustment.

More decisive steps to improve banks' balance sheets are desirable. Weak profitability provides little cushion for banks to absorb further losses, in the context of still-rising non-performing loans. More concerted efforts are needed to reduce operating costs in order to improve financial performance and accelerate the process of balance sheet repair; banks should not rely on economic growth alone to mend their balance sheets.

A more forceful approach to corporate debt work-outs is needed to accelerate the structural transformation of the economy. Corporate debt leaves economic resources excessively tied up in unviable and low-productivity firms, constraining lending to productive firms and weighing on new investment and medium-term growth prospects. The authorities should be proactive in putting in place a coordinated approach to debt work-outs to restructure the debts of viable firms, and move forward with liquidation of those that are no longer viable.

[3] 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.

It will be essential to regain momentum on structural reforms when a newly elected government is formed. The current economic recovery and beginning of a new political cycle presents a favorable opportunity to press ahead with reforms, particularly in the areas of labor market and public sector reform. Moving forward, it is critical to ensure that product market reforms introduced in recent years are fully implemented as intended, to achieve tangible results on the ground. It will also be important to ensure that the difficult reforms that have been undertaken, such as to contain the rise in energy costs, are not reversed.

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	2.2	1.7	1.6	1.5
Public consumption	-0.3	-0.5	0.9	1.1
Gross fixed capital formation	2.5	4.2	2.5	2.4
Exports	3.3	5.5	4.8	4.7
Imports	6.4	4.5	4.8	5.0
Contribution to growth (percentage points)				
Total domestic demand	2.1	1.2	1.6	1.5
Foreign balance	-1.2	0.3	0.0	-0.1
Resource utilization				
Employment	1.6	-0.2	0.6	0.5
Unemployment rate (percent)	13.9	13.4	12.9	12.5
Prices				
GDP deflator	1.3	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	-2.7	-2.5
Primary government balance	0.5	1.6	1.8	1.9
Structural primary balance (percent of potential GDP)	3.6	2.9	2.6	2.2
General government debt	130.2	127.1	124.4	122.0
Current account balance (percent of GDP)	0.6	1.1	0.8	0.6
Nominal GDP (billions of euros)	173.0	177.5	182.6	187.7

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/ In 2014, includes one-off measures from SOE and banking sector support operations, CIT credit, and the upfront costs of mutual agreements for 1.1 percent of GDP.

INTERNATIONAL MONETARY FUND

PORTUGAL

SECOND POST-PROGRAM MONITORING

July 16, 2015

EXECUTIVE SUMMARY

Portugal's economic recovery remains on track, boosted by a generally supportive external environment and a rebound in confidence. Despite recent market volatility related to Greece, Portugal continues to benefit from favorable commodity prices, low interest rates and a weaker euro. Real GDP growth is projected at 1.6 percent for 2015, supported by a pickup in exports and a welcome upturn in investment. But growth is expected to moderate over the medium term as cyclical factors weaken and still high public and private debt constrain the pace of recovery.

Further fiscal adjustment is needed to reduce risks from high public debt, particularly given volatile market conditions. Fiscal adjustment has slowed, with a structural loosening likely in 2015. The authorities' Stability Program sets appropriately ambitious targets for medium-term debt reduction, but this needs to be accompanied by credible measures to achieve the required fiscal adjustment. The authorities have made progress in improving the profile of public debt and retain a large cash buffer, but sizable medium-term financing needs leave Portugal vulnerable to any prolonged financial market turbulence.

More decisive steps to improve banks' balance sheets are needed. Non-performing loans have continued to increase in 2015, while weak profitability provides little cushion for banks to absorb further losses. Banks should not rely on economic growth to mend their balance sheets—they need more concerted efforts to raise additional capital from the markets, address non-performing legacy assets and improve financial performance.

A proactive approach to corporate debt work-outs is needed to accelerate the structural transformation of the economy. Corporate debt leaves economic resources excessively tied up in unviable and low-productivity firms, constraining lending to productive firms and weighing on new investment and medium-term growth prospects. The authorities should introduce a coordinated approach to debt work-outs to restructure viable firms, and liquidate those that are no longer viable.

It will be essential to regain momentum on structural reforms after parliamentary elections later this year. The current economic recovery and beginning of a new political cycle presents a favorable opportunity to press ahead with reforms, particularly in the areas of labor market and public sector reform. To ensure tangible results on the ground, it is also critical that the long list of reforms introduced in recent years is fully implemented.

Approved By
Mahmood Pradhan and Seán Nolan

Discussions took place in Lisbon during June 4–12, 2015. The staff team comprised S. Lall (head), M. Gaertner, D. Gershenson, I. Yackovlev, and L. Zeng (from headquarters) (all EUR); K. Wiseman (SPR); M. Queyranne (FAD); A. Bouveret (MCM); and A. Jaeger (RR). Ms. Lopes (OED) participated in most key meetings. D. Smith 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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ECONOMIC DEVELOPMENTS AND OUTLOOK

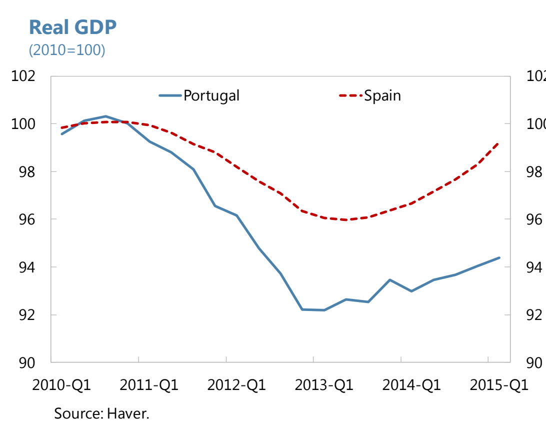
The recovery is poised to continue in 2015, supported by an improved external environment, but raising medium-term growth prospects remains an ongoing challenge. High public and private debt is a significant vulnerability, particularly given potentially volatile financial markets, and will continue to constrain the pace of recovery, as well as medium-term growth.

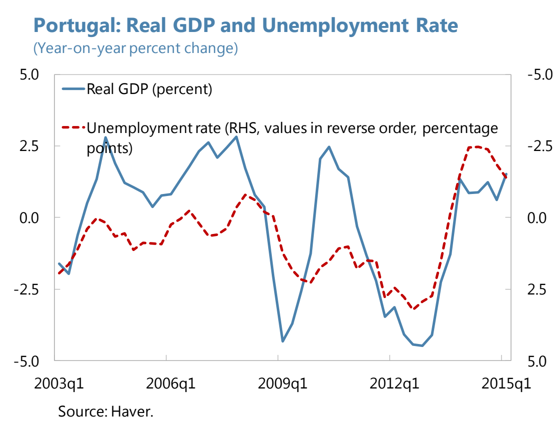
1. Portugal's economic recovery remained on track in the first quarter, supported by a marked upturn in investment and a continued rebound in confidence. Real GDP expanded by 1.5 percent (year-on-year) in Q1, following overall growth of 0.9 percent in 2014. Despite recent market volatility related to Greece, Portugal continues to benefit from favorable movements in commodity prices, interest rates and the euro, all of which are at close to five-year lows. The initiation of the European Central Bank's expanded asset purchase program (QE), in particular, has helped to underpin lower bond yields. Further growth in exports and the recovery in private consumption remained important drivers of economic activity in Q1, but unlike in previous quarters, investment rose rapidly as well. In particular, construction investment posted positive year-on-year growth for the first time since 2007. Still, Portugal's recovery is lagging behind that of Spain, its most important trading partner. Employment has declined in the past two quarters, meanwhile, after rising sharply from early-2013 through mid-2014, and now appears more in line with the pace of recovery. The unemployment rate has edged up as a result, from 13.1 percent in 2014Q3 to 13.7 percent in 2015Q1.[1]

Contributions to Year-on-Year Growth, 2015 Q1
(Percentage points, unless indicated otherwise)

Total domestic demand	**1.6**
Final consumption expenditure	1.5
Public	-0.1
Private	1.6
Gross fixed capital formation	1.3
Structures	0.6
Equipment, machinery	0.7
Changes in inventories	-1.3
Foreign balance	**0.0**
Exports GS	2.7
Imports GS	-2.7
Real GDP growth, percent	**1.5**

Source: INE

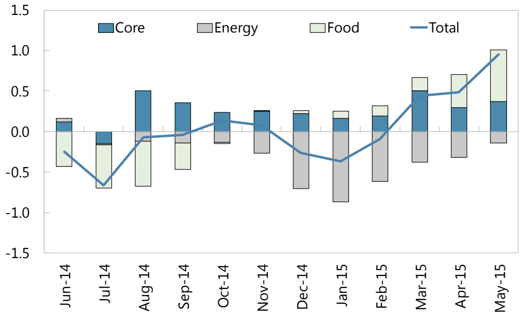




[1] The monthly data through May suggest that labor market conditions continue to improve, but these data are subject to revisions and are therefore not as reliable as the quarterly data.

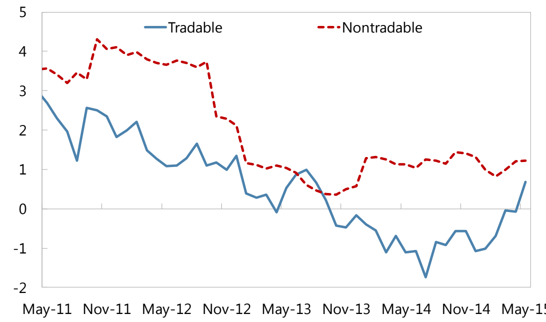
2. Inflation picked up in early 2015, following deflation in 2014. Twelve-month inflation (harmonized CPI) rose to 1.0 percent in May, its highest level since mid-2013, and was 0.6 percentage point above the euro area average. The rise in headline inflation reflects a pick-up in food prices, as well as the diminishing negative impact from the fall in energy prices.

Contributions to yoy Change in Harmonized CPI, by Category (Percentage points)



Source: Haver.

Consumer Price Index
(Weighted average, year-on-year percent change)

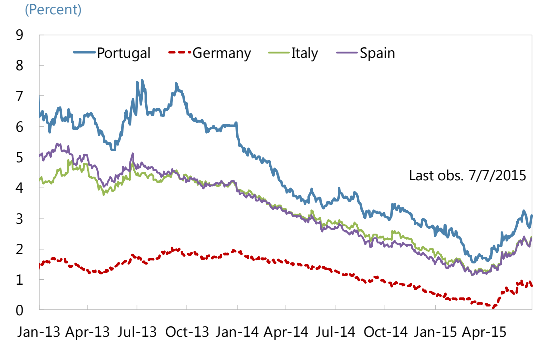


Sources: Haver and Statistics Portugal.

3. Rising exports resulted in a modest widening of the current account surplus in the first quarter. Exports of goods and services rose 5 percent during the first quarter (year-on-year), reflecting strong tourist receipts and the reversal of one-off factors that negatively affected fuel exports in the first half of 2014. The direct impact of the weaker euro on external competitiveness appears likely to be smaller for Portugal than for other euro area countries, due to the large share of Portuguese exports to the euro area, as well as exchange rate depreciation in Angola, Portugal's largest non-euro area export market[2]. Import volumes have also accelerated in line with the recovery in domestic demand, but the impact on the current account has been mitigated so far by lower oil prices.

4. Financing conditions have worsened somewhat since March, but remain manageable. Portuguese bond yields have risen by 160 basis points[3] from the historic lows recorded in mid-March, reflecting both rising yields on German bunds and a modest rebound in spreads after they had narrowed sharply earlier in the year. The response to recent events in Greece has been relatively muted, however, with yields remaining slightly below their mid-June peak. Portugal has already executed three quarters of planned bond issuance for 2015, including a 30-year bond issued in the first quarter at a yield of 4.1 percent. Buybacks of shorter-term debt have further helped to smooth the redemption profile, with the average maturity of public debt increasing from 7.4 to 8.0 years by the end of May. In addition, the authorities retained a cash buffer of €15.9 billion at end-May, sufficient to cover refinancing needs through March 2016.

10 Year Government Bond Yields
(Percent)



Source: Bloomberg.

[2] Exports to Angola dropped by nearly one-fourth (y/y) in the first quarter, as the sharp fall in world oil prices impacted Angolan demand.

[3] As of July 7.

Staff's views

5. The growth forecast for 2015 remains unchanged from the recent Article IV consultation, with risks to the short-term outlook broadly balanced. Real GDP growth is projected to rise to 1.6 percent, supported by a pickup in exports and investment, with possible upside to the near-term outlook mainly from domestic demand. External conditions remain broadly favorable despite recent volatility though risks remain, particularly with respect to growth in partner countries and potential financial contagion in the euro area.

6. Output growth is expected to moderate over the medium-term as cyclical tailwinds fade. High public and private debt, together with structural impediments to resource allocation, are expected to constrain the pace of recovery and weigh on medium-term growth prospects. The recent upturn in investment is encouraging and may suggest an emerging structural transformation of the economy has begun that could produce higher growth over the medium term. But this rebalancing would have to accelerate further over the next several quarters to yield a definitive improvement in medium term growth prospects above the current baseline. Without further progress on structural reforms—and attendant improvements in external competitiveness—GDP growth will be dependent on domestic demand, which is constrained by the slow growth of disposable income and the large debt overhang. In light of the above, staff's medium-term projections rely on the assumption that productivity growth in the medium term will remain broadly in line with historical developments.

7. The potential for prolonged market turbulence associated with events in Greece remains the largest outstanding risk. Portugal's direct trade and financial exposure to Greece is minimal, but the risk of financial market contagion remains. The steps taken by the authorities over the past year to retain a large cash buffer and smooth out their borrowing needs should enable Portugal to withstand short-term volatility, but debt dynamics remain vulnerable in the event of a sustained deterioration in market conditions. In addition, volatility in sovereign debt markets would likely adversely impact the profitability of banks' trading operations. It will be important to maintain Portugal's hard-won and established policy credibility with investors in order to ensure continued favorable market access. Beyond Greece, Portugal's large stocks of public, private, and external debt remain a source of vulnerability, as outlined in the 2015 Article IV consultation.

Authorities' views

8. The authorities believe that reforms in recent years have laid the foundation for a structural transformation toward stronger export-oriented growth. The recovery has been export-led to date, which they view as a permanent feature of a reformed Portuguese economy, reflected in recent market share gains. The authorities were also encouraged by the composition of the recent pick-up in investment; in contrast to the pre-crisis trend of heavy investment in construction and the non-tradable sector, recent investment has been concentrated in machinery and equipment and focused on firms in the tradable sector.

9. Structural reforms have promoted a more efficient allocation of resources towards higher-productivity firms that will be the engine of growth. Lending to exporting firms has increased as bank balance sheet repair has permitted some reallocation of credit, even as the deleveraging process is driving credit down on aggregate. High-productivity firms are expected to hire more staff in anticipation of sustained growth going forward, facilitated by a more flexible labor market. In view of these developments, the authorities project an acceleration in potential output growth, led by a rebound in total factor productivity growth from its long-run decline.

10. The authorities were confident that they are well-insulated from any short-term volatility related to Greece. They believe that their cash buffer is sufficient to successfully navigate short-term market turbulence, and that their record of fiscal adjustment and reform implementation has strengthened both their credibility among investors and the resiliency of the economy. The authorities intend to maintain a cash buffer sufficient to cover at least 6 months of gross financing needs on a rolling basis through 2017. They noted that the investor base has continued to diversify in both geography and investor type, with increasing participation from traditionally risk averse, buy and hold segments, including pension and insurance funds.

SECURING HIGHER GROWTH AND ADDRESSING UNDERLYING VULNERABILITIES

Reducing debt-related vulnerabilities requires further fiscal adjustment, and continued efforts to boost growth prospects by addressing the corporate debt overhang and advancing structural reforms. Further structural reforms to improve competitiveness are needed to move Portugal to a higher-growth trajectory and allow the economy to fully utilize available resources, especially labor.

A. Fiscal Policy

11. There is a tangible risk that the 2015 fiscal deficit target of 2.7 percent of GDP will not be met without additional spending restraint. Cash-based fiscal data show improved revenue performance during January-May, particularly from VAT. This is partly due to the continued rebound in consumption and improved compliance, but also reflected a slowdown in refund payments in the first quarter during the transition to new procedures for verification. VAT refund payments have begun to pick up in the second quarter, and are expected to further catch up in the remainder of the year. In addition, data for January-May suggests that corporate and personal income tax receipts are likely to fall short of the budget target. In the absence of steps to reduce primary spending, staff projects a full-year deficit of 3.2 percent of GDP, which would imply a structural easing of 0.7 percent of GDP this year.

12. The authorities' Stability Program for 2015–19 (SP) sets ambitious goals for reducing public debt over the medium-term. The SP targets a decline in public debt to 107.6 percent of GDP by 2019, broadly in line with staff's recommendation from the recent Article IV consultation. The SP proposes the rollback of a number of key revenue and spending measures adopted under the adjustment program, with sizable savings anticipated from streamlining public services, rationalizing the public wage bill and reducing social security spending and interest costs.

13. The structural fiscal agenda has focused on completing measures adopted under the adjustment program, with no new initiatives expected in the near term. The authorities have accelerated the pace of privatizations (the winning bidder for TAP was announced in June 2015) and concessions (for Porto and Lisbon public transport systems). They also aim to finalize PPP renegotiations in the road sector to reduce future service payments. In addition, the draft Budget Framework Law (BFL), which aims to reduce budget fragmentation and strengthen the Treasury Single Account, is expected to be approved by parliament by end-July.

Staff's views

14. Putting public debt on a firmly downward trajectory will require the articulation of concrete measures to underpin the fiscal goals in the SP. The SP sets appropriately ambitious targets for debt reduction, but is predicated on optimistic medium-term growth assumptions, as also highlighted by the Public Finance Council[4] in its assessment of the macroeconomic projections. In addition, the SP provides little specificity on the measures that will be implemented to realize the envisaged expenditure rationalization. The proposed savings on the public sector wage bill, social benefits and pension outlays, in particular, appear overly optimistic when compared to recent spending trends (see text table). Specific spending measures to achieve the required fiscal adjustment are necessary to give credibility to the targets in the SP; under staff's baseline, an annual structural primary adjustment of about ½ percent of GDP from 2016–19 will be needed. Priorities for medium-term spending reform should include rationalizing public employment, streamlining public administration and services, and containing health and pension-related spending pressures, as highlighted in the 2015 Article IV consultation.

Change in General Government Expenditure (ppts of GDP)

	2010-2014	2015-2019*
Total expenditure	-2.8	-4.7
Primary Expenditure	-4.9	-3.3
Current spending	0.5	-4.6
Compensation of employees	-1.9	-1.2
Goods and services	0.0	-0.7
Interest payments	2.1	-1.4
Subsidies	0.0	0.0
Social benefits	1.1	-1.1
Other expense	-0.8	-0.1
Capital spending	-3.3	-0.1

Sources: Eurostat, Authorities, and IMF staff calculations.
* 2015-2019 SP projections

15. A national expenditure rule that sets targets for each level of government could help anchor fiscal consolidation and avoid the need for less growth-friendly revenue measures. This would 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 an expenditure rule should cover general government primary expenditure to neutralize the impact of shifts in financial market conditions on interest costs. It could also exclude cyclical spending (such as unemployment benefits), in line with the EU's expenditure benchmark.

[4] The Public Finance Council is an independent body responsible for providing assessments of the government's budgets and medium-term fiscal program, including the underlying macroeconomic assumptions, as well as monitoring budget execution, public debt sustainability, and compliance with established fiscal rules.

16. The authorities should move cautiously in reversing key revenue measures adopted in recent years. Lower revenues than projected or insufficient spending adjustment would require postponing or partially cancelling the proposed phasing out of the PIT surcharge, the extraordinary contributions on energy and natural gas, and the reform of real estate taxes. The proposed gradual reduction in the CIT statutory rate will also need to be carefully assessed each year, to avoid revenue shortfalls.

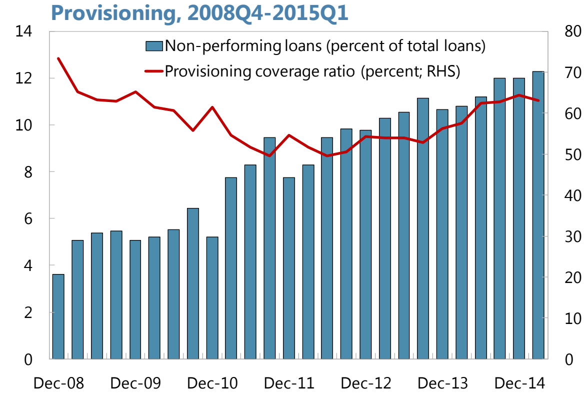
Authorities' views

17. The authorities are committed to exiting the EU's Excessive Deficit Procedure this year, and remain confident that the 2015 deficit target is well within reach. They have been encouraged by the results from their efforts to reduce fraudulent VAT refund claims, and are convinced that the positive revenue outturn for January-May largely reflects improved compliance that will be sustained for the remainder of the year. In addition, they expect that any revenue shortfall or spending pressures could be accommodated within the budgeted contingency reserve. The authorities are committed to the medium-term goals laid out in the SP, which have been designed to comply with EU rules under the Stability and Growth Pact, and indicated that more concrete spending proposals would follow in the 2016 budget as needed. The authorities agreed that fiscal consolidation should be more expenditure-based, but see challenges in introducing an expenditure rule across the general government given the constitutional autonomy of regional and local governments.

B. Financial Sector

18. Overall financial stability has been maintained in a gradually improving operating environment, but bank profitability remains weak (Figure 3)**.** Most of the large banks reported profits in the first quarter, but this largely reflected income from trading activity as they continue to struggle with high operating costs and additional impairment expenses. Impairment charges amounted to €963 million in 2015Q1, driven by the still rising levels of non-performing loans; the latter increased to 12.3 percent of gross loans at end-March from 11.9 percent at end-December 2014. The banking system remains adequately capitalized, but weak profitability continues to put pressure on Common Equity Tier 1 capital, which fell to 11.1 percent as of end-March. Banks' loan-to-deposit ratio remains unchanged from end-2014 at 107 percent, while the reliance on Eurosystem financing remained broadly stable at 6 percent of total banking system liabilities at end-May (€28.5 billion) down from 9 percent at the end of 2013.

Portugal: Non-Performing Loans and Provisioning, 2008Q4-2015Q1



Source: Bank of Portugal

19. The sale of Novo Banco is proceeding broadly as planned. Binding offers from three bidders were received in late June. The regulatory approval process will begin once a contract with the winning bidder has been signed. The sale is expected to be finalized once regulatory approval is granted, a process that will likely take several months[5]. The authorities have not yet specified the details of the loss allocation mechanism, in the event that the sale price does not fully cover Resolution Fund liabilities.

20. Non-bank financial institutions account for a small share of financial sector assets, but there are strong inter-linkages between banks and non-banks in Portugal. Most large insurance companies and pension funds (ICPFs) and investment funds are owned by financial groups also involved in commercial banking, and have significant exposures to the group bank, which in turn impacts their liquidity and funding strategies (Box 1). However, the insurance sector in Portugal was reported to be better positioned than many of its European peers, with a low duration mismatch (1.3 years) and a positive investment spread (1.3 percent)[6].

21. The pace of deleveraging has slowed, but access to finance is increasingly uneven across firms. Loans to private NFCs increased by just €246 million in 2015Q1 (up 0.3 percent from the end of 2014), but large corporations enjoyed increased access to credit while lending to micro and small NFCs contracted by €426 million (down 0.9 percent). Export-oriented firms with higher productivity appear to have comfortable access to financing, as banks compete to provide funding to this segment of the corporate sector.

Staff's views

22. Low profitability is the main challenge confronting the banking sector. With further provisioning against bad loans likely to continue to weigh on banks' financial performance, banks should not rely on economic growth alone to mend their balance sheets. More concerted efforts are needed to strengthen their capital positions to create room to absorb further losses, including raising additional capital from markets, taking steps to rein in operating costs and shedding non-performing legacy assets in order to accelerate the process of balance sheet repair and improve financial performance. The authorities should reduce uncertainty by clarifying the loss allocation mechanism among banks arising from the sale of Novo Banco.

23. A more forceful approach to corporate debt resolution is needed to accelerate the reallocation of resources to more productive firms. There is a large segment of potentially viable but overly leveraged firms that are unable to obtain financing. A coordinated approach is required to bring together firm owners, creditors, and potential new investors to restructure the debts of these firms and create space for new investment. At the same time, a large share of bank assets remains tied up in unproductive firms that are no longer viable. More concerted efforts to liquidate

[5] The timing of the sale of Novo Banco will have implications for the fiscal outturn reported for 2014, which will be restated to reflect the fiscal cost of the public recapitalization of the bank.

[6] Based on the latest round of stress tests conducted by the European Insurance and Occupational Pensions Authority (EIOPA).

these entities are needed in order to allow the reallocation of financial resources to more productive firms that would contribute to medium-term growth.[7]

Authorities' views

24. The authorities stressed that the profitability and solvency of banks is gradually improving. Banks are expected to have lower impairments and lower costs by next year and should be able to take advantage of market conditions to increase capital, which would further strengthen financial stability.

25. The authorities do not see excessive private corporate debt as a major constraint on overall growth in the short term. They prefer a more gradual pace of debt-workouts in order to maintain at manageable levels the potential need for additional bank capital and minimize the near term adverse impact on growth, and are of the view that the current approach is working quite well, as evidenced by the ample access to credit for productive, export-oriented firms. They are also optimistic that recovering collateral values, as real estate prices recover from an excessive decline in recent years, will help reduce the need for further capital increases. The authorities expressed concern that accelerated restructuring could endanger financial stability and result in idle liquidity at banks, with little impact on lending.

C. Structural reforms

26. With the government approaching the end of its current term, the authorities' have focused on wrapping up some of the reforms started under the program. The authorities have pressed ahead with measures aimed at containing energy costs, especially natural gas prices, improving services of transport and water SOEs, and privatizing air and railway enterprises (for details on measures, see Boxes 2 and 3). At the same time, new efforts to reform labor markets and to increase the effectiveness of the public sector appear to have stalled.

Staff's views

27. Rebalancing the economy will require continued structural reform efforts. Job creation for lower-skilled workers and raising investment by viable firms will remain key to achieving faster medium-term growth. Product market reforms that are now on paper need to be effectively implemented with an eye to producing tangible results in terms of lower cost and higher quality of goods and services. Moreover, new pressures to add to already existing overcapacities in the energy and transport sectors should be resisted. The impact of past labor market reforms needs to be assessed, while fresh reform initiatives regarding employment protection rules and collective bargaining are needed. In addition, a still large and inefficient public sector remains a source of high transaction costs; improving the efficiency of public administration, SOEs, and courts, while

[7] For further details, see the staff report to the 2015 Article IV Consultation and the accompanying Selected Issues Paper, "Supporting Medium-Term Growth through Corporate Debt Restructuring: Progress, Impediments and Challenges."

increasing the payments discipline of public sector entities, would boost potential growth. The current environment presents a favorable opportunity to press ahead with reforms.

Authorities' views

28. Reform efforts have continued in many areas, and pay-offs are already visible on many fronts. Key and politically difficult reforms regarding SOEs and privatization have continued to advance at a good pace. At the same time, improvements in international competitiveness rankings, confidence indicators, and selected statistics on job creation, retirement behavior, investments, and export activities all point to increasing pay-offs from past reforms. While agreeing in principle that more needs to be done, the authorities reiterated their view that more time should be given for the reforms already implemented to produce results.

FINANCING AND POST-PROGRAM MONITORING

Portugal has taken advantage of favorable financing conditions to improve the structure of public debt and reduce interest costs, including through partial early repurchases with the Fund. Nevertheless, medium-term financing needs remain sizable, while rising bond market volatility implies significant risks around the baseline financing plan.

29. Debt operations in 2015 have helped to improve the structure of public debt considerably. Following early repurchases in March and June totaling SDR 6.6 billion, no further amortization is due to the Fund until the second quarter of 2018. Portugal has received approval from its European partners for total early repayment of SDR 11.5 billion. The authorities anticipate that this would be completed by March 2016, which is reflected in staff's baseline projections. This schedule would still keep Portugal above the 200 percent of quota indicative threshold for post program monitoring through March 2022, as under the original repurchase schedule.

30. While medium-term financing needs still remain large, Portugal's capacity to repay the Fund is adequate. Public debt is expected to have peaked in 2014, and should start on a declining trend, although the level of debt is projected to still remain above 118 percent of GDP at the end of 2020. Recent debt operations have reduced debt redemptions to an average of about €13 billion per year in 2016–20, of which Fund repurchases represent 20 percent; this would be further reduced by the remaining prepayment already approved. This appears manageable, assuming no reversal in market access or in fiscal and structural policies. However, a sudden change in market sentiment due to concerns about the direction of economic policies or re-pricing of risk could render Portugal's capacity to repay more vulnerable. The authorities recently assessed the cost of a uniform rise of 100 basis points across all debt instruments at €400 million for 2015, rising to €1 billion annually by 2019.

STAFF APPRAISAL

31. The economic recovery remains on track, but the public and private debt overhang is likely to constrain medium-term growth prospects as favorable cyclical factors weaken. The pickup in investment in the first quarter is encouraging, but this will be difficult to sustain without greater efforts to reduce the corporate debt overhang and alleviate structural impediments to reallocating resources away from nonviable and low-productivity firms. Exports have benefitted from the strong recovery underway in Spain, but will need to be supported by faster progress on structural reforms to underpin external competitiveness and expand market share over the medium-term.

32. Maintaining policy credibility will be essential to ensure favorable financing conditions. With increased financial market volatility in the context of developments in Greece, it is crucial to ensure that investors retain confidence in the direction of economic policies. The authorities have made progress in improving the profile of public debt, but medium-term financing needs remain large, and rising bond market volatility implies significant risks around the baseline financing plan. The authorities should continue to retain a large cash buffer in order to maintain flexibility in implementing their borrowing program.

33. Further fiscal adjustment is needed to further reduce vulnerabilities from high public debt, particularly given the increased risk of financial market turbulence. The authorities' Stability Program sets appropriately ambitious targets for medium-term debt reduction, but this needs to be accompanied by credible measures to achieve the required fiscal adjustment.

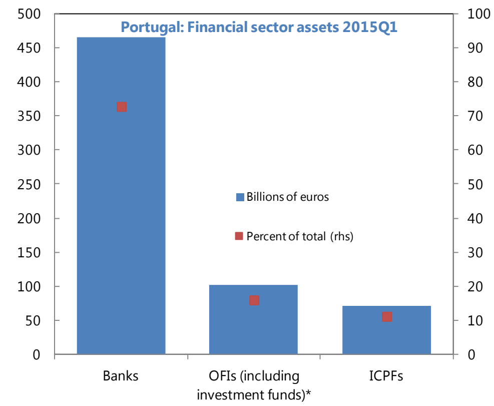
34. More decisive steps to improve banks' balance sheets are desirable. Weak profitability provides little cushion for banks to absorb further losses, in the context of still-rising non-performing loans. More concerted efforts are needed to reduce operating costs in order to improve financial performance and accelerate the process of balance sheet repair; banks should not rely on economic growth alone to mend their balance sheets.

35. A more forceful approach to corporate debt work-outs is needed to accelerate the structural transformation of the economy. Corporate debt leaves economic resources excessively tied up in unviable and low-productivity firms, constraining lending to productive firms and weighing on new investment and medium-term growth prospects. The authorities should be proactive in putting in place a coordinated approach to debt work-outs to restructure the debts of viable firms, and move forward with liquidation of those that are no longer viable.

It will be essential to regain momentum on structural reforms when a newly elected government is formed. The current economic recovery and beginning of a new political cycle presents a favorable opportunity to press ahead with reforms, particularly in the areas of labor market and public sector reform. Moving forward, it is critical to ensure that product market reforms introduced in recent years are fully implemented as intended, to achieve tangible results on the ground. It will also be important to ensure that the difficult reforms that have been undertaken, such as to contain the rise in energy costs, are not reversed.

Box 1. Non-Bank Financial Institutions in Portugal

Non-bank financial institutions (NBFI) account for a small share of financial sector assets compared to banks. Insurance Corporations and Pension Funds (ICPFs) account for 10 percent of financial sector assets (€71 billion) and Other Financial Intermediaries for 16 percent (€102 billion, including €28 billion for investment funds), while banks account for around ¾ of the total (€465 billion). Investment funds are mainly exposed to real estate (50 percent of investment funds assets) and bonds (25 percent).



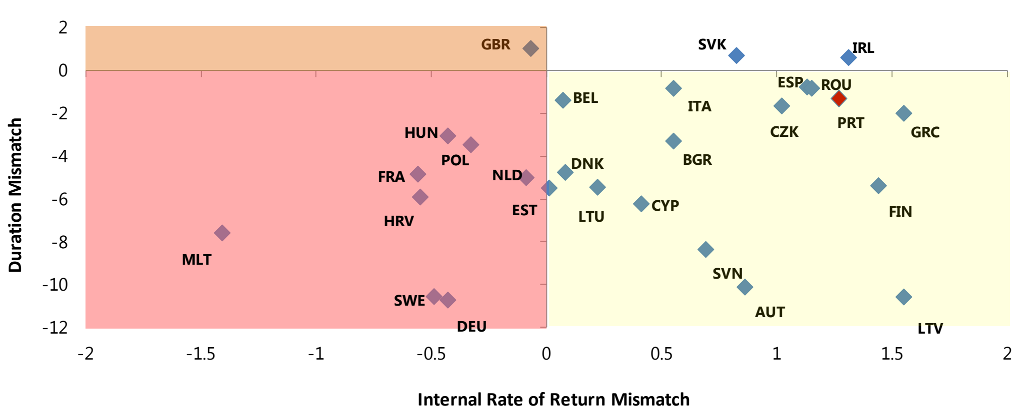
*2014Q1 data for OFIs.
Sources: ASF; ECB; and IMF staff estimates.

Risks to NBFIs stemming from a low interest rate environment remain limited. In the latest round of stress tests conducted by the European Insurance and Occupational Pensions Authority (EIOPA), the insurance sector in Portugal was reported to be better positioned than many of its European peers, with a low duration mismatch (1.3 years) and a positive investment spread (1.3 percent). On the asset side, Portuguese sovereign bonds account for more than 30 percent of assets, offering higher yields than other European sovereigns, but also generating sovereign-NBFI linkages. On the liability side, insurance corporations offer guaranteed rates for only one year, which reduces the risk of a mismatch between the return on assets and liabilities.

There are strong interlinkages between banks and NBFIs in Portugal. Most of the large ICPFs and investment funds belong to banking groups. Intragroup exposures are significant, although encouragingly declining, at 15.9 percent of ICPFs' assets in 2014 (compared to 23 percent in 2013). The life insurance business, in particular, is driven by the financial group funding and liquidity strategy. Depending on the needs of the group, household savings are channeled to deposits, insurance products, investment funds or other savings schemes.

Figure 1. Europe: Duration Mismatches and Negative Investment Spreads, 2013

(Baseline; percent)



Source: European Insurance and Occupational Pensions Authority.

Box 2. Status of and Prospects for Structural Reforms (continued)

As reported in the 2015 Article IV consultation (*IMF Country Report 15/126*), staff undertook a survey of Portuguese firms in March to identify their views on the effectiveness of specific structural reform measures already implemented and on the need for new reform measures.[1] Their views, already reported in the earlier documents, are summarized in columns 2 and 3 below; column 4 describes the status of ongoing or planned reform actions.

	Perceived impact of reforms so far[2]	Perceived urgency of more reforms[2]	Ongoing or Planned Reform Actions
Product market reforms			
Licensing environment			(1) Implementation of the recent adopted licensing regimes (e.g. commercial, industrial, spatial planning).
Energy costs			(1) Audit revised CMEC calculation method. (2) Implementation of new co-generation regime. (3) Implementation of new remuneration scheme for renewables. (4) Introduce coal-plant levy. (5) Reduce regions' costs of producing energy. (6) Negotiate full integration of MIGAS. (7) Follow up on the energy interconnections, that aims strengthening the links between Iberian countries and France. (8) Implementation of levy to reduce natural gas prices. (9) Review legal regime of oil sector.
Costs of telecommunication and postal services			(1) Implementation of reforms adopted during the program.
Costs of road use			(1) Implementation of reforms adopted during the program.
Costs of using railways			(1) Implementation of strategic plan for transports. (2) Privatizate CP Carga. (3) Implementation of the merger of Estradas de Portugal and REFER.
Cost of using ports			(1) Renegotiate Port concession contracts. (2) Adopt new concessions framework law for new contracts.
Costs of professional services			(1) Adopt new professional bodies by-laws.
Costs of other services			(1) Finalize the legal transposition of the Services Directive and full implementation. (2) Adopt the new construction services laws.
Enforcement of competition			(1) Full implementation of the transports regulator.
Labor market reforms			
Increases in work time			(1) Implementation of reforms adopted during the program.
Increases in work time flexibility			(1) Implementation of reforms adopted during the program.
Collective bargaining			(1) Implementation of reforms adopted during the program.
Hiring and firing costs			(1) Implementation of reforms adopted during the program.
Active labor market policies			(1) Continue implementation of Estimulo Emprego, Estagios Emprego, Apoio a mobilidade, Incentivo emprego e Reativar, Garantia Emprego, Emprego jovem activo, and Invest jovem.
Effectiveness of employment agencies			(1) Implementation of reforms adopted during the program.
Education	Not surveyed.	Not surveyed.	(1) Set up European quality assurance in vocational education and training. (2) Implementation of new monotiring tool that covers financial and performance KPIs. (3) New business schools of reference. (4) GPEARI to evaluate education reforms by end-2015.

[1] About 200 large non-financial firms and about 300 relatively successful SME's were sent surveys in March 2015, with the sample weighted towards manufacturers and exporters, who are expected to be most sensitive to structural reforms. The 17.4 percent response rate, healthy for a voluntary firm survey, consisting of two-thirds exporters and a plurality of manufacturers. For discussion of the survey methodology, see the 2015 Selected Issues Paper "Taking Stock of Structural Reforms: A Firm-Level Perspective."

[2] For perceived impact, firms had the choice between "no impact" (score=-1), "some impact" (score=0), or "significant impact" (score=1). For perceived urgency of more reforms to increase firms' competitiveness and growth prospects, 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." Colors reflect average scores: red below -0.5; orange between -0.5 and 0; light green between 0 and 0.5; and dark green above 0.5.

Box 2. Status of and Prospects for Structural Reforms (concluded)

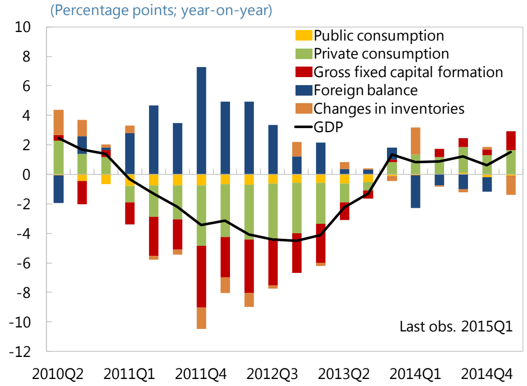
	Perceived impact of reforms so far[2]	Perceived urgency of more reforms[2]	Ongoing or Planned Reform Actions
Public sector reforms			
Effectiveness of central administration			(1) Adopt Budgetary Framework Law (BFL). (2) Adopt the Single Supplement scheme. (3) Adopt the Single Wage scheme. (4) Simplify administrative procedures.
Effectiveness of local administrations			(1) Implementation of Program Aproximar (decentralization of education, health, social safety net, and culture.)
Costs of paying taxes			(1) Implementation of strategic plan to fight tax evasion. (2) Adopt exchange of information between public entities to fight tax evasion on rental market.
Effectiveness of VAT re-imbursement			(1) Implementation of reforms adopted during the program.
Investment incentives			(1) Reorganize National Innovation Agency to improve the cooperation between firms and scientific and technological institutions. (2) Define competitiveness clusters to channel public support for exporting and import substitution activities through dynamic business cooperation and R&D that adds value to tradable goods. (3) Implementation of the national strategy for research and innovation. (4) Implementation of "Agenda Portugal Digital" that aims to stimulate the digital economy, the information technology, communication and electronics sector.
Payment on time by central administration			(1) Keep reducing the stock of arrears program.
Payment on time by local administrations			(1) Make Municipal Assistance Fund operational. (2) Complete Madeira financial assistance program.
Payment on time by SOEs			(1) Continue arrears clearing program, including capital increases of hospitals SOEs.
Quality of services provided by SOEs			(1) Implementation of the merger of Estradas de Portugal and REFER. (2) Privatize TAP. (3) Implementation of transport concessions (Carris and Metro in Lisbon; public transports in Porto). (4) Reform of water system. (5) Improve the operational balance of SOEs.
Privatization program			(1) Continue privatizations program: TAP; CP Carga; EMEF; EGF.
Effectiveness of labor courts			(1) Fully implement judiciary map. (2) GPEARI to evaluate reforms in justice by end-2015.
Effectivess of litigation courts			(1) Fully implement judiciary map. (2) GPEARI to evaluate reforms in justice by end-2015.
Effectiveness of civil and commercial courts			(1) Fully implement judiciary map. (2) GPEARI to evaluate reforms in justice by end-2015.
Effectiveness of alternatives to litigation			(1) Implementation of reforms adopted during the program.
Financial sector and insolvency reforms			
Efficiency of insolvency framework			(1) Implementation of reforms adopted during the program.
Out-of-court debt restructuring framework (PER)			(1) Implementation of PER legislative changes.
Out-of-court debt restructuring framework (SIREVE)			(1) Implementation of SIREVE legislative changes.
Provision of alternative financing options			(1) Prepare new legal framework for real estate investment firms. (2) Review the credit mediator regime. (3) Make Development Finance Institution (DFI) operational.
Efficiency of credit allocation by banks			(1) Implementation of Single Supervisory Mechanism (SSM). (2) Implementation of Early Warning System by the BoP.

Sources: Survey; and IMF staff estimates.

Figure 1. Recovery Continues, Challenges Remain

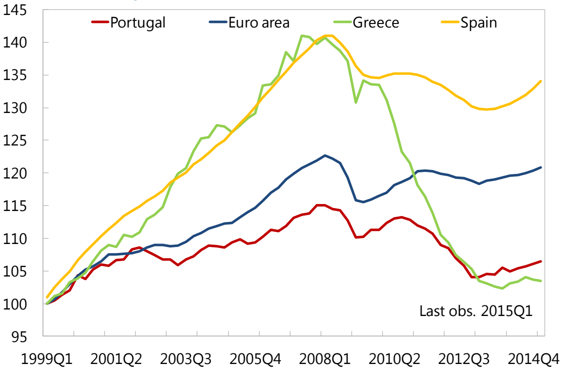
Investment is finally picking up.

Contributions to Real GDP Growth
(Percentage points; year-on-year)



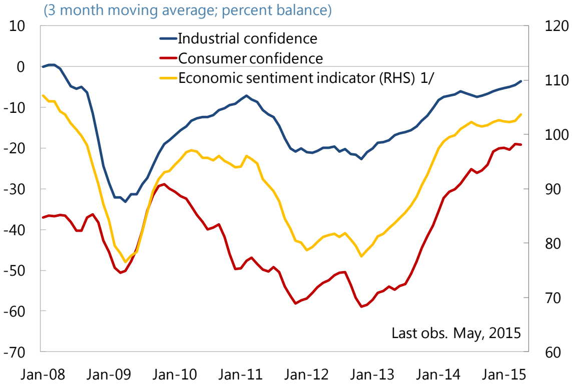
Portugal is growing at par with the euro area, but is not converging.

Real GDP
(Index, 1999Q1=100)



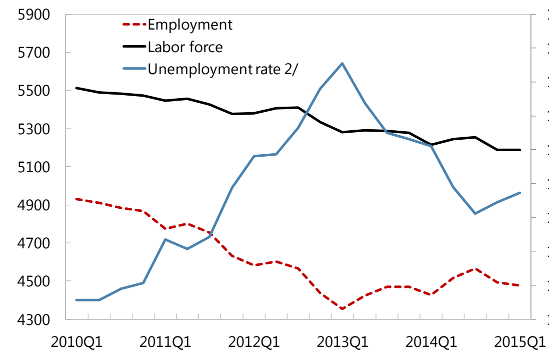
Confidence indicators remain strong....

Confidence Indicators
(3 month moving average; percent balance)



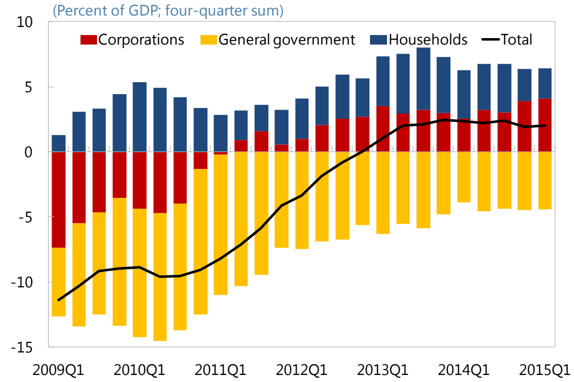
...but unemployment stays high.

Labor Market Indicators
(Thousands of people)



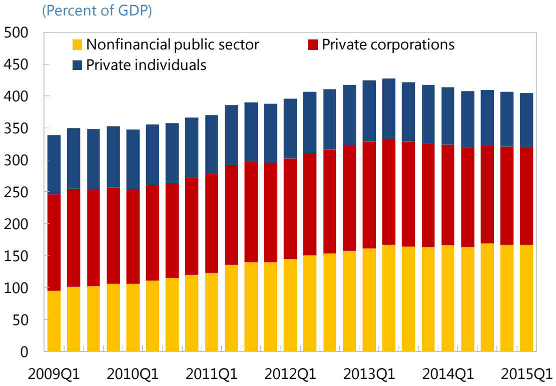
The country stopped borrowing two years ago ...

Net Lending by Sector
(Percent of GDP; four-quarter sum)



...but debt is declining only gradually.

Nonfinancial Sector Debt 3/
(Percent of GDP)



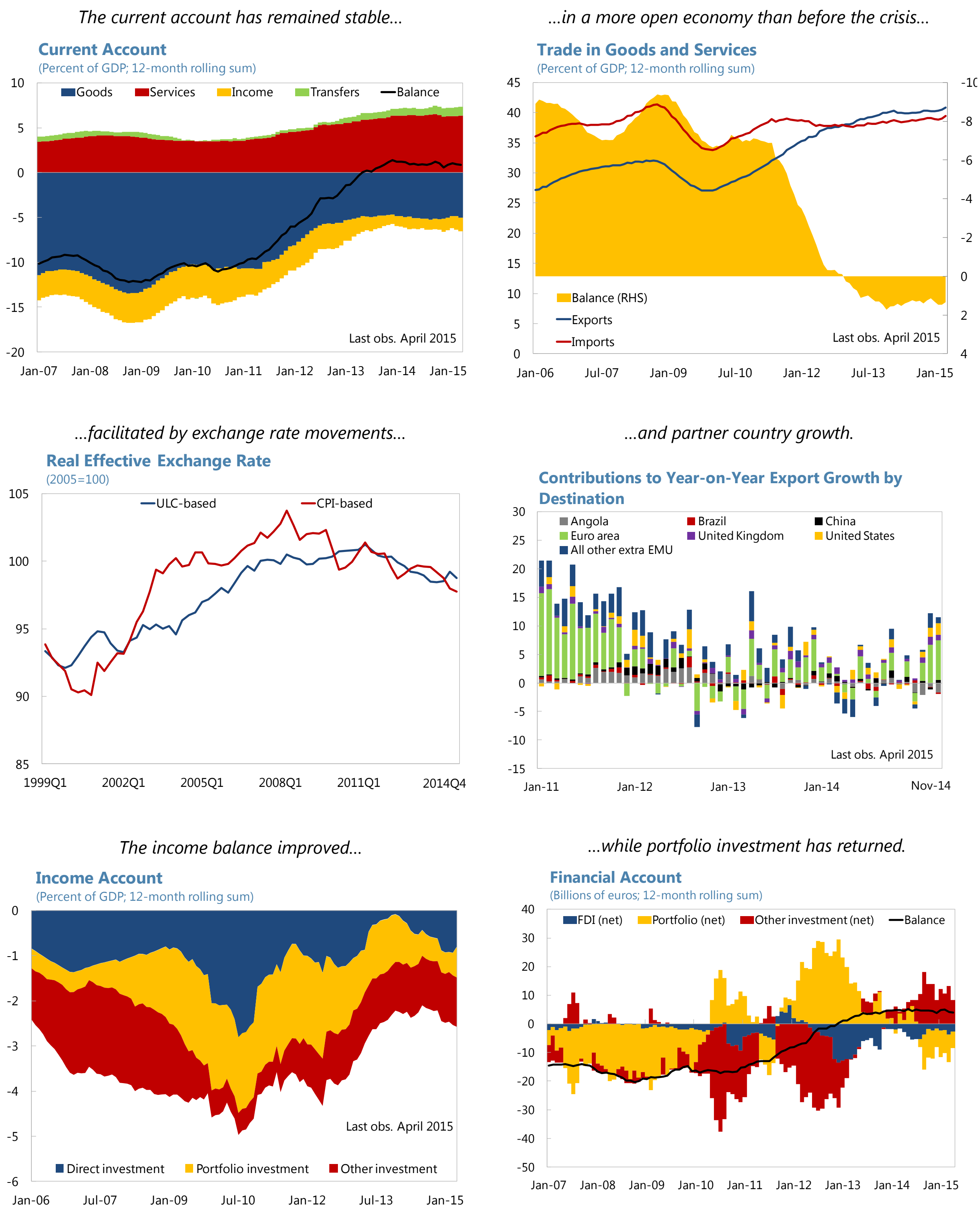
Sources: Haver; and INE.

1/ Long term average = 100.

2/ Percent; right hand scale.

3/ Non-consolidated debt.

Figure 2. Portugal, Balance of Payments Developments

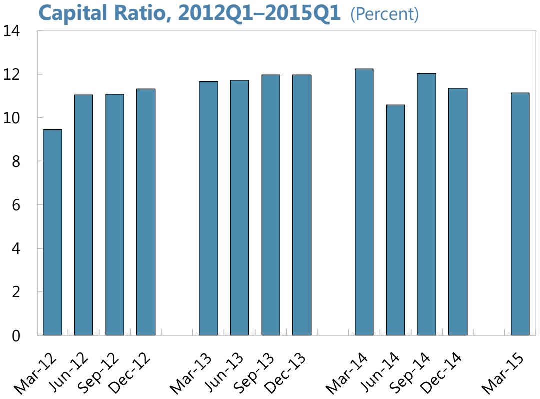


Sources: INE; Bank of Portugal; Eurostat; and IMF staff calculations.

Figure 3. Financial Sector Developments

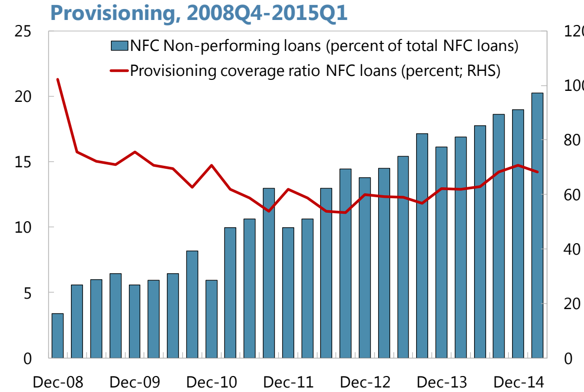
Capital remains broadly stable…

Portugal: Core Tier 1/Common Equity Tier 1 Capital Ratio, 2012Q1–2015Q1 (Percent)



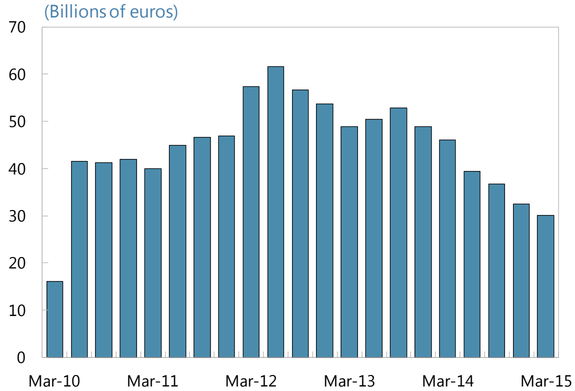
…and provisioning of NFC loans increased.

Portugal: NFC Non-Performing Loans and Provisioning, 2008Q4-2015Q1



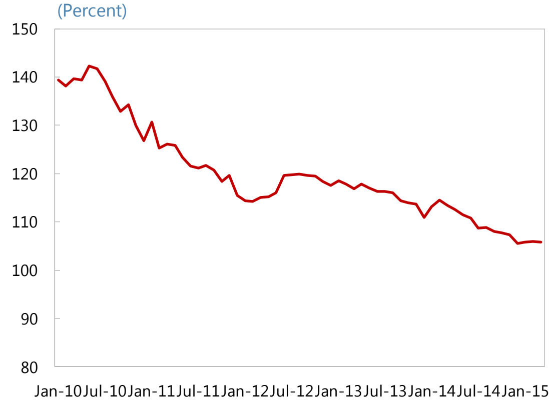
Reliance on the Eurosystem is waning…

Portugal: Eurosystem Financing, 2010–Mar 2015
(Billions of euros)



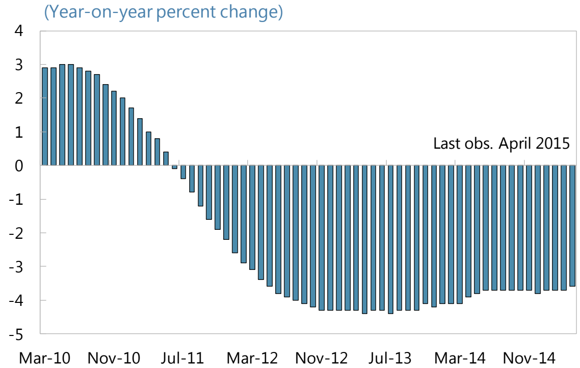
…and loan-to-deposit ratios are falling.

Portugal: Loan to Deposit Ratio, 2010–Mar 2015
(Percent)



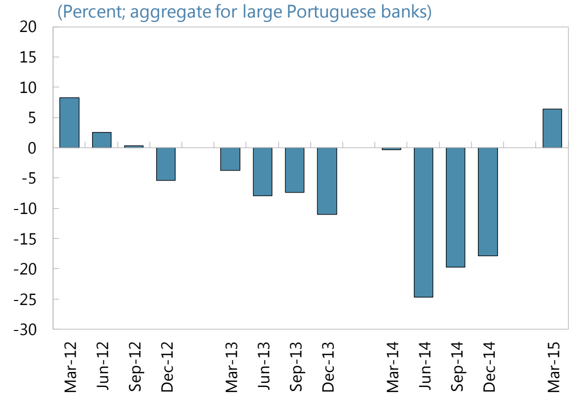
Although lending continues to contract…

Portugal: Private Sector Credit, Mar 2010–Apr 2015
(Year-on-year percent change)



…and profitability remains low.

Portugal: Return on Equity, 2012–Mar 2015
(Percent; aggregate for large Portuguese banks)



Sources: Haver Analytics; Bank of Portugal; and IMF staff calculations.

Table 1. Portugal: Selected Economic Indicators, 2012–20
(Year-on-year percent change, unless otherwise indicated)

	2012	2013	2014	2015 Article IV	2015 2nd PPM	2016	2017	2018	2019	2020
				Projections 1/						
Real GDP	-4.0	-1.6	0.9	1.6	1.6	1.5	1.4	1.3	1.2	1.2
Total domestic demand	-7.3	-2.5	2.1	1.0	1.2	1.6	1.5	1.4	1.3	1.2
Private consumption	-5.5	-1.5	2.2	1.7	1.7	1.6	1.5	1.3	1.1	1.1
Public consumption	-3.3	-2.4	-0.3	-0.5	-0.5	0.9	1.1	0.8	0.7	0.5
Gross fixed investment	-16.6	-6.7	2.5	3.1	4.2	2.5	2.4	2.4	2.4	2.4
Private	-13.2	-5.3	2.7	0.0	1.3	2.2	2.6	2.6	2.6	2.6
Government	-31.3	-14.4	0.9	21.7	22.0	3.7	1.4	1.2	1.2	1.1
Exports	3.4	6.4	3.3	5.5	5.5	4.8	4.7	4.5	4.4	4.3
Imports	-6.3	3.9	6.4	4.0	4.5	4.8	5.0	4.8	4.6	4.5
Contribution to Growth										
Total domestic demand	-7.6	-2.5	2.1	1.0	1.2	1.6	1.5	1.4	1.3	1.3
Private consumption	-3.6	-1.0	1.4	1.1	1.1	1.1	1.0	0.9	0.7	0.7
Public consumption	-0.7	-0.5	-0.1	-0.1	-0.1	0.2	0.2	0.2	0.1	0.1
Gross fixed investment	-3.1	-1.1	0.4	0.5	0.6	0.4	0.4	0.4	0.4	0.4
Foreign balance	3.6	0.9	-1.2	0.6	0.3	0.0	-0.1	-0.2	-0.1	-0.1
Savings-investment balance (percent of GDP)										
Gross national savings	14.1	15.0	15.5	15.9	15.9	16.0	16.0	15.9	16.1	16.4
Private	18.3	17.7	17.9	16.6	16.6	16.3	16.0	15.8	16.1	16.4
Public	-4.2	-2.7	-2.4	-0.7	-0.7	-0.3	0.0	0.1	0.1	0.0
Gross domestic investment	15.7	14.5	14.9	14.6	14.8	15.2	15.4	15.6	16.0	16.3
Private	13.3	12.4	12.8	12.2	12.4	12.8	13.0	13.2	13.5	13.8
Public	2.5	2.1	2.1	2.5	2.4	2.4	2.4	2.4	2.5	2.5
Resource utilization										
Potential GDP	-0.9	-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	-4.9	-3.1	-3.2	-1.8	-0.8	-0.3	-0.1	0.0
Employment	-4.1	-2.6	1.6	0.2	-0.2	0.6	0.5	0.5	0.5	0.5
Unemployment rate (%)	15.5	16.2	13.9	13.1	13.4	12.9	12.5	12.0	11.6	11.2
Prices										
GDP deflator	-0.4	2.2	1.3	1.0	1.0	1.3	1.3	1.4	1.5	1.6
Consumer prices (harmonized index)	2.8	0.4	-0.2	0.6	0.6	1.3	1.5	1.6	1.7	1.7
Compensation per worker (whole economy	-3.0	3.7	-0.9	1.8	1.8	1.5	1.5	1.5	1.5	1.5
Labor productivity	0.2	1.2	-1.5	1.4	1.7	1.0	0.9	0.7	0.7	0.6
Unit labor costs (whole economy)	-3.2	2.4	0.6	0.3	0.0	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	-7.5	-2.8	-2.8	0.3	0.8	1.3	1.7	1.7
Broad money	-6.2	-0.2	0.0	2.1	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	-4.5	-3.2	-3.2	-2.7	-2.5	-2.4	-2.4	-2.4
Revenues	42.9	45.2	44.5	44.7	44.7	44.8	44.8	44.7	44.7	44.6
Expenditures	48.5	50.1	49.0	47.8	47.9	47.5	47.2	47.1	47.1	47.1
Primary government balance	-0.7	0.1	0.5	1.6	1.6	1.8	1.9	1.8	1.8	1.8
General government debt	125.8	129.7	130.2	126.3	127.1	124.4	122.0	120.4	119.4	118.6
External sector (percent of GDP)										
Trade balance (goods)	-5.6	-4.7	-5.2	-3.9	-4.4	-5.2	-5.7	-6.2	-6.7	-7.1
Trade balance (G&S)	-0.1	1.7	1.1	2.6	2.4	2.2	1.9	1.6	1.3	1.2
Current account balance	-2.1	1.4	0.6	1.4	1.1	0.8	0.6	0.3	0.1	0.1
Net international investment position	-146.9	-157.5	-111.6	-105.9	-106.5	-101.4	-96.9	-92.9	-89.2	-85.6
REER based on ULC (1999=100)	101.2	102.9	100.7	86.1	84.6	84.7	85.0	85.3	85.5	85.8
(rate of growth)	-4.8	1.7	-2.1	-14.5	-16.0	0.2	0.3	0.3	0.3	0.4
REER based on CPI (1999=100)	107.3	107.4	104.8	89.6	88.3	88.4	88.9	89.5	90.2	90.2
(rate of growth)	-1.3	0.1	-2.4	-14.5	-15.7	0.1	0.6	0.7	0.8	0.0
Nominal GDP (billions of euro)	168.4	169.4	173.0	177.6	177.5	182.6	187.7	192.6	197.9	203.3

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 1.1 percent of GDP.

Table 2a. Portugal: General Government Accounts, 2012–20 1/
(Billions of euros)

	2012	2013	2014	Projections 2/ 2015	2016	2017	2018	2019	2020
Revenue	72.2	76.6	77.0	79.4	81.8	84.0	86.2	88.4	90.7
Taxes	38.7	42.8	43.5	45.5	47.0	48.4	49.8	51.2	52.6
Taxes on production and imports	23.3	23.4	24.6	26.0	26.8	27.6	28.4	29.1	29.9
Current taxes on income, wealth, etc. and capital taxes	15.4	19.4	18.9	19.5	20.2	20.8	21.4	22.1	22.7
Current taxes on income, wealth, etc.	15.1	19.4	18.9	19.5	20.2	20.8	21.4	22.1	22.7
Capital taxes	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	19.1	20.1	20.5	20.9	21.5	21.9	22.3	22.8	23.3
Grants and other revenue	14.3	13.8	13.0	13.0	13.3	13.7	14.1	14.4	14.8
Property income	1.9	2.1	1.7	1.7	1.7	1.8	1.8	1.9	1.9
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	3.2	3.4	3.2	3.1	3.1	3.2	3.3	3.4	3.5
Capital transfers and investment grants	2.7	1.6	1.3	1.3	1.4	1.4	1.4	1.5	1.5
Expenditure	81.6	84.8	84.7	85.0	86.8	88.7	90.7	93.2	95.7
Expense	83.0	86.3	86.4	85.9	87.7	89.7	91.8	94.2	96.7
Compensation of employees	19.7	21.1	20.5	19.6	20.0	20.5	21.1	21.7	22.1
Use of goods and services	9.7	9.7	10.2	10.5	10.8	11.1	11.4	11.7	12.1
Consumption of fixed capital	5.2	5.2	5.2	5.3	5.5	5.6	5.8	5.9	6.1
Interest	8.2	8.3	8.6	8.5	8.4	8.2	8.1	8.3	8.6
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	34.8	35.8	36.8	37.7	38.8	39.8
Grants and other expense	6.2	6.5	6.7	6.2	6.3	6.4	6.6	6.8	7.0
Other current expense	4.6	5.0	4.6	5.7	5.6	5.7	5.9	6.0	6.2
Capital transfers	1.6	1.5	2.0	0.4	0.7	0.7	0.7	0.7	0.8
Net acquisition of nonfinancial assets	-1.3	-1.5	-1.6	-1.0	-1.0	-1.0	-1.0	-1.0	-1.1
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	-5.2	-5.2	-5.2	-5.3	-5.5	-5.6	-5.8	-5.9	-6.1
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	-4.2	-1.2	-0.5	0.0	0.2	0.1	0.1
Net lending (+)/borrowing (–)	-9.5	-8.2	-7.7	-5.6	-5.0	-4.7	-4.5	-4.8	-4.9
Net acquisition of financial assets	1.6	-2.3	-2.7	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	1.4	1.4	-0.2	...	...	...	...	...	...
Debt securities	6.5	-1.0	-4.7	...	...	...	...	...	...
Loans	1.3	-0.1	-0.4	...	...	...	...	...	...
Equity and investment fund shares	-4.1	-0.8	2.9	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	-0.2	0.0	0.1	...	...	...	...	...	...
Other accounts receivable	-3.4	-1.9	-0.4	...	...	...	...	...	...
Net incurrence of liabilities	11.0	5.9	5.0	...	...	...	...	...	...
SDRs	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	-1.4	1.2	4.8	...	...	...	...	...	...
Debt securities	-7.9	-3.0	-1.8	...	...	...	...	...	...
Loans	24.4	9.7	2.8	...	...	...	...	...	...
Equity and investment fund shares	0.0	0.0	0.0	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	0.0	...	...	...	...	...	...
Other accounts payable	-4.1	-2.0	-0.8	...	...	...	...	...	...
Memorandum items:									
Primary balance	-1.2	0.1	0.9	2.9	3.4	3.5	3.6	3.6	3.7
Debt at face value (EDP notification)	211.8	219.6	225.3	225.7	227.1	228.9	231.9	236.2	241.1
Nominal GDP	168.4	169.4	173.0	177.5	182.6	187.7	192.6	197.9	203.3

Sources: Portuguese statistical authorities; and IMF staff projections.
1/ GFSM 2001 presentation.
2/ One-off measures in 2014 from SOE (Carris and STCP) and banking operations (BPN Credito), CIT credit, and the upfront costs of mutual agreements amounted to 1.1 percent of GDP. Projections reflect current policies after 2015.

Table 2b. Portugal: General Government Accounts, 2012–20 1/
(Percent of GDP)

				Projections 2/					
	2012	2013	2014	2015	2016	2017	2018	2019	2020
Revenue	42.9	45.2	44.5	44.7	44.8	44.8	44.7	44.7	44.6
Taxes	23.0	25.3	25.2	25.7	25.7	25.8	25.8	25.9	25.9
Taxes on production and imports	13.9	13.8	14.2	14.7	14.7	14.7	14.7	14.7	14.7
Current taxes on income, wealth, etc. and capital taxes	9.1	11.4	10.9	11.0	11.0	11.1	11.1	11.2	11.2
Current taxes on income, wealth, etc.	9.0	11.4	10.9	11.0	11.0	11.1	11.1	11.2	11.2
Capital taxes	0.2	0.0	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	11.6	11.5	11.5
Grants and other revenue	8.5	8.1	7.5	7.3	7.3	7.3	7.3	7.3	7.3
Property income	1.1	1.2	1.0	1.0	1.0	1.0	1.0	1.0	1.0
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	1.9	2.0	1.9	1.7	1.7	1.7	1.7	1.7	1.7
Capital transfers and investment grants	1.6	0.9	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Expenditure	48.5	50.1	49.0	47.9	47.5	47.2	47.1	47.1	47.1
Expense	49.3	51.0	49.9	48.4	48.0	47.8	47.6	47.6	47.6
Compensation of employees	11.7	12.4	11.8	11.0	11.0	10.9	10.9	10.9	10.9
Use of goods and services	5.8	5.7	5.9	5.9	5.9	5.9	5.9	5.9	5.9
Consumption of fixed capital	3.1	3.1	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Interest	4.9	4.9	5.0	4.8	4.6	4.4	4.2	4.2	4.2
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	19.6	19.6	19.6	19.6	19.6	19.6
Grants and other expense	3.7	3.8	3.9	3.5	3.4	3.4	3.4	3.4	3.4
Other current expense	2.7	2.9	2.7	3.2	3.1	3.1	3.1	3.1	3.1
Capital transfers	0.9	0.9	1.2	0.3	0.4	0.4	0.4	0.4	0.4
Net acquisition of nonfinancial assets	-0.8	-0.9	-0.9	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
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	-3.1	-3.1	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0
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	-2.4	-0.7	-0.3	0.0	0.1	0.1	0.0
Net lending (+)/borrowing (–)	-5.6	-4.8	-4.5	-3.2	-2.7	-2.5	-2.4	-2.4	-2.4
Net acquisition of financial assets	0.9	-1.3	-1.6	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	0.9	0.9	-0.1	...	...	...	...	...	...
Debt securities	3.9	-0.6	-2.7	...	...	...	...	...	...
Loans	0.7	-0.1	-0.2	...	...	...	...	...	...
Equity and investment fund shares	-2.4	-0.4	1.7	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	-0.1	0.0	0.1	...	...	...	...	...	...
Other accounts receivable	-2.0	-1.1	-0.2	...	...	...	...	...	...
Net incurrence of liabilities	6.5	3.5	2.9	...	...	...	...	...	...
SDRs	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	-0.8	0.7	2.8	...	...	...	...	...	...
Debt securities	-4.7	-1.8	-1.1	...	...	...	...	...	...
Loans	14.5	5.7	1.6	...	...	...	...	...	...
Equity and investment fund shares	0.0	0.0	0.0	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	0.0	...	...	...	...	...	...
Other accounts payable	-2.4	-1.2	-0.5	...	...	...	...	...	...
Memorandum items:									
Primary balance	-0.7	0.1	0.5	1.6	1.8	1.9	1.8	1.8	1.8
Structural balance (Percent of potential GDP)	-3.0	-2.0	-1.1	-1.7	-1.9	-2.1	-2.2	-2.3	-2.4
Structural primary balance (Percent of potential GDP)	1.6	2.6	3.6	2.9	2.6	2.2	2.0	1.9	1.8
Debt at face value (EDP notification)	125.8	129.7	130.2	127.1	124.4	122.0	120.4	119.4	118.6
Nominal GDP	168,398	169,395	173,044	177,475	182,640	187,660	192,641	197,869	203,262

Sources: Portuguese statistical authorities; and IMF staff projections.
1/ GFSM 2001 presentation.
2/ One-off measures in 2014 from SOE (Carris and STCP) and banking operations (BPN Credito), CIT credit, and the upfront costs of mutual agreements amounted to 1.1 percent of GDP. Projections reflect current policies after 2015.

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

						Projections					
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
					(Billions of euro)						
Current account	-18.3	-10.6	-3.5	2.4	1.0	1.9	1.6	1.2	0.6	0.3	0.3
Balance of goods and services	-12.8	-6.5	-0.2	3.0	2.0	4.2	4.0	3.6	3.1	2.6	2.4
Trade balance	-19.3	-14.5	-9.5	-8.0	-9.0	-7.8	-9.4	-10.6	-11.9	-13.2	-14.3
Exports fob	36.9	42.3	44.3	46.6	47.4	54.6	56.8	60.2	63.2	66.1	68.6
Imports fob	56.2	56.8	53.8	54.6	56.4	62.4	66.2	70.8	75.1	79.2	83.0
Services, net	6.5	8.0	9.3	10.9	10.9	12.0	13.4	14.2	15.0	15.8	16.8
Exports	17.2	19.3	19.9	21.9	22.8	24.2	26.0	27.6	29.2	30.9	32.8
Imports	10.8	11.3	10.6	11.0	11.9	12.2	12.6	13.4	14.2	15.1	16.0
Of which:											
Tourism	4.6	5.2	5.7	6.1	7.1	7.6	8.3	8.8	9.3	9.9	10.5
Exports	7.6	8.1	8.6	9.2	10.4	11.0	11.8	12.6	13.3	14.1	15.0
Imports	3.0	3.0	2.9	3.1	3.3	3.4	3.5	3.7	4.0	4.2	4.5
Primary income, net	-5.7	-4.7	-4.3	-1.8	-2.5	-3.9	-4.1	-4.0	-4.1	-4.1	-3.9
Secondary income, net	0.3	0.6	1.0	1.3	1.6	1.6	1.6	1.6	1.7	1.7	1.7
Private remittances, net	1.9	2.1	2.7	3.1	3.1	3.2	3.3	3.4	3.5	3.7	3.8
Official transfers, net	-1.6	-1.5	-1.7	-1.8	-1.5	-1.6	-1.6	-1.8	-1.8	-2.0	-2.1
Capital account	2.5	2.6	3.5	2.8	2.6	2.2	2.2	2.2	2.2	2.2	2.2
Financial account	-15.4	25.6	28.0	16.4	9.0	4.1	3.7	3.4	2.9	2.5	2.5
Direct investment	-9.2	6.5	-13.5	-1.7	-1.6	-1.7	-1.6	-1.4	-1.3	-1.0	-0.8
Direct investment assets	-2.9	11.4	3.8	5.8	6.8	7.0	7.2	7.5	7.8	8.1	8.5
Direct investment liabilities	6.3	4.9	17.3	7.5	8.4	8.7	8.8	9.0	9.1	9.2	9.3
Portfolio investment, net	11.3	2.2	29.5	1.8	-6.5	-6.8	-7.1	-7.3	-7.5	-7.7	-7.9
Financial derivatives	-0.4	-0.5	-0.1	1.0	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Other investment, net	-18.0	18.6	11.9	14.8	13.7	10.1	10.3	10.2	9.8	9.4	9.5
Reserve assets	1.0	-1.2	0.2	0.4	1.7	0.9	0.4	0.2	0.1	0.1	0.0
Errors and omissions	0.4	-0.3	0.3	-0.5	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	...	33.9	27.7	11.7	5.2	...	...	...	...	...	...
European Union	...	20.9	19.4	8.2	3.5	...	...	...	...	...	...
IMF	...	13.1	8.2	3.4	1.8	...	...	...	...	...	...
Memorandum items:											
Net international investment position 1/	-187.7	-177.5	-192.4	-200.9	-193.1	-189.0	-185.2	-181.9	-179.0	-176.5	-174.0
Direct investment, net	-39.4	-29.9	-42.1	-44.8	-41.3	-43.0	-44.6	-46.1	-47.4	-48.4	-49.2
Portfolio investment, net	-49.7	-31.9	-16.9	-23.6	-28.1	-34.9	-42.0	-49.3	-56.7	-64.4	-72.4
Financial derivatives	-1.1	-2.4	-3.6	-3.1	-1.9	-0.1	1.6	3.3	5.0	6.7	8.4
Other investment, net	-113.2	-129.8	-146.9	-142.1	-138.0	-127.9	-117.6	-107.4	-97.7	-88.2	-78.7
Reserve assets	15.7	16.5	17.2	12.7	16.2	17.0	17.4	17.7	17.8	17.8	17.8
Nominal GDP	179.9	176.2	168.4	169.4	173.0	177.5	182.6	187.7	192.6	197.9	203.3
					(Percentage of GDP)						
Current account	-10.1	-6.0	-2.1	1.4	0.6	1.1	0.8	0.6	0.3	0.1	0.1
Current account (including capital transfers)	-8.8	-4.5	0.0	3.1	2.1	2.3	2.1	1.8	1.5	1.2	1.2
Of which: Balance of goods and services	-7.1	-3.7	-0.1	1.7	1.1	2.4	2.2	1.9	1.6	1.3	1.2
Net international investment position 1/	-104.3	-100.8	-114.2	-118.6	-111.6	-106.5	-101.4	-96.9	-92.9	-89.2	-85.6
Direct investment, net	-21.9	-17.0	-25.0	-26.4	-23.9	-24.3	-24.4	-24.6	-24.6	-24.5	-24.2
Portfolio investment, net	-27.6	-18.1	-10.0	-14.0	-16.2	-19.7	-23.0	-26.2	-29.5	-32.6	-35.6
Financial derivatives	-0.6	-1.4	-2.2	-1.8	-1.1	-0.1	0.9	1.7	2.6	3.4	4.1
Other investment, net	-62.9	-73.7	-87.2	-83.9	-79.7	-72.1	-64.4	-57.2	-50.7	-44.6	-38.7
Reserve assets	8.7	9.4	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, 2008–2015 1/

(Percent)

	2008	2009	2010	2011	2012				2013				2014				2015
					Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.
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	12.0
Common Equity Tier 1 capital to risk-weighted assets													12.2	10.6	12.0	11.3	11.1
Regulatory tier 1 capital to risk-weighted assets	6.6	7.9	8.3	8.6	9.5	11.0	11.1	11.3	11.7	11.7	12.0	11.9	11.1	10.7	12.1	11.4	11.2
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	8.0
Asset composition and quality																	
Non-performing 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	12.3
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	85.7
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	3.9
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	0.7
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	3.2
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	3.3
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	29.8
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	44.8
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	14.3
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	0.5
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	6.4
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	44.7
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	53.3
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	19.4
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	154.7
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	106.8
Loans (as defined in footnote 5)	...	352.9	363.9	342.7	340.9	335.9	329.0	321.0	314.4	306.7	299.4	295.9	292.3	285.7	276.5	270.2	269.60
Deposits (as defined in footnote 5)	...	218.5	230.6	244.4	249.0	246.3	246.8	251.0	253.5	250.1	248.0	253.2	249.4	250.8	247.0	252.1	252.39
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	4.6

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)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
					Projections					
	Aggregated Balance Sheet of Monetary Financial Institutions (MFIs) 1/									
Assets	483,537	457,434	427,726	407,595	400,293	404,088	405,263	408,569	412,148	414,611
Cash	1,606	1,605	1,622	1,150	815	578	410	291	206	146
Claims on Bank of Portugal	5,692	8,136	8,219	3,943	3,058	2,371	1,839	1,426	1,106	858
Claims on other FIs	53,526	46,870	46,693	44,215	42,424	44,215	42,424	43,015	42,866	42,717
Claims on non-MFIs	307,355	296,043	282,510	266,560	259,505	260,415	262,434	265,182	268,769	272,403
General government	32,317	38,768	38,692	41,054	40,313	40,566	40,826	40,692	40,464	40,217
Central government (excluding SOEs)	19,115	27,109	27,678	29,447	29,044	29,828	30,153	30,085	30,053	30,088
loans	38	464	594	1,762	1,712	1,662	1,612	1,599	1,579	1,559
securities	19,078	26,645	27,084	27,685	27,332	28,166	28,541	28,485	28,474	28,530
Bonds	10,307	16,078	22,220	22,052	22,099	22,932	23,307	23,251	23,240	23,296
Tbills (up to 1 year maturity)	8,770	10,567	4,865	5,634	5,234	5,234	5,234	5,234	5,234	5,234
Regional and local government (excl SOEs)	6,405	5,592	5,496	6,070	6,070	6,099	6,099	6,160	6,167	6,167
SOEs	6,797	6,067	5,519	5,537	5,199	4,639	4,574	4,448	4,244	3,961
Private sector	275,038	257,275	243,818	225,506	219,192	219,849	221,608	224,489	228,305	232,187
Corporates	135,433	123,256	115,703	101,573	104,968	108,219	111,265	114,062	116,723	119,425
Households	139,605	134,019	128,115	123,933	112,771	109,489	107,676	107,411	108,347	109,305
Claims on non-residents	96,585	88,380	71,566	70,865	73,094	74,489	75,531	76,051	75,963	75,267
Other assets	18,773	16,400	17,116	20,862	21,396	22,019	22,624	22,604	23,238	23,220
Liabilities	483,537	457,434	427,726	407,595	403,565	404,088	405,263	408,569	412,148	414,611
Liabilities to Bank of Portugal	46,928	53,724	48,810	32,503	32,906	29,167	25,853	25,595	25,339	25,085
Liabilities to other FIs	60,889	46,542	43,761	40,742	41,275	42,156	40,287	40,690	41,504	42,334
Deposits of non-MFIs	176,289	170,955	174,157	176,004	178,015	184,249	187,663	191,822	193,932	186,697
General government	12,278	13,218	12,429	12,672	8,679	8,679	8,679	8,679	8,679	8,679
Private sector	164,011	157,737	161,728	163,332	169,336	175,570	178,984	183,143	185,253	178,018
Securities other than capital	53,345	46,342	37,858	28,644	35,919	35,504	34,965	33,931	32,984	31,737
Liabilities to non-residents	105,131	89,484	70,136	69,446	58,456	51,461	53,092	53,691	56,059	66,890
Other	349	326	313	0	299	307	316	324	333	342
Capital and reserves	40,606	50,061	52,691	60,256	56,695	61,243	63,086	62,515	61,997	61,526
Money and Credit										
Broad Money (M3)	172,547	161,855	161,531	161,531	164,859	168,833	172,629	176,354	180,261	184,276
Intermediate money (M2)	169,872	156,877	156,563	156,563	159,789	163,640	167,320	170,930	174,717	178,609
Narrow money (M1)	67,504	65,785	65,653	65,653	67,006	68,621	70,164	71,678	73,266	74,898
Private sector credit	275,038	257,275	243,818	225,506	219,192	219,849	221,608	224,489	228,305	232,187
Public sector credit	32,317	38,768	38,692	41,054	40,313	40,566	40,826	40,692	40,464	40,217
	(Percent of GDP)									
Broad Money	97.9	96.1	95.4	93.3	92.9	92.4	92.0	91.5	91.1	90.7
Private sector credit	156.1	152.8	143.9	130.3	123.5	120.4	118.1	116.5	115.4	114.2
Public sector credit	18.3	23.0	22.8	23.7	22.7	22.2	21.8	21.1	20.4	19.8
	(Percentage change)									
Broad Money	-1.3	-6.2	-0.2	0.0	2.1	2.4	2.2	2.2	2.2	2.2
Private sector credit	-1.5	-6.5	-5.2	-7.5	-2.8	0.3	0.8	1.3	1.7	1.7
Public sector credit	-4.5	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)	9.7	11.7	11.4	8.0	8.2	7.2	6.4	6.3	6.1	6.1
Credit to deposits (percent) 2/	146.1	148.9	141.4	132.2	124.2	121.3	120.4	119.5	119.6	124.8
Loan to deposits (percent) 2/	140.6	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/	28.9	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)

	2010	2011	2012	2013	Projections 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	235.0	233.0	226.2	218.4	217.2	214.7	211.7	-0.6
Change in external debt	6.4	1.9	5.6	-9.0	4.2	-2.0	-6.8	-7.8	-1.2	-2.5	-3.0	
Identified external debt-creating flows (4+8+9)	8.2	6.1	16.7	-3.1	-4.9	-5.3	-4.9	-4.2	-3.3	-2.8	-2.6	
Current account deficit, excluding interest payments	5.0	-0.5	-5.0	-7.2	-5.2	-5.8	-5.4	-5.2	-5.0	-5.1	-5.3	
Deficit in balance of goods and services	7.1	3.7	0.1	-1.7	-1.1	-2.4	-2.2	-1.9	-1.6	-1.3	-1.2	
Exports	30.1	35.0	38.2	40.4	40.6	44.4	45.3	46.7	48.0	49.0	49.9	
Imports	37.2	38.6	38.3	38.7	39.4	42.0	43.1	44.8	46.4	47.7	48.7	
Net non-debt creating capital inflows (negative)	3.6	-4.9	3.8	-0.2	0.6	-0.6	-0.6	-0.4	-0.3	-0.2	-0.1	
Automatic debt dynamics 1/	-0.5	11.5	17.9	4.3	-0.3	1.1	1.1	1.5	2.0	2.5	2.7	
Contribution from nominal interest rate	5.1	6.5	7.1	5.7	4.6	4.7	4.6	4.5	4.7	4.9	5.1	
Contribution from real GDP growth	-4.2	4.3	9.9	3.8	-2.0	-3.6	-3.5	-3.1	-2.7	-2.5	-2.4	
Contribution from price and exchange rate changes 2/	-1.4	0.6	0.9	-5.2	-2.9	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-1.8	-4.3	-11.1	-5.9	9.1	3.4	-2.0	-3.6	2.2	0.3	-0.4	
External debt-to-exports ratio (in percent)	772.3	669.9	628.4	570.6	579.2	524.7	499.1	467.2	452.8	438.1	424.1	
Gross external financing need (in billions of Euros) 4/				182.5	169.5	155.3	156.3	151.3	148.9	156.3	167.1	
in percent of GDP				107.7	98.0	87.5	85.6	80.6	77.3	79.0	82.2	
Scenario with key variables at their historical averages 5/						234.3	237.5	238.8	246.3	252.3	257.7	2.9
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	1.2	
GDP deflator in Euros (percent)	0.6	-0.3	-0.4	2.2	1.3	1.0	1.3	1.3	1.4	1.5	1.6	
Nominal external interest rate (percent)	2.3	2.8	2.9	2.4	2.0	2.0	2.0	2.1	2.2	2.3	2.5	
Growth of exports (Euros, percent)	13.8	13.8	4.3	6.6	2.5	12.3	5.0	6.0	5.4	4.9	4.6	
Growth of imports (Euros, percent)	12.6	1.7	-5.3	1.7	4.1	9.4	5.6	6.8	6.2	5.6	4.9	
Current account balance, excluding interest payments	-5.0	0.5	5.0	7.2	5.2	5.8	5.4	5.2	5.0	5.1	5.3	
Net non-debt creating capital inflows	-3.6	4.9	-3.8	0.2	-0.6	0.6	0.6	0.4	0.3	0.2	0.1	

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	11,393	4,694	462	460	2,825	5,024
Interest and charges	14	152	171	241	859	537	462	460	453	308
Repayments	0	0	0	0	10,534	4,157	0	0	2,373	4,717
Total debt service, in percent of										
Exports of goods and services	0.0	0.2	0.2	0.3	14.5	5.7	0.5	0.5	2.9	5.0
GDP	0.0	0.1	0.1	0.1	6.4	2.6	0.2	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	19,084	14,337	14,279	14,214	11,785	6,995
percent of quota	1,117.1	1,787.1	2,076.2	2,228.0	1,429.0	1,107.8	1,107.8	1,107.8	922.1	550.8
percent of GDP	7.4	13.0	14.4	15.2	10.8	7.8	7.6	7.4	6.0	3.4
Memorandum Items (billions of euros)										
Exports of goods and services	62	64	69	70	79	83	88	92	97	101
GDP	176	168	169	173	177	183	188	193	198	203

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

Table 8. Portugal: General Government Financing Requirements and Sources, 2014–20 1/
(Billion of euros)

	2014	2015	2016	2017	2018	2019	2020
Gross borrowing need	58.8	39.0	27.7	27.8	27.9	34.4	45.3
Overall balance	7.7	5.6	5.0	4.7	4.5	4.8	4.9
Amortization	47.9	34.3	26.2	23.2	22.8	29.1	40.4
M&LT	33.7	11.1	9.3	10.6	10.1	14.1	23.0
Residents	10.3	4.4	2.8	3.7	5.7	6.7	10.2
Of which within general government	1.0	0.9	1.0	1.8	1.9	0.7	0.0
Non-residents	23.4	6.7	6.5	6.9	4.5	7.4	12.8
ST 2/	14.3	12.7	12.7	12.7	12.7	12.7	12.7
Residents	12.9	9.8	8.9	8.9	8.9	8.9	8.9
Non-residents	1.4	2.8	3.8	3.8	3.8	3.8	3.8
EU and IMF 3/	0.0	10.5	4.2	0.0	0.0	2.4	4.7
Other (net) 4/	3.2	-0.9	-3.5	-0.2	0.5	0.5	0.0
Gross financing sources	49.0	39.0	27.7	27.8	27.9	34.4	45.3
Privatization receipts	1.7	0.0	0.0	0.0	0.0	0.0	0.0
Market access	47.4	34.7	27.7	25.0	25.9	33.4	45.3
M&LT	34.7	22.0	15.0	12.3	13.2	20.7	32.6
Residents	15.0	7.9	5.3	4.8	5.1	7.9	12.0
Of which from general government	10.9	…	…	…	…	…	…
Non-residents	19.7	14.1	9.7	7.5	8.1	12.8	20.6
ST 2/	12.7	12.7	12.7	12.7	12.7	12.7	12.7
Residents	9.8	8.9	8.9	8.9	8.9	8.9	8.9
Of which from general government	3.2	…	…	…	…	…	…
Non-residents	2.8	3.8	3.8	3.8	3.8	3.8	3.8
Use of deposits 5/	-0.2	4.4	0.0	2.8	2.0	1.0	0.0
Of which intra-government	0.1	…	…	…	…	…	…
Financing under the program 3/	5.2	0.0	0.0	0.0	0.0	0.0	0.0
European Union	3.4	…	…	…	…	…	…
IMF	1.8	…	…	…	…	…	…
Net placement (market access-amortization)	-0.5	0.4	1.5	1.7	3.0	4.3	4.9
Residents	1.7	-2.8	0.4	1.1	-0.6	0.6	0.6
M&LT	4.8	-1.8	0.4	1.1	-0.6	0.6	0.6
ST (net increase)	-3.1	-1.0	0.0	0.0	0.0	0.0	0.0
Non-residents	-2.2	3.1	1.1	0.6	3.6	3.6	4.3
M&LT	-3.7	2.2	1.1	0.6	3.6	3.6	4.3
ST (net increase)	1.5	1.0	0.0	0.0	0.0	0.0	0.0

Source: Portuguese authorities and IMF staff estimates.

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

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

3/ On June 21st 2013, ECOFIN decided to extend the average maturity of EFSM loans by 7 years, which will bring the average maturity from 12.5 to 19.5 years. Although the final maturity date of each individual loan has not been set yet, the table reflects this maturity extension. Changes to IMF disbursements compared to initial programmed amounts reflect EUR/SDR exchange rate variations.

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

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

Table 9. Portugal: External Financing Requirements and Sources, 2014–20
(Billion of euros)

	2014	2015	2016	2017	2018	2019	2020
Gross Financing Requirements	169.5	159.2	155.0	148.6	148.9	156.3	167.1
Current account deficit	-1.0	-1.9	-1.6	-1.2	-0.6	-0.3	-0.3
Medium- and long-term debt amortization	45.7	25.4	26.0	26.9	29.6	33.9	41.7
Public sector	23.4	6.7	6.5	6.9	4.5	7.4	12.8
Banks	16.9	13.2	14.1	15.6	19.7	20.0	20.2
Other private	5.4	5.5	5.3	4.4	5.4	6.5	8.7
Short-term debt amortization	124.9	125.1	126.5	122.9	120.0	120.3	120.9
Public sector	72.4	69.0	70.4	66.7	63.3	63.1	62.8
Central Bank	71.1	66.2	66.6	62.8	59.5	59.3	59.0
Of which: ECB access	48.8	32.5	32.9	29.2	25.9	25.6	25.3
General government and SOEs	1.4	2.8	3.8	3.8	3.8	3.8	3.8
Banks	39.5	39.5	41.2	42.8	44.5	46.4	48.3
Other private	13.0	16.6	14.9	13.4	12.1	10.9	9.8
EU and IMF 1/	0.0	10.5	4.2	0.0	0.0	2.4	4.7
Sources of Financing	164.3	159.2	155.0	148.6	148.9	156.3	167.1
Capital account (net)	2.6	2.2	2.2	2.2	2.2	2.2	2.2
Foreign direct investment (net)	-1.6	-1.7	-1.6	-1.4	-1.3	-1.0	-0.8
Inward	8.4	8.7	8.8	9.0	9.1	9.2	9.3
New borrowing and debt rollover	159.6	164.1	157.4	149.2	158.2	163.0	172.8
Medium and long-term borrowing	34.5	37.6	34.5	29.2	37.9	42.1	51.1
General government	19.7	14.0	12.9	7.5	11.7	14.5	20.6
Banks	14.0	17.0	15.3	16.8	20.7	21.1	21.8
Other private	0.8	6.6	6.4	4.8	5.4	6.5	8.7
Short-term borrowing	125.1	126.5	122.9	120.0	120.3	120.9	121.6
Public sector	69.0	70.4	66.7	63.3	63.1	62.8	62.6
Central bank	66.2	66.6	62.8	59.5	59.3	59.0	58.8
Of which: ECB access	32.5	32.9	29.2	25.9	25.6	25.3	25.1
General government	2.8	3.8	3.8	3.8	3.8	3.8	3.8
Banks	39.5	41.2	42.8	44.5	46.4	48.3	50.3
Other private	16.6	14.9	13.4	12.1	10.9	9.8	8.8
Other (includes asset operations)	3.8	-5.4	-2.9	-1.3	-10.3	-7.9	-7.1
Of which: Net errors and omissions	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Equities (net)	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Assets drawdown (- increase)	9.7	16.0	7.4	12.2	15.1	12.8	10.8
Derivatives	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Use of reserves	1.7	0.9	0.4	0.2	0.1	0.1	0.0
Other	-9.6	-24.1	-12.5	-15.5	-27.3	-22.5	-19.8
Financing Gap	5.2	0.0	0.0	0.0	0.0	0.0	0.0
European Union (2/3 of total) 1/	3.5	...	...	...	...	...	...
IMF (1/3 of total) 2/	1.8	...	...	...	...	...	...
Rollover Rates							
General government	91.0	186.2	161.0	105.8	187.5	163.0	146.9
Private	94.8	106.6	103.1	102.7	102.0	102.4	103.0
Banks	94.9	110.4	105.1	105.0	104.5	104.6	105.2
Other private	94.5	97.5	97.9	94.9	93.1	93.7	94.7

Sources: Bank of Portugal and IMF staff estimates.

1/ On June 21st 2013, ECOFIN decided to extend the average maturity of EFSM loans by 7 years, which will bring the average maturity from 12.5 to 19.5 years. Although the final maturity date of each individual loan has not been set yet, the table reflects this maturity extension.

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

Annex I. 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 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, as well as the adverse valuation effects of euro depreciation[1]. 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 due to lower bond yields and early repayment to the Fund -- but would still remain more than 118 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 2015–19 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 economies of 85 percent of GDP under the baseline scenario. The same applies to Portugal's public

[1] The majority of Portugal's foreign-currency denominated debt is hedged through currency swaps; following the early repayments to the IMF in 2015, unhedged foreign-currency denominated debt is now less than 1 percent of GDP. The chart in Figure 4 shows total foreign-currency debt, not accounting for hedging operations.

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 Figures 4 and 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 (Figures 4 and 5), as also highlighted by the asymmetric fan chart analysis in Figure 1, which shows the risks to the debt outlook if only negative shocks to the primary balance were to materialize. The authorities' medium-

[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.

term fiscal strategy under the Stability Program for 2015–19 envisages a reduction in public debt to 107.6 percent of GDP by 2019 (in line with the EU fiscal framework). However, this target is based on considerably more optimistic growth assumptions than in staff's baseline scenario; the SP projects annual real GDP growth of 2.4 percent in 2017–19, as opposed to staff's baseline projection of average annual growth of 1.3 percent over the same period. In addition, the SP targets an overall improvement in the primary fiscal balance of 1.5 percent of GDP from 2015–19, but without fully specifying all the reforms that would be implemented to realize the required savings.

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, 12 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 close to 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 2016 debt ratio to 129 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 remaining at this level over the medium term.

6. The authorities took note of the risks highlighted by staff, but also stressed the divergence of their Stability Program (SP) from staff's baseline scenario. The authorities were optimistic that reforms in recent years have laid the foundation for a structural transformation toward stronger export-oriented growth, which would underpin a larger improvement in medium-term debt dynamics than projected by staff. In addition, they remained confident 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. Over the medium-term, the authorities reiterated their commitment to the debt reduction targets laid out in the SP, and indicated that more concrete spending proposals would follow the Parliamentary elections as needed. In the near-term, the authorities were optimistic that their recent track record of fiscal adjustment and reform implementation had strengthened both Portugal's credibility with investors and the soundness of the economy, and would enable them to avoid any prolonged deterioration in market access.

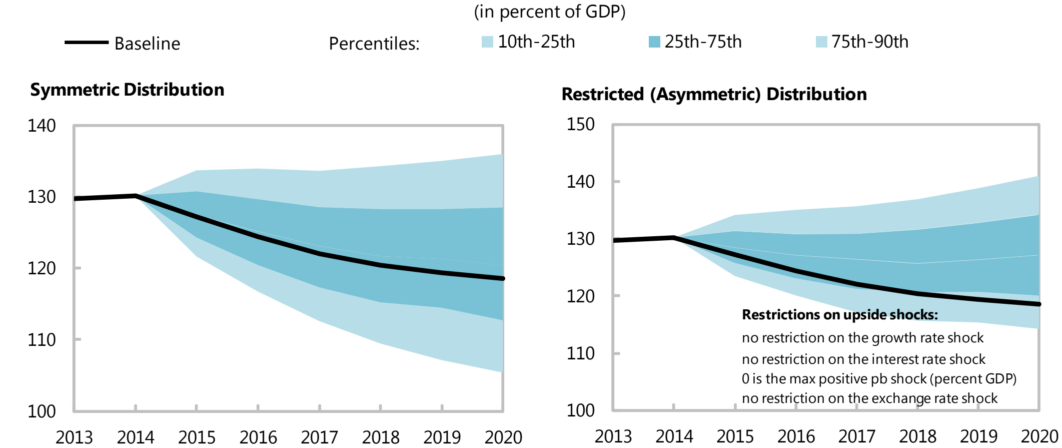
Figure 1. Portugal: Public DSA Risk Assessment, 2013–20

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

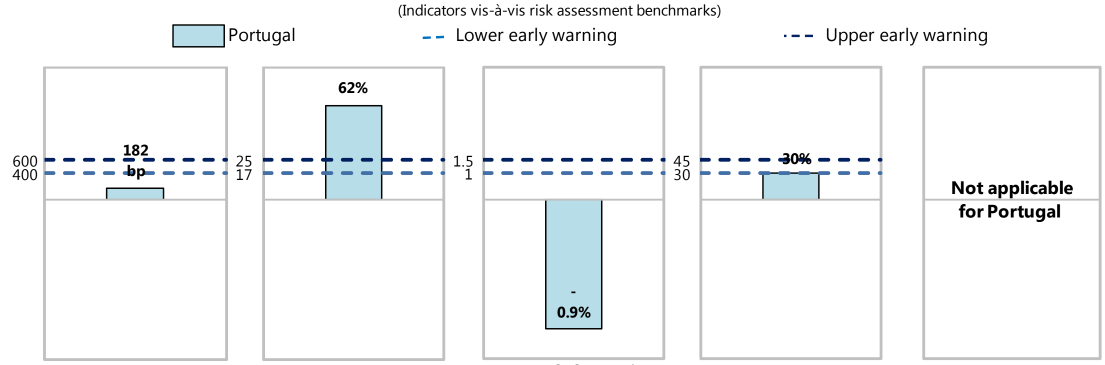
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)



Bond Spread over German Bonds	**External Financing Requirement**	**Annual Change in Short-Term Public Debt**	**Public Debt Held by Non-Residents**	**Public Debt in Foreign Currency**
(in basis points) 4/	(in percent of GDP)	(in percent of total)	(in percent of total)	(in percent of total)

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.

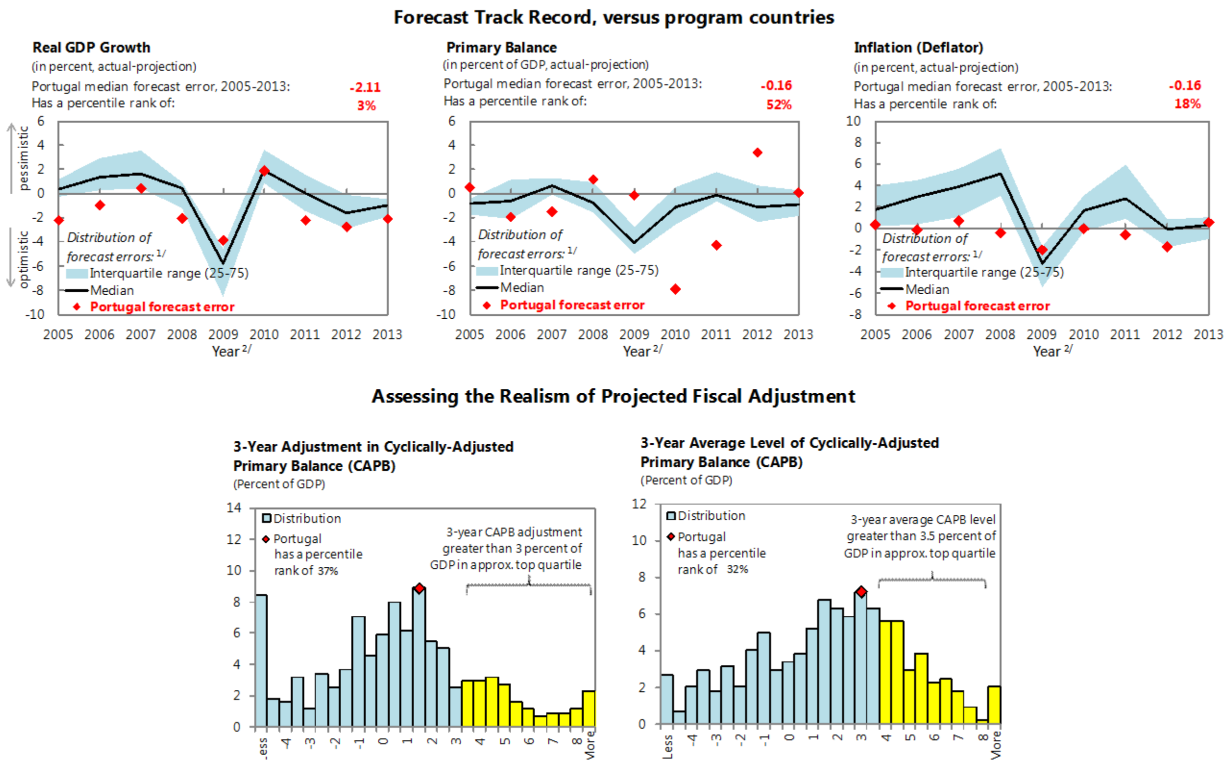
2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

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/ An average over the last 3 months, 18-Mar-15 through 16-Jun-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)

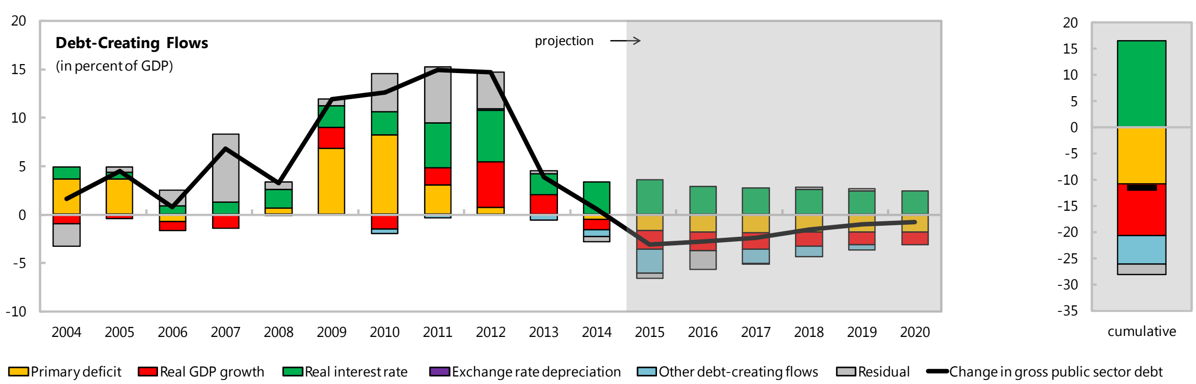
Debt, Economic and Market Indicators 1/

	Actual		Prel.	Projections					
	2004-2012 2/	2013	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	81.7	129.7	130.2	127.1	124.4	122.0	120.4	119.4	118.6
Public gross financing needs	...	23.5	25.1	22.4	19.6	14.9	16.9	18.3	22.3
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	1.3	1.0	1.3	1.3	1.4	1.5	1.6
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	3.6	3.7

As of June 16, 2015		
Sovereign Spreads		
Spread (bp) 3/		186
CDS (bp)		182
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	-3.0	-2.8	-2.4	-1.6	-1.0	-0.7	-11.6	
Identified debt-creating flows	5.5	3.6	1.0	-2.6	-0.9	-2.3	-1.8	-1.3	-0.7	-9.6	
Primary deficit	2.9	-0.1	-0.5	-1.6	-1.8	-1.9	-1.8	-1.8	-1.8	-10.8	1.1
Primary (noninterest) revenue and grants	41.2	45.2	44.5	44.7	44.8	44.8	44.7	44.7	44.6	268.3	
Primary (noninterest) expenditure	44.1	45.2	44.0	43.1	42.9	42.9	42.9	42.9	42.8	257.5	
Automatic debt dynamics 5/	2.6	4.2	2.2	1.5	1.0	1.0	1.1	1.0	1.1	6.7	
Interest rate/growth differential 6/	2.6	4.2	2.2	1.5	1.0	1.0	1.1	1.0	1.1	6.7	
Of which: real interest rate	2.3	2.2	3.4	3.5	2.9	2.7	2.5	2.4	2.4	16.5	
Of which: real GDP growth	0.4	2.0	-1.1	-2.0	-1.9	-1.7	-1.5	-1.4	-1.3	-9.8	
Exchange rate depreciation 7/	0.0	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	-0.1	-0.5	-0.7	-2.5	0.0	-1.5	-1.0	-0.5	0.0	-5.5	
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)	0.2	0.3	-0.5	-2.5	0.0	-1.5	-1.0	-0.5	0.0	-5.5	
Residual, including asset changes 8/	2.4	0.3	-0.5	-0.5	-1.9	-0.1	0.3	0.3	0.0	-2.0	



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).

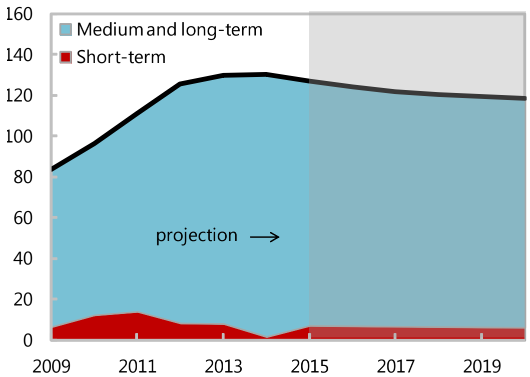
8/ For projections, this line includes exchange rate changes during the projection period.

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.

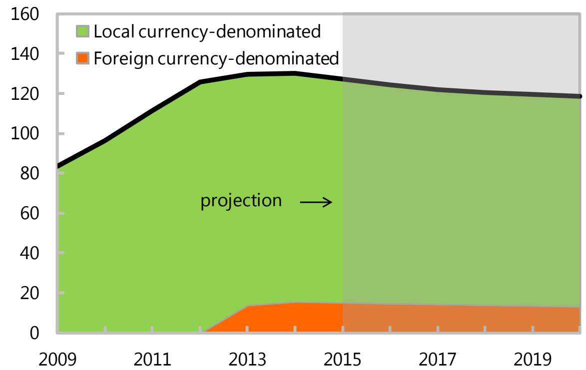
Figure 4. Portugal: Public DSA - Composition of Public Debt and Alternative Scenarios, 2009–2020

Composition of Public Debt

By Maturity
(in percent of GDP)



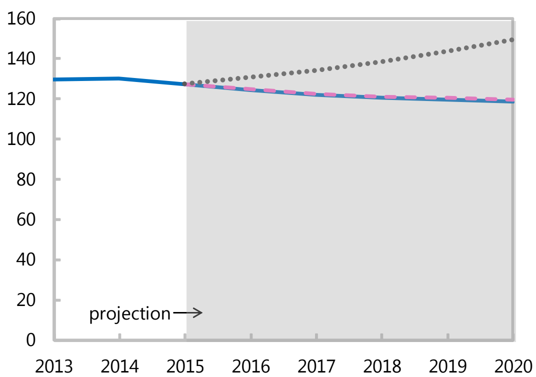
By Currency
(in percent of GDP)



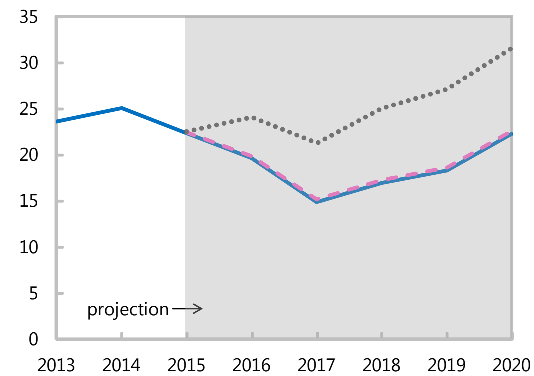
Alternative Scenarios

Baseline   Historical, 2004-2013   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

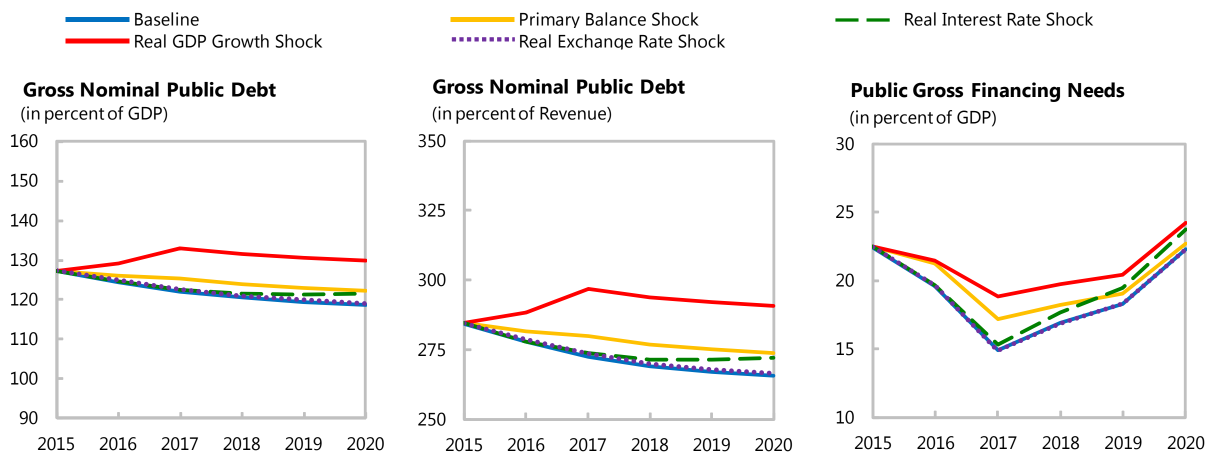
Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	1.6	1.5	1.4	1.3	1.2	1.2
Inflation	1.0	1.3	1.3	1.4	1.5	1.6
Primary Balance	1.6	1.8	1.9	1.8	1.8	1.8
Effective interest rate	3.8	3.7	3.6	3.5	3.6	3.7
Constant Primary Balance Scenario						
Real GDP growth	1.6	1.5	1.4	1.3	1.2	1.2
Inflation	1.0	1.3	1.3	1.4	1.5	1.6
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	3.6	3.6

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	3.7	3.8

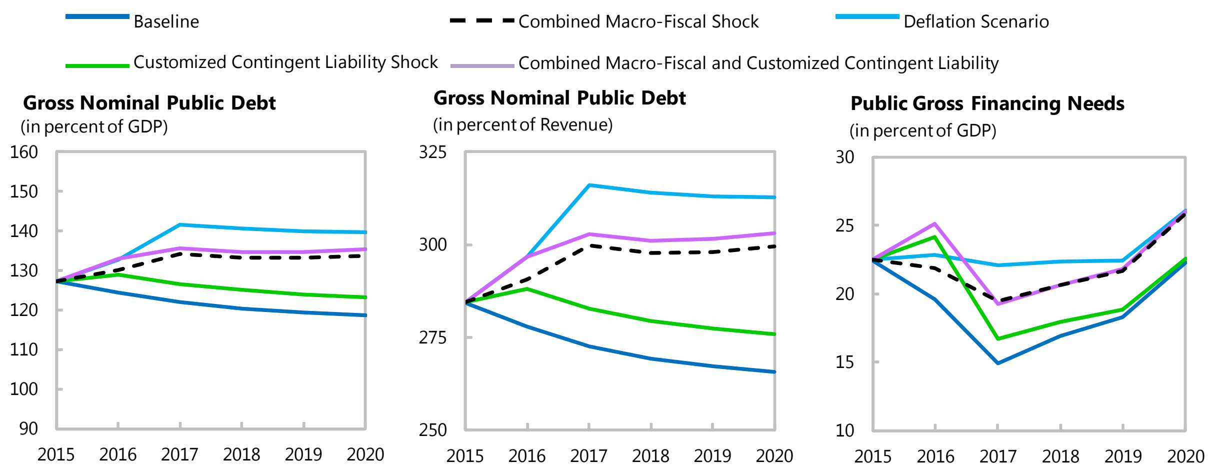
Source: IMF staff.

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	1.6
Primary balance	1.6	0.3	0.3	1.8	1.8	1.8
Effective interest rate	3.8	3.7	3.6	3.6	3.6	3.7
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	1.6
Primary balance	1.6	1.8	1.9	1.8	1.8	1.8
Effective interest rate	3.8	3.7	4.0	4.0	4.3	4.5
Combined Shock						
Real GDP growth	1.6	-0.7	-0.8	1.3	1.2	1.2
Inflation	1.0	0.8	0.8	1.4	1.5	1.6
Primary balance	1.6	0.3	-0.5	1.8	1.8	1.8
Effective interest rate	3.8	3.7	3.9	4.0	4.3	4.5
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	1.6
Primary balance	1.6	-2.7	1.9	1.8	1.8	1.8
Effective interest rate	3.8	3.7	3.6	3.5	3.6	3.6

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	0.8	0.8	1.4	1.5	1.6
Primary balance	1.6	0.7	-0.5	1.8	1.8	1.8
Effective interest rate	3.8	3.7	3.6	3.6	3.6	3.7
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	1.6
Primary balance	1.6	1.8	1.9	1.8	1.8	1.8
Effective interest rate	3.8	3.7	3.6	3.5	3.6	3.6
Deflation Scenario						
Real GDP growth	1.6	-1.2	-1.4	1.3	1.2	1.2
Inflation	1.0	-0.7	-0.7	1.4	1.5	1.6
Primary balance	1.6	-0.3	-2.5	1.8	1.8	1.8
Effective interest rate	3.8	3.7	3.7	3.9	3.8	3.8
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	0.8	0.8	1.4	1.5	1.6
Primary balance	1.6	-3.0	1.0	1.8	1.8	1.8
Effective interest rate	3.8	3.7	4.0	4.1	4.3	4.6

Source: IMF staff.