INTERNATIONAL MONETARY FUND

IMF Country Report No. 15/21

PORTUGAL

January 2015

FIRST POST-PROGRAM MONITORING DISCUSSIONS—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY EXECUTIVE DIRECTOR

In the context of the First Post-Program Monitoring Discussions, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on January 23, 2015, following discussions that ended on November 5, 2014, 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 December 16, 2014.
- A **Press Release** including a statement by the Chair of the Executive Board.
- A **Statement by the Executive Director** for Portugal.

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

PORTUGAL

FIRST POST-PROGRAM MONITORING

December 16, 2014

EXECUTIVE SUMMARY

The three year Fund-supported program that expired at end-June 2014 succeeded in stabilizing Portugal's economy and restoring access to sovereign debt markets. Following the deep downturn of 2011–12, the economy has expanded in six of the last seven quarters, albeit at a moderate pace. The cumulative fiscal consolidation over the past three years has been substantial, and the current account is now in surplus. Regained policy credibility and benign market conditions have facilitated the resumption of market access at declining yields.

But private consumption is driving the recovery, while the necessary rebalancing of the economy remains elusive. With post-crisis labor slack still extensive, attaining higher growth through private investment and export-led growth continues to be constrained by high corporate debt and weak external competitiveness.

Moreover, the momentum for reforms and fiscal adjustment appears to have flagged over the past six months. Notwithstanding past structural reform efforts aimed at improving competitiveness, the slow expansion despite the high labor slack suggests that the unfinished agenda is substantial. Corporate debt is also excessively high, acting as a brake on investment and job creation. While the fiscal targets for 2014 seem well within reach, significantly more ambitious expenditure reforms will be needed to comply with the government's own medium-term budget framework.

Recently regained policy credibility and benign market conditions provide a welcome but only limited window of opportunity to press ahead with necessary reforms. With elections due by October 2015, building consensus around these reforms will prove difficult in the short term. In this context, discussions focused on three key areas necessary to maintaining economic and financial stability and improving medium-term growth prospects: (i) enhancing competitiveness through further reforms to improve the functioning of labor and product markets, and making progress on corporate deleveraging; (ii) safeguarding financial sector stability in a low profitability and low growth environment; and (iii) ensuring fiscal sustainability against the backdrop of vulnerable debt dynamics and large financing needs.

Approved By
Poul M. Thomsen and Seán Nolan

Discussions took place in Lisbon during October 28 through November 4, 2014. The staff team comprised S. Lall (head), D. Gershenson, M. Goretti, I. Yackovlev, and L. Zeng (all EUR); R. Vermeulen (SPR); M. Poplawski-Ribeiro (FAD); C. Verkoren (MCM); and A. Jaeger (RR). Ms. Lopes (OED) participated in key meetings. U. Niman and D. Santos (both EUR) provided assistance from HQ; E. Martins and A. Gomes (both local staff) provided assistance from the Lisbon office.

CONTENTS

TABLES

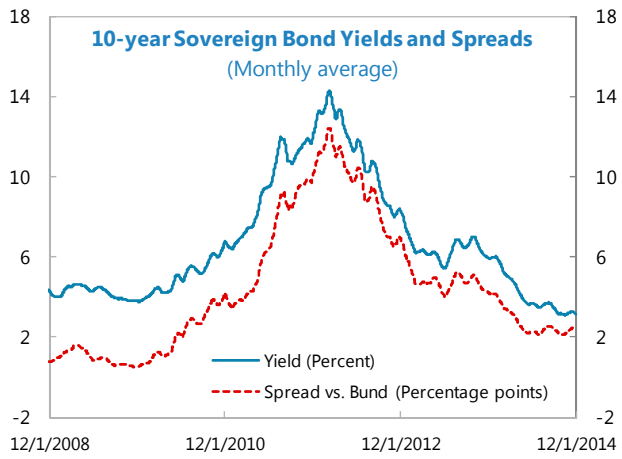
ANNEXES

INTRODUCTION

1. With the expiration of Portugal's EFF-supported arrangement on June 30th, the IMF Executive Board authorized the initiation of post-program monitoring (PPM). Following an adverse Constitutional Court (CC) ruling on expenditures in May, the authorities' decided to defer formulating a comprehensive response until after a second anticipated ruling on pensions and wages. As a result, the program expired without completion of the 12th review.

2. The pace of economic activity has moderated in 2014. Following the sharp turnaround in activity last year, momentum has eased in the context of slowing export growth and weak—albeit improving—investment. Private consumption continues to be the primary driver of growth, and rebalancing of the sources of growth remains elusive. Risks to the outlook are mainly tilted to the downside, although cushioned in part by the recent sharp fall in oil prices.

3. Benefiting from the reestablishment of policy credibility and market conditions, Portugal has been able to issue bonds at declining yields. The sovereign has issued both euro and U.S. dollar denominated bonds in 2014, successfully extending maturities to 15 years, and conducted a number of bond swap operations to improve the repayment profile of public debt. Overall, Portugal has built up a comfortable cash buffer and undertaken a substantial amount of pre-financing for 2015.



Source: Bloomberg; and IMF staff estimates.

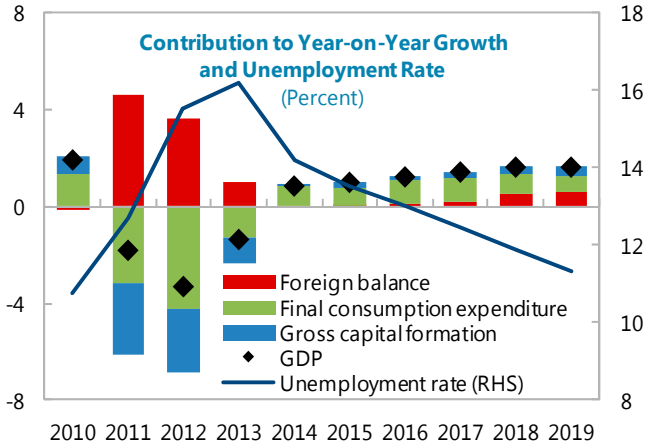
4. Many policies agreed towards the end of the program have been taken forward, but important challenges persist. Notwithstanding past efforts, improvements in competitiveness through sustained structural reforms and the reduction of corporate debt remain important priorities. In addition, there is a need to continue to reinforce financial sector stability in an environment of low growth and excessive corporate leverage. As regards fiscal policy, the attainment of the deficit target in 2015 relies on optimistic growth and revenue projections and implies a procyclical loosening of the fiscal stance in the context of a still significant debt stock.

5. Building consensus around reforms will prove challenging in the run-up to elections due by October 2015. As already witnessed over the past six months, the pre-election period is not conducive to bold reform initiatives, with a temptation towards populist policies expected to rise. Nevertheless, the authorities' hard-won credibility and currently benign market conditions provide a welcome but only limited window of opportunity to press ahead with reforms to unlock higher growth while safeguarding against risks.

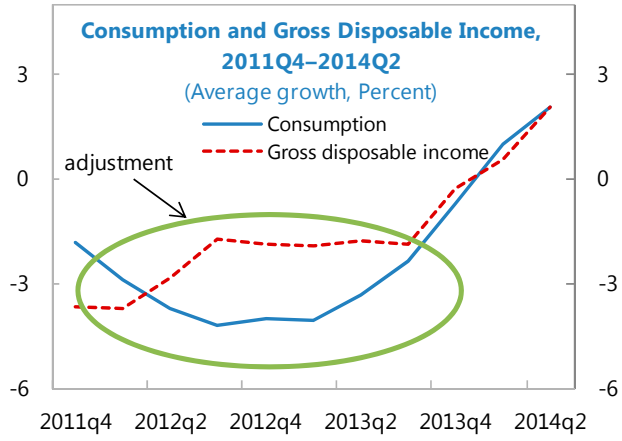
ECONOMIC DEVELOPMENTS AND OUTLOOK

Activity is expanding at a moderate pace with private consumption as the main driver. The recovery is clouded by a number of downside risks. Raising growth over the medium term will require higher investment and exports.

6. The pace of the recovery is slowing, as the contribution of net exports tapers off. The strong growth in private consumption since early 2013 continues, supported by the reduction in uncertainty, improved consumer confidence and a rise in disposable income. The contribution of net exports to year-on-year growth turned negative in the first three quarters of 2014 due to a combination of one-off factors impacting exports, limited competitiveness gains, and a recovery in domestic demand for tradables that has led exporters to reorient to the domestic market, reversing the trend observed during 2011–13.[1]

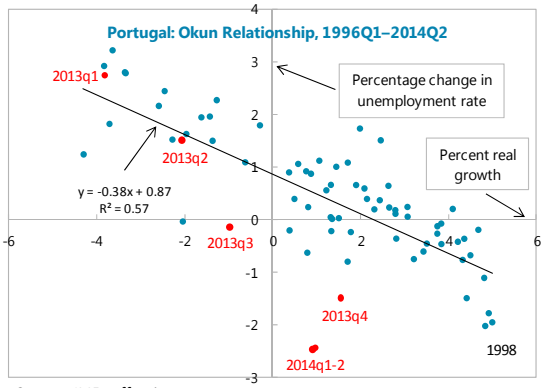


Sources: INE; and IMF staff estimates.



Sources: INE; and IMF staff estimates.

7. The decline in unemployment is outpacing GDP growth, but labor market slack is high. Unemployment data indicate a sharp decline since the third quarter of 2013 that is far in excess of what the Okun's relationship for Portugal would have suggested. Unemployment stands at 13.1 percent as of the third quarter of 2014, well below the crisis peak of 17.5 percent. However, broader measures of labor market slack—which also include discouraged workers and adjust for involuntary part-time work—suggest that

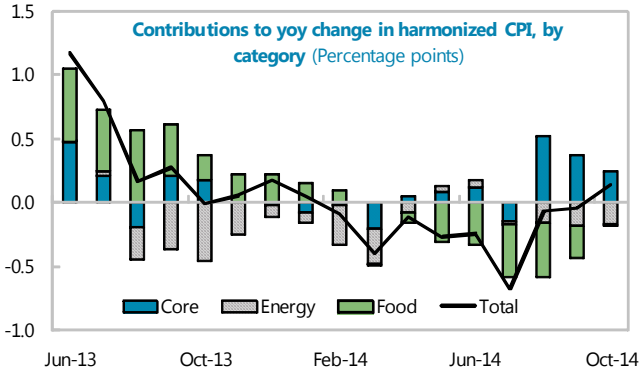


Sources: IMF staff estimates.

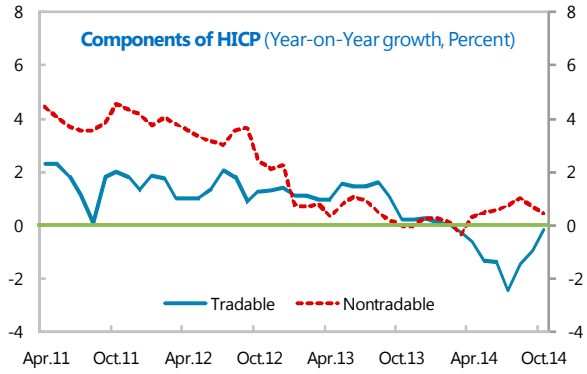
[1] In nominal terms, fuel exports in the first nine months of 2014 dropped by nearly 25 percent (y-o-y), reducing export growth by some 2.5 percentage points.

the official unemployment data provide only a partial measure of slack in a post-crisis setting (Box 1).

8. Falling food and energy prices are exerting a significant downward pull on inflation. While core inflation has recovered in recent months, overall inflation—at 0.1 percent in October—is still below the euro area average. The price of nontradables has been rising as the sector rebuilds margins eroded during the crisis, while tradable price inflation has been negative for most of this year.



Sources: IMF staff estimates.



Sources: IMF staff estimates.

9. The current account surplus is narrowing. Following an estimated market share gain of 4.6 percentage points in 2013 as export growth outpaced trading partners' import demand growth, Portugal is projected to register a market share loss of 0.4 percentage points in 2014. Of note, exports to non-EU trading partners declined by 2.5 percent in the year to September (y-o-y). While exports to EU countries still grew by 2.5 percent over the same period, exports to Spain–Portugal's largest trading partner–only grew by 1.1 percent (down from 8.4 percent for the same period in 2013). At the same time, nontradable prices have started rising again in the course of 2014 and outpaced tradable price growth, undermining efforts to regain cost competitiveness.

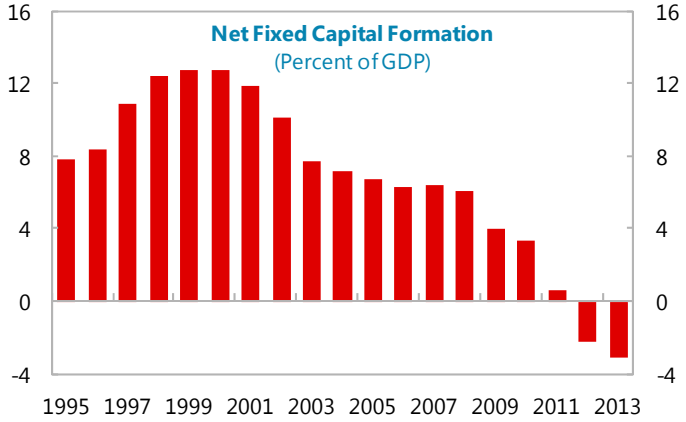
10. Euro area-wide conditions and regained policy credibility continue to support low sovereign yields. Portugal has successfully restored market access, issuing close to €17 billion in debt in 2014 through syndications and auctions, excluding bond exchanges and premiums/discounts, that met with strong demand from foreign investors and an increasing uptake from institutional investors. In line with broader patterns in the euro area, Portuguese sovereign yields have continued to decline, and are now some 260 basis points below their level at end-2013. With a successful 10-year bond auction in early November, at a yield of 3.2 percent, Portugal has completed its issuance program for 2014, and the cash buffer of €10.5 billion at end-October is expected to cover financing needs through June 2015.

Staff's views

11. Near-term growth prospects have weakened. With private consumption the main driver of growth and a negative contribution from net exports, the economy is expected to expand by around 0.8 percent in 2014 and by 1.2 percent in 2015. Investment and exports are expected to remain subdued mainly due to structural factors (discussed below). With import growth picking up

in tandem with domestic demand, the current account balance is expected to decline marginally this year and next. This narrowing of the current account surplus is worrisome in light of the still substantial external adjustment needed to bring Portugal's net foreign liabilities to more robust levels.[2]

12. The bottlenecks to growth and employment are significant. Over the medium term, growth is expected to plateau at about 1½ percent. Negative net investment and unfavorable population trends are curbing Portugal's potential growth, and the projected medium-term growth path relies on substantial increases in total factor productivity, which themselves depend on successful implementation of structural reforms. Should the reform effort begin to show signs of a prolonged pause, further downward revisions to the medium-term growth path may become inevitable. In this context, the most binding constraints to growth that need to be addressed are still weak external competitiveness that restrains the upside potential for exports, and excessive corporate leverage that restricts the upside for investment. Higher exports would facilitate sustainable increases in imports, especially of investment goods; and lower debt—aided by a concerted deleveraging effort—would also allow non-financial corporations to invest and expand. Failure to meet this growth challenge would prevent absorption of the substantial post-crisis labor market slack and likely result in outward migration of workers as seen in recent years, while the skills of the unemployed that stay but cannot find jobs will degrade.



Source: AMECO.

13. Financing conditions have continued to improve but are at risk of a reversal, absent further reforms in the context of a sizable debt burden. While Portugal enjoys market access at remarkably favorable nominal yields, further reforms are needed to preserve recently regained policy credibility and market confidence in view of Portugal's high debt levels.[3] Based on current fiscal policies, the debt-to-GDP ratio is projected to continue to decline only gradually over the medium term to around 123 percent by 2019. Higher growth and additional fiscal consolidation will be critical to anchor debt safely on a downward-sloping path in 2015 and beyond. Moreover, debt sustainability hinges on further structural reforms to support competitiveness and growth over the medium term (Annex I).

[2] Should the current account stabilize at about ½ percent of GDP, it would take 13 years to bring Portugal's net foreign liabilities to half the level observed in 2013.

[3] Following rating and outlook upgrades by all major rating agencies earlier in the year, a widely expected upgrade to investment grade by Fitch in October did not materialize. In its ratings review in November, Standard and Poor's also decided to keep the rating unchanged and not to upgrade the outlook to positive. Both rating agencies emphasized fiscal and financial risks.

14. The baseline is characterized by risks that are mainly on the downside. The fall in oil and commodity prices in recent months provides a positive terms-of-trade shock and higher disposable income for households that could translate into higher overall growth especially in 2015. However, this upside is small relative to the downside risks which are interconnected and would likely cascade, with existing vulnerabilities amplifying the initial trigger event (Figure 1).

- **Trigger events could be domestic or external.** Global financial volatility, possibly triggered by geo-political events or a broad reappraisal of European bond market valuations, would have a direct impact on Portugal through financial stress and weaker confidence. Any associated slowdown in external demand would have implications for Portuguese exports. A prolonged period of low growth in the euro area could also slow the recovery of exports and/or lead to increases in financing costs. This could be in conjunction with excessively low inflation in both trading partners and Portugal, which would work through financial and real channels, exacerbating ongoing challenges from low inflation. Political and legal setbacks are also important trigger events that may cause a reappraisal of Portugal's prospects and operate through both financial and real channels.

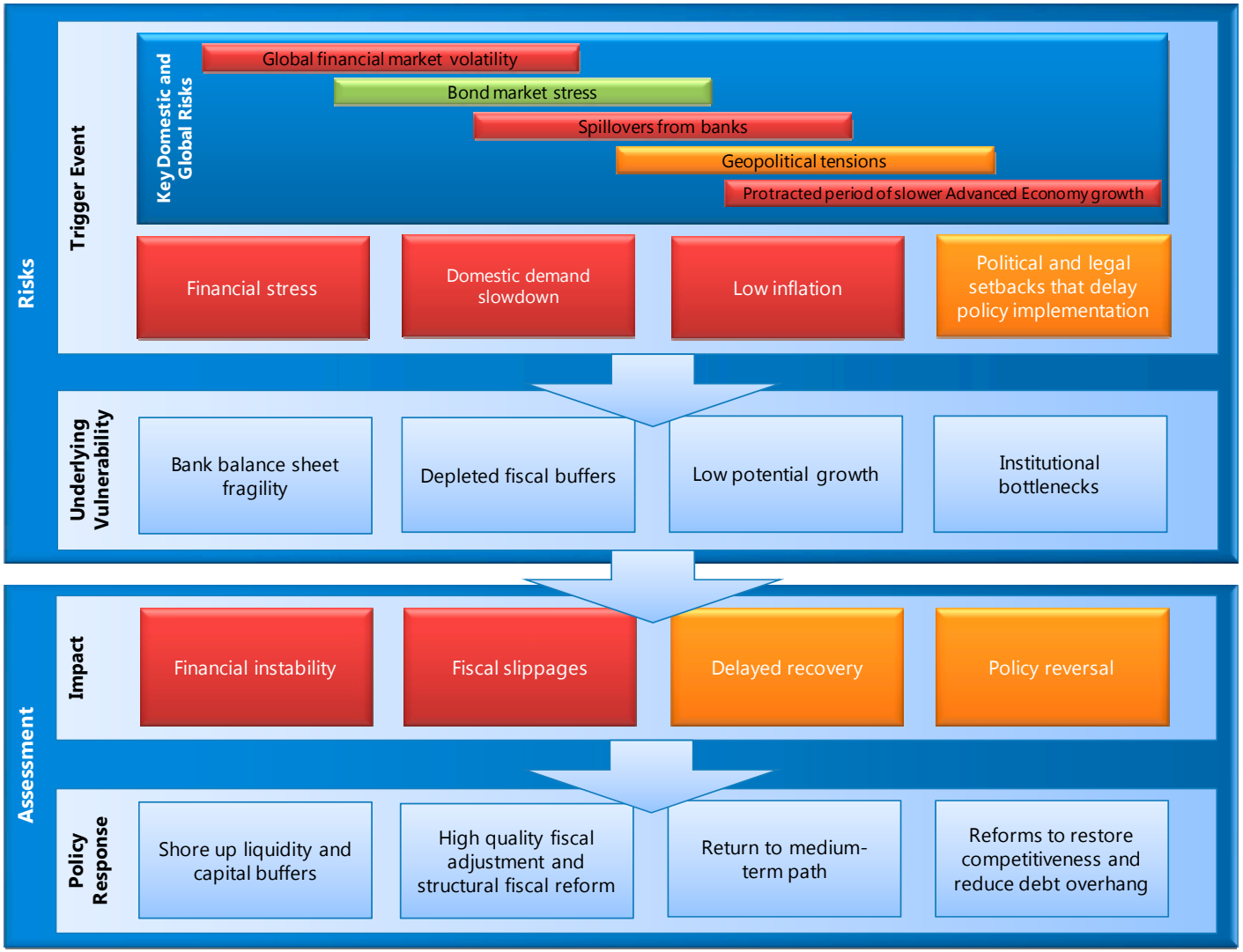
- **Portugal's underlying vulnerabilities are significant.** Balance sheet fragilities continue to be elevated in the banking and corporate sector and public debt is still very high. Potential growth is curtailed by the overhang of public and private debt and the need for further improvement in external competiveness. In addition, institutional and legal bottlenecks could constrain the effectiveness of policy responses.

- **The impact of downside risks materializing depends on the specific confluence of events.** Risks and underlying vulnerabilities are interconnected and mutually reinforcing. Depending on the specifics, the materialization of risks would likely manifest itself in heightened financial instability, deteriorating fiscal and public debt positions, and further delay in the restoration of internal and external balance, or indeed an outright reversal of reforms.

Authorities' views

15. The authorities are of the view that the recent growth underperformance can be attributed in much larger part to temporary factors. These include less favorable external conditions and domestic one-off factors, such as production stoppages at important exporting firms. The authorities agreed that the balance of risks are on the downside, but saw the risks as mostly external in nature and had a more optimistic view of the potential upsides from ECB's accommodative monetary policy stance and from faster export growth. As a result, the macroeconomic framework in the 2015 budget projects growth of 1 percent in 2014 and 1.5 percent in 2015. Accordingly, the authorities foresee a significant improvement in debt dynamics, and expect gross debt to decline to 123¾ percent of GDP by end-2015. With projected current and capital account surpluses of about 1 and 2 percent of GDP respectively over the medium term, the Bank of Portugal views the pace of external adjustment as appropriate to lower Portugal's sizable net foreign liabilities, albeit over a prolonged period.

Figure 1. Risk Assessment Matrix and Interconnectedness[1]



[1]The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low/green" is meant to indicate a probability below 10 percent, "medium/yellow" a probability between 10 and 30 percent, and "high/red" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

POLICY DISCUSSIONS: BUILDING ON THE FOUNDATIONS ESTABLISHED UNDER THE PROGRAM

Reforms initiated under the program provide a sound foundation to build on. Momentum needs to be regained on policies that deliver a higher growth trajectory and reduce underlying vulnerabilities.

A. Structural Reforms to Boost Competitiveness and Growth

16. The minimum wage was raised in October and several measures relating to collective bargaining have been adopted since June. The minimum wage, which had been frozen since the beginning of the program, was raised from €485 to €505 per month starting October 1, 2014. The increase was accompanied by a reduction of 0.75 percentage points in employers' social security contribution for minimum wage earners. Regarding labor market flexibility, recently adopted measures on collective agreements allow for the extension of collective agreements to all firms in a sector, including firms that are not members of the signatory employers' associations, if 30 percent of micro and SME firms of that sector are represented directly or indirectly in the signatory employers' associations. The survival period of collective agreements has been shortened from 5 to 3 years, and the possibility of temporary suspension of collective agreements in the face of economic crises or natural disasters has been introduced.

17. A sizable increase of the non-social tariff on electricity is envisaged for 2015, in conjunction with a significant expansion of the social tariff program. The number of households eligible to receive the social tariff discount will increase from the current 60,000 to 500,000 in 2015, and the tariff discount will rise from 6 to 20 percent, mainly funded by additional contributions from large hydro and non-renewable energy producers. The non-social tariff consumers, however, will see their electricity tariff go up by 3.3 percent in 2015, breaking through the ceiling for tariff increases established by the authorities under the program.[4] Interim targets for eliminating the tariff debt by 2020 were however missed again, and the tariff debt is now projected to be eliminated only in 2022. Meanwhile, the anticipated reduction in natural gas prices, through the amendment of the concession contract with the natural gas supplier, has yet to take place.

18. Reforms in other areas are proceeding with delay or are being reversed in some cases. Notably, the adoption of new by-laws for the 18 highly regulated professions is delayed once more, and it is still unclear when they will be submitted to Parliament for approval. The latest amendments to the housing lease law give additional protections to tenants, going against the spirit of the measures adopted under the program that aimed to promote a more dynamic housing and rental

[4] With the electricity system costs determined independently from demand—through contracts with generators that hedge the sale price from the market price—and with the end-user prices below these costs, the electricity system has been generating "tariff deficits", which resulted in a stock of tariff debt currently estimated at some €4.6 billion. While taking measures in the past three years to curtail the rise in electricity tariffs, the authorities were committed to annual real price increases between 1.5 to 2 percent—a range set to balance the needs of eliminating the tariff debt by 2020 and limiting the adjustment burden on end-users.

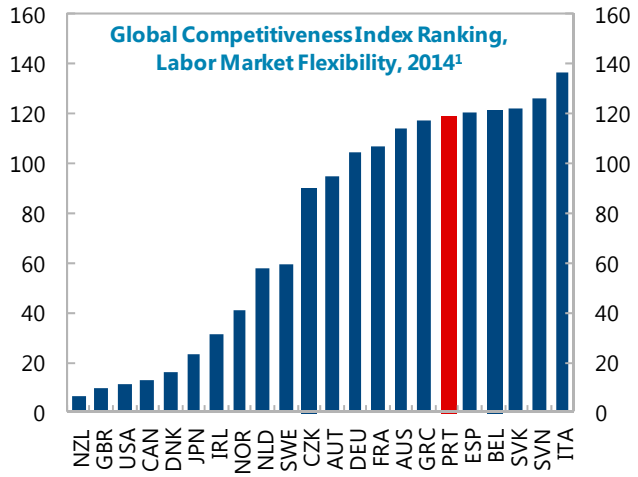
market. Finally, IT problems have caused severe operational issues in the newly implemented judicial roadmap.

Staff's views

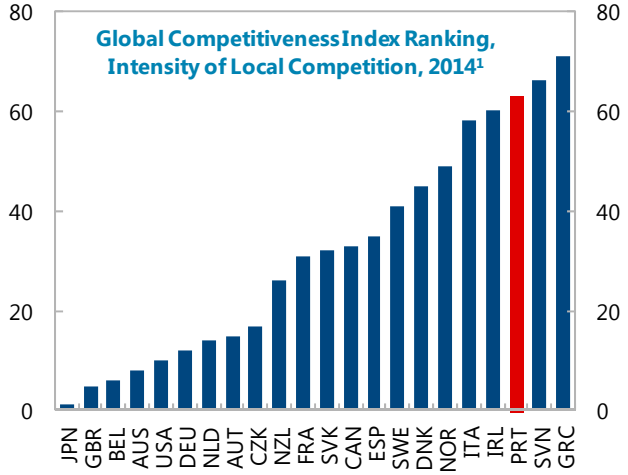
19. Despite the reform efforts undertaken during the program, significant constraints to competitiveness and growth persist. As underscored by the most recent international competitiveness rankings, Portugal has large upside potential, but impediments continue to constrain its external competitiveness, including restrictive labor regulations and lack of effective competition in local product markets. The latter is also reflected, for instance, in the still large gap between the tradable and nontradable sector FDI inflows and markups.[5]

20. Structural bottlenecks should be addressed with more purpose and closer coordination. The reform process should be oriented towards achieving measurable outcomes. In this context, it will be important for the government to step up its efforts on both ex-ante and ex-post assessment of structural reforms, gauging the impact through outcome-based indicators and dynamically adjusting the reform inputs as needed. From this perspective, the dissolution of ESAME, the monitoring entity in the Prime Minister's office established during the program and the reduction in associated staffing, represents an unwelcome downward reprioritization of the coordination of structural reform efforts.

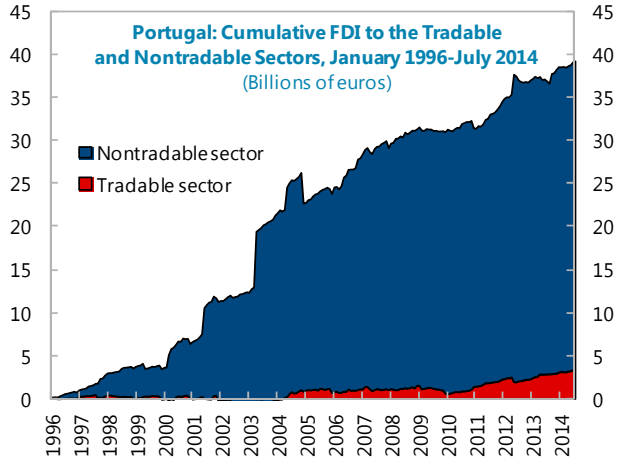
21. In recent months, however, labor market and energy sector reform efforts appear to have flagged. With low-skilled



Source: World Economic Forum.
[1]A lower rank corresponds to a more advantageous competitive position.



Source: World Economic Forum.
[1]A lower rank corresponds to a more advantageous competitive position.



Sources: Banco de Portugal; and IMF staff estimates.

[5] For an extended discussion on product market reforms, see IMF Country Report No. 14/56, Box 5 and IMF Country Report No. 14/102, Box 4.

workers having borne the brunt of the crisis, the recent minimum wage increase in an environment of very low inflation appears premature and could impede a normalization of labor markets, particularly for low-skilled workers and youth (Box 2). The reduction in the survival period of collective agreements and the possibility for temporary suspension are welcome measures. However, the new option of extending agreements to the whole sector even if only 30 percent of micro and SMEs are represented undermines the progress towards a more dynamic and inclusive system of collective bargaining. In the energy sector, while the reduction in electricity costs for low-income consumers is welcome, the large increase for other users will undermine efforts to improve competitiveness.

22. Near-term reform priorities continue to be in line with past program recommendations. Rather than resort to increases in the minimum wage before the labor slack has been significantly reduced, the authorities could use other policy tools such as earned income tax credits to help low-skilled workers and their families without eroding competitiveness. Further loosening employment protection, particularly for permanent contracts, would boost labor demand and reduce labor market segmentation. The continued reduction in excessive rents in the nontradable sectors is also important. In this context, the authorities should take further measures to reduce the high overhead costs of the electricity system, to enhance external competitiveness and to improve the welfare of households, including those that do not benefit from the social tariff regime. This would also help to eliminate the by now sizeable tariff debt by 2020. In the gas sector, the planned clawback of windfall profits currently benefiting the main natural gas operator, should be pursued, and the savings should be passed on to end-users.

Authorities' views

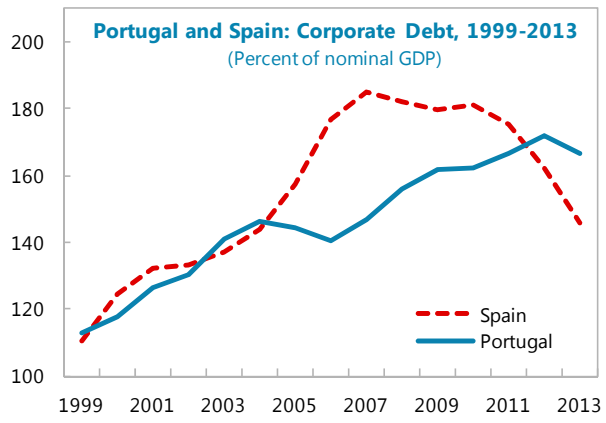
23. The authorities are mindful of the difficulty in implementing structural reforms, while agreeing that these reforms are essential to promote jobs and growth. They argued that the increase in the minimum wage was a result of reaching a broad-based social consensus similar to what was done to freeze the minimum wage in 2011, and regarded the increase as a necessary step toward linking future minimum wage changes to productivity gains. They believed that the positive effect on domestic demand would offset the potential negative impact on employment and competitiveness. The authorities agreed that high energy prices still weighed on competitiveness, but emphasized that there was an inherent contradiction between targeting the elimination of the tariff deficit and limiting tariff increases.

B. Reducing the Corporate Debt Overhang

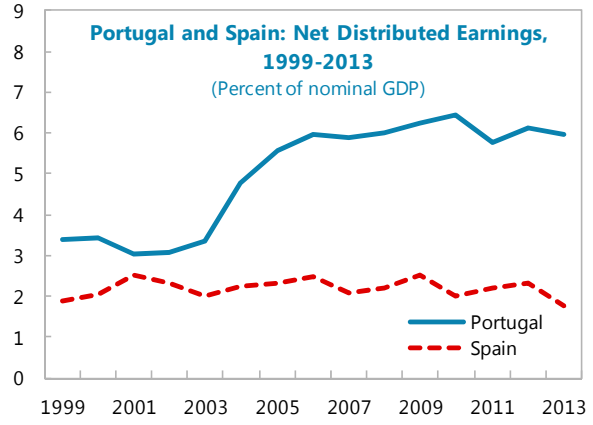
24. The pace of corporate deleveraging has been slow. Corporate debt as a percent of GDP started to decline in 2013, but remains well above its pre-crisis level in 2008. This contrasts, for example, with Spain where corporate debt has already declined significantly over the last few years,[6]

[6] For a more detailed discussion of developments in Spain, see IMF Country Report No. 14/192.

with deleveraging being underpinned by substantially lower levels of distributed earnings than in Portugal.



Sources: INE; Banco de Portugal; and Banco de España.
Unconsolidated national accounts.



Sources: INE; Banco de España; and Eurostat.

Staff's views

25. A more forceful and systemic deleveraging strategy is necessary to accelerate the pace of corporate deleveraging. Excessive debt is constricting firms' investment, undermining productivity, and resulting in resource misallocation to unviable firms.[7] While the legal frameworks to facilitate in-court (PER) and out-of-court (SIREVE) debt restructuring that were put in place under the EFF would be adequate for the normal cyclical load of corporate debt workout cases, significantly reducing the level of corporate debt amid weak prospects for recovery requires more timely action and enhanced creditor coordination. Hence, staff continued to encourage the authorities to implement a standardized resolution strategy by (i) setting up a standardized bank-led time-bound framework to deal with debt restructuring of highly-indebted micro and SMEs; and (ii) establishing a body with sufficient credibility, supported by a robust reporting framework, to coordinate action across banks and debtors. In designing the deleveraging strategy, the authorities will need to carefully balance the benefits of accelerating the deleveraging process with financial stability considerations. In this context, a successful implementation of the strategy to address the stock problem hinges on efforts to strengthen bank capital buffers above and beyond regulatory requirements to create the room necessary for banks to absorb the impact of faster deleveraging of corporate debt. At the same time, to address the flow problem, further reforms also need to be undertaken to discourage the debt bias of owners of Portuguese firms and encourage a higher share of equity, to encourage better risk sharing between the corporate and financial sectors.

[7] Please refer to IMF Country Reports No. 14/102 and No. 13/19 for further analysis, as well as IMF Working Paper 13/154 for a review of the literature and an analysis of the impact of the corporate debt overhang on investment.

Authorities' views

26. The authorities reaffirmed that reducing corporate indebtedness remains a priority. During recent months, the authorities have worked on a strategic action plan for promoting orderly deleveraging of the non-financial corporate sector. The measures *inter alia* envisaged in the plan seek to (i) generate further incentives for borrowers and creditors to engage in timely restructurings; (ii) fine-tune restructuring procedures; (iii) encourage more balanced capital structures for companies, including through the development of alternatives to bank debt financing; and (iv) enhance oversight of the restructuring processes. The authorities noted that close monitoring of those measures should continue in order to assess their effectiveness.

C. Safeguarding Financial Sector Stability

27. The banking system is adjusting while operating in a difficult environment. By the end of June 2014, the loan-to-deposit ratio of banks had declined to 114 percent—down from over 140 percent at the program's outset—allowing banks to significantly reduce their reliance on Eurosystem refinancing operations. In parallel, capital buffers have been strengthened with a Common Equity Tier 1 ratio of 10.6 percent (12.3 percent if the exceptional losses incurred by Banco Espírito Santo are excluded). Bank supervision has been enhanced via the adoption of new supervisory methodologies and regulatory improvements, *inter alia* pertaining to the treatment of non-performing exposures and restructured loans. However, underlying bank balance sheet challenges persist, largely on account of the heavily indebted corporate sector (as highlighted above).

28. The Portuguese banking system continues to struggle with low profitability, which in turn limits its ability to finance new borrowing for investment. Weak credit fundamentals in combination with exceptionally low interest rates on mortgage portfolios and declining lending volumes continue to weigh heavily on the banking system. While bank earnings are being aided by ongoing cost-rationalization, non-recurrent income—notably income from financial operations—and the reimbursement of contingent capital instruments subscribed by the Portuguese government, such positive developments cannot be counted on to sustainably buoy bank earnings.

29. Financial stability has been maintained despite the challenge posed by the resolution of Banco Espírito Santo (BES). The exceptionally large losses reported by BES at end-July exacerbated market concerns and cast doubt on the feasibility of prompt recapitalization of the bank via private sources. Attendant liquidity pressures, together with the imminent suspension of the bank's counterparty status by the ECB's Governing Council necessitated decisive action. Considering the bank's importance in the banking system and in the financing of the economy, the Banco de Portugal (BdP) decided to apply a resolution measure that comprised the creation of a bridge bank (Novo Banco) to which critical functions and viable operations of BES were transferred. In line with current state aid requirements, BES' equity holders and outstanding claims of subordinated creditors were left behind in the bad bank, while most other claims were transferred in full to Novo Banco. Via this intervention, the stability of the Portuguese banking system was maintained without generating any substantial spillovers to the rest of the banking system.

Staff's views

30. Efforts to strengthen the resilience of the banking system need to be sustained. To guard against a possible reversal in market sentiment and facilitate the mandatory repayment in Q1 2015 of the European Central Bank's three-year long-term refinancing operations (LTROs), banks should continue to strengthen their liquidity positions and address residual funding imbalances.[8] Building on the successful completion of the Comprehensive Assessment (CA) (Box 3), efforts to increase capital buffers and fortify provisioning levels under benign market conditions, including by ensuring that banks maintain prudent collateral valuations, should continue—for the largest banks under the direct supervision of the Single Supervisory Mechanism—to allow banks to reduce the corporate debt overhang on their balance sheets in an orderly fashion. In parallel, supervisory vigilance is necessary to further strengthen banks' risk management and oversight capabilities—particularly with regard to overseas operations—with the aim of preventing excessive risk-taking to compensate for weak profitability prospects in their domestic operations.

31. The restructuring and sale of Novo Banco needs to ensure financial stability as its primary objective. The strategy used for the resolution of BES (Box 4), although in line with the internationally accepted objective of minimizing the cost of resolution actions for taxpayers, could generate spillovers to Portugal's banks via the allocation of potential losses of the Resolution Fund if the eventual sale proceeds of bridge bank Novo Banco are insufficient to fully reimburse the loans granted to the fund. To reduce market uncertainty, the authorities should aim to clarify, as soon as practicable, the modalities for loss allocation, as well as the envisaged accounting and prudential treatment of the transaction. In particular, the authorities should consider introducing an extended repayment schedule of the government's loan to the Resolution Fund, allowing the banking industry to absorb any costs of the resolution over a longer horizon.

Authorities' views

32. The authorities noted that the financial sector has continued to be stable despite recent headwinds. While the authorities do not view the Comprehensive Assessment as a recurrent exercise, they reaffirmed their commitment to the close supervision of Portuguese banks, both domestically and abroad. In view of the difficult operating environment, efforts to buttress bank buffers will continue, notwithstanding the CA conclusion that capitalization levels under the baseline scenario (incorporating the findings of the asset quality review) are adequate. The resolution of BES used the resolution regime that was put in place under the EFF, as well as the authorities' operational capacity to intervene decisively, but the authorities also acknowledged that the sale of Novo Banco will need to be carefully managed to minimize spillover

[8] Nonetheless, measures recently announced by the European Central Bank, notably the introduction of the targeted longer-term refinancing operations, the third covered bond purchase program and the asset backed securities purchase program provide an additional cushion against potential liquidity pressures.

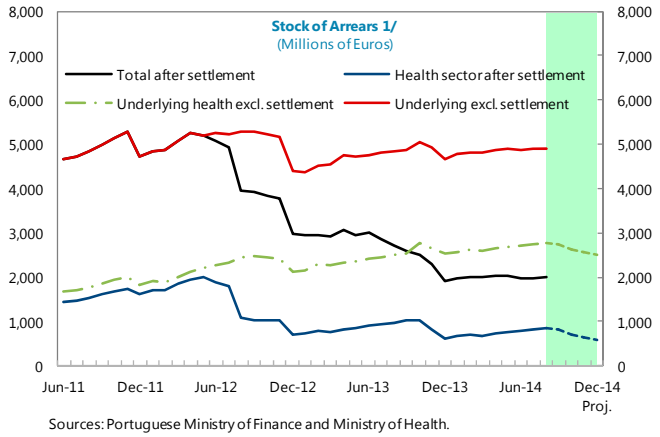
risks and avoid overburdening of the largest Portuguese banks. However, they felt it was premature to define the modalities for loss allocation, until a loss had materialized and its magnitude was known.

D. Ensuring Fiscal Sustainability

33. Budgetary performance for 2014 is on track. The Constitutional Court (CC) overturned key provisions in the 2014 budget in May, notably with regard to public sector wage cuts, constraining the authorities' ability to rebalance the fiscal adjustment away from revenues. However, the legally mandated additional spending on wages (0.3 percent of GDP) and significant new pressures on public spending, largely from SOEs, are expected to be offset by robust revenue performance in VAT and PIT as well as significant savings from lower unemployment benefits. The overall projected fiscal deficit of about 5 percent of GDP in 2014 includes sizable one-off transactions in SOE and banking support operations as well as other one-off measures related to growth-enhancing tax incentives and structural spending reforms. Net of these one-off items, the 2014 deficit is expected to be about 3.9 percent of GDP.

34. The 2015 budget submitted to Parliament targets a somewhat larger deficit than in the authorities' 2014 Fiscal Strategy Document (FSD). The authorities are now targeting a smaller reduction in the fiscal deficit in 2015, to 2.7 percent of GDP. Only modest progress on spending reforms is envisaged in the budget, as the authorities decided against the introduction of new compensatory measures to offset the CC rulings on public wages and pensions. This is in the context of stiff resistance encountered by any broad-based reform of public administration and pensions in the run-up to the elections next year. Moreover, the budget envisages new reductions in PIT revenues—as part of the ongoing reform—and in the CIT statutory rate against expected receipts from green taxes and sustained strong revenue windfalls from efficiency gains in tax administration.

35. The authorities' strategy to address arrears in the SOE sector has begun to appreciably reduce the stock of arrears. Last April, the Ministry of Health concluded the contract renegotiations with the SOE hospitals for 2014 and, as of September, started allocating additional budgetary funds to these entities to close any residual operational imbalances, conditional on progress towards their financial targets. As a result, health arrears started declining in September, with the accumulation of new arrears registered in 2014 (€245 million as of end-August) expected to be more than offset by end-year. A new debt management strategy was also launched in April for the railroad company, *Comboios de Portugal*, aimed at improving the company's funding model and halting any further accumulation of arrears (see Annex II).

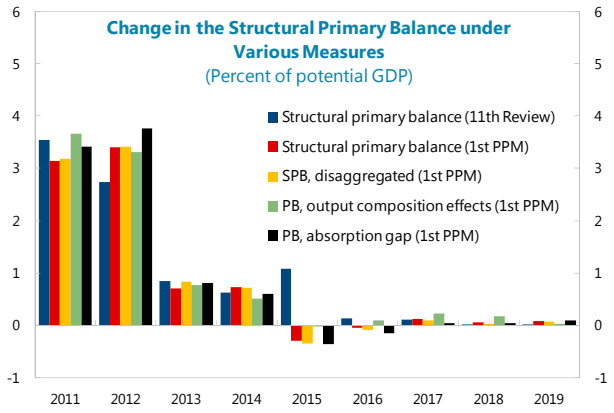


Sources: Portuguese Ministry of Finance and Ministry of Health.
1/ Values from Sep-14 to Dec-14 correspond to projections.

Staff's views

36. The fiscal path in the 2015 budget is underpinned by optimistic macroeconomic projections and revenue assumptions. Staff's assessment of the 2015 budget points to a markedly higher deficit of 3.4 percent of GDP compared to the authorities 2.7 percent of GDP target, consistent with more conservative macro projections and, to a lesser extent, different revenue assumptions. This implies a procyclical loosening of the fiscal stance of around 0.3 percent of potential GDP.

37. In view of Portugal's high debt and significant financing needs, additional measures appear necessary to safeguard the 2015 deficit target and the fiscal consolidation path articulated in the 2014 FSD. Notwithstanding recurring legal challenges and rising political pressures ahead of the elections next year, further measures to contain the wage and pension bills, including by building on the earlier recommendations of the Public Expenditure Review,[9] are critical to achieve the necessary fiscal adjustment. In particular, in the short-term, there appears to be scope for further streamlining public expenditure, including through additional reductions in public employment via mutual agreements and requalification schemes in areas of over-employment, more ambitious savings from the reduction or elimination of public wage supplements, as well as further efforts in the means-testing of fiscal and non-contributory social benefits. Most importantly, further expenditure measures could create the necessary fiscal space for comprehensive tax reforms supportive of growth and employment while minimizing risks to the achievement of the deficit targets. Accordingly, while the revenue-neutral aspects of the authorities' PIT reform—notably in terms of simplification and harmonization with the CIT system—are welcome, the decrease in revenues from the PIT reform and the further reduction in the CIT statutory rate appear premature, given that the necessary rebalancing of the adjustment effort is still pending.



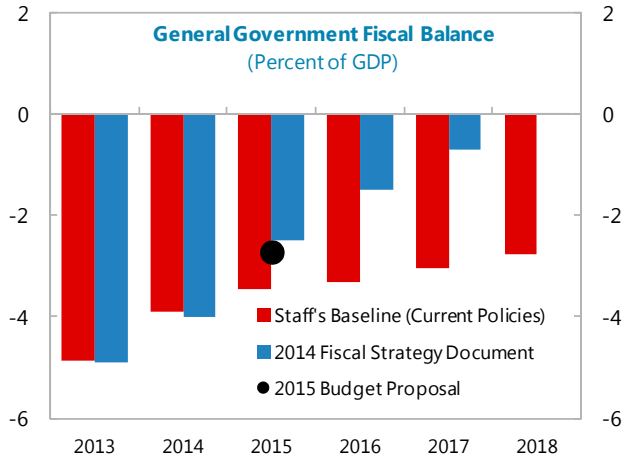
Source: IMF staff estimates.

38. In the absence of renewed reform momentum, the targeted and realized fiscal paths are expected to diverge sharply over the medium-term.[10] Based on current policies, the entirety of the public sector wage cuts introduced under the program would be reversed by 2016, in line with the CC ruling, and no further savings from social security would be realized. Further efforts over the medium term are needed to enhance the equity and affordability of the pension system, in line

[9] See also "Portugal: Rethinking the State—Selected Expenditure Reform Options", IMF Country Report No. 13/6.

[10] The authorities' 2014 FSD is consistent with a minimum structural adjustment effort of ½ percent of GDP per year, as envisaged by the European Treaty on Stability, Coordination, and Governance framework.

with past policy advice.[11] In this context, a broad reform of the civil servants' regime (CGA)—whose beneficiaries receive disproportionately higher old-age pensions than in the general social security regime (CGR)—is critical. These efforts to reform the pension system should be supported going forward by the introduction of a new pension indexation rule based on economic and demographic factors —as proposed earlier in 2014 by the Pension Reform Committee. Similarly, a more ambitious reform of public sector remunerations and careers—building on the recently enforced single wage bill and the comprehensive review of supplements— is necessary to guarantee the sustainability of the wage bill while ensuring a more meritocratic system able to retain and attract talent in the public sector. Until these structural consolidation efforts are completed, the authorities should consider postponing, to the extent possible, the full reversal of the temporary measures related to public wages and pension payments.



Sources: Portuguese authorities; and IMF staff calculations.

39. Considerable progress has been made in the fiscal structural reform agenda, but challenges persist. As also highlighted in the recent Fiscal Transparency Evaluation (FTE), staff welcomes the stronger understanding and reporting of fiscal risks as well as the enhanced transparency within the general government perimeter delivered by public financial management (PFM) reforms undertaken by the authorities under the program. Tax administration reforms have also advanced, successfully delivering on their objective to fight fraud and broaden the tax base. Nevertheless, the ongoing work in the following areas are critical to the completion of the reform agenda:

- *Strengthening public financial management* calls for (i) a more comprehensive revision of the Budget Framework Law; and (ii) further centralization of risk management at the general government level within a coherent framework under the responsibility of the Minister of Finance.

- *Enhancing fiscal oversight of SOEs, PPPs, and regional and local governments* requires further steps to strengthen the monitoring and reporting of fiscal risks, which, despite numerous initiatives undertaken in the last few years, continue to be fragmented. While gaps continue to exist in specific central government's entities, these are mainly concentrated in PPPs and state-owned enterprises in municipalities and regions outside the general government.

[11] Please refer to Box 3 on "The Portuguese Pension System: Sustainability and Equity Considerations" in IMF Country Report No. 14/102.

Authorities' views

40. The authorities believe that the revised deficit path is within reach. They stressed their continued commitment to fiscal discipline, while noting that scope for further spending measures was severely constrained by the recent adverse CC rulings on the wage bill and pensions—which, together with the interest bill, account for nearly three-quarters of public spending. They highlighted that the revenue projections in the 2015 budget are underpinned by a stronger macroeconomic outlook and the anticipation of significant efficiency gains. They also noted that, despite reported delays in implementation, steps are being taken to advance the residual Public Expenditure Review measures in the budget, in line with the commitments in the 2014 FSD. Moreover, they are closely monitoring budget implementation and stand ready to adapt the budget strategy in order to ensure that the fiscal targets for 2015 are met. Finally, they envisioned continued fiscal consolidation over the medium-term, although specific measures have not been identified yet.

41. The authorities agreed with staff that fiscal structural reforms play a crucial supporting role in fiscal consolidation efforts. The tax authorities highlighted their sustained efforts to strengthen revenue collection, including through the introduction of further measures in the 2015 budget to broaden the scope of the electronic invoicing. On PFM, the reform of the accounting framework is continuing and consultations with stakeholders on a new budget framework law are forthcoming. Moreover, they stressed their commitment to strengthen fiscal oversight of all public entities, as demonstrated by the recent operationalization of the SOE monitoring unit (UTAM).

POST-PROGRAM MONITORING

42. Portugal has prefunded a significant part of next year's financing needs and is on track to start Fund repurchases in November 2015. Since exiting the program, spreads have further narrowed and—despite a bout of volatility in the summer triggered by the resolution of BES—long-term bond yields are now below 3 percent. Favorable financing conditions allowed Portugal to issue close to €17 billion in debt in 2014, excluding bond exchanges and premiums/discounts, with recent issuances helping lengthen the maturity profile and diversify the currency composition. In addition, to smooth the redemption profile, the treasury and debt management agency (IGCP) in late November swapped €1.75 billion of bonds maturing in 2015–16 for bonds maturing in 2021 and 2023. A cash buffer of €10.5 billion at end-October, excluding the remaining deposits in the Bank Solvency Support Facility (BSSF) account, is sufficient to cover financing needs up to mid-2015. The financing of some €11 billion to cover financing needs through end-December 2015, including the first EFF repurchase of €0.5 billion in November, is manageable under baseline assumptions.[12]

[12] The authorities project to issue some €13.6 billion in debt in 2015 through a combination of auctions, syndications and MTN issuance, frontloading this so as to be fully financed for the year by May. Stepped-up retail issuance, bond purchases by the social security fund in the primary market, and, if needed, net T-bill

(continued)

43. While medium-term financing needs are sizeable, Portugal's capacity to repay the Fund is expected to be adequate. With debt redemptions increasing to an average of about €14 billion per year in 2016–19, of which Fund repurchases represent just over one quarter, maintaining an adequate cash buffer over the medium term would require significantly stepping up regular issuance from 2016 onward. This appears manageable, assuming no reversal in market access or in fiscal and structural policies. Signs that policy reversals are taking place as reform momentum is waning, however, render Portugal's capacity to repay more vulnerable to a sudden change in market sentiment.

STAFF APPRAISAL

44. Portugal's adjustment program has been successful in stabilizing the economy. Portugal ended its EU-IMF supported program in June with restored access to sovereign debt markets and a strong record of policy implementation, having initiated reforms to remove long-standing structural impediments to growth and job creation. The economy has emerged from a deep recession and unemployment is declining rapidly from very high levels. The large pre-crisis current account deficit has turned into a surplus, while substantial fiscal consolidation has been achieved.

45. Notwithstanding the progress already made, the current policy trajectory appears insufficient for attaining sustained higher growth. Therefore, efforts to reorient the economy towards higher investment and exports should be reinvigorated. This is essential to rebuild the economy's capital stock and absorb the significant labor slack that has emerged since the onset of the crisis. From this perspective, the recent loss of reform momentum is not encouraging.

46. Two main bottlenecks to high growth and durable rebalancing persist: low external competitiveness and excessive leverage, especially in the corporate sector. With no effective devaluation tools available, and with low inflation in Portugal's key trading partners rendering the needed relative price adjustment especially difficult, structural reforms of labor and product markets provide the only route to increase the attractiveness of producing tradable goods and services. In parallel, a systemic approach to the corporate debt overhang is urgently needed to alleviate the coordination failures that prevent firm owners, creditors, and potential new investors from restructuring the debt of viable firms, thus freeing up resources for private investment and job creation.

47. Reducing corporate indebtedness is also central to improving banks' operating environment and supporting the process of balance sheet repair, under vigilant supervision by the BdP. While financial stability has been maintained, recent events underscore that recovering from a severe debt crisis tends to be a protracted process, replete with unpleasant surprises. It is important that the opportunity provided by the ECB's Comprehensive Assessment of the largest

---

issuance would help ensure that financing needs through end-2015 could still be met should market sentiment reverse.

banks is a catalyst to strengthen the resilience of the banking system. In particular, banks need to maintain robust risk management practices to avoid taking excessive risks, including in their overseas operations, creating additional challenges for supervision. Looking ahead, the authorities' strategy for Novo Banco will need to ensure the preservation of financial stability while safeguarding public finances.

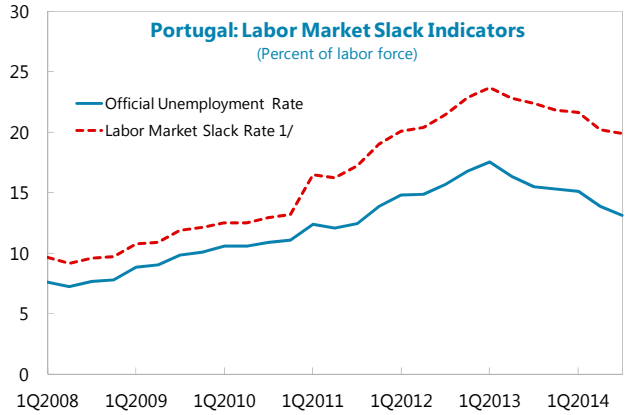
48. Portugal has little leeway to digress from its fiscal policy commitments, which will need to be sustained over the medium term. In the absence of further fiscal consolidation efforts in 2015 and over the medium term, the projected deficit is expected to diverge from the authorities' medium-term budgetary commitments, jeopardizing the authorities' hard-won policy credibility under the program. While past Constitutional Court rulings may have constrained fiscal consolidation options, continued fiscal adjustment within a medium-term perspective is critical to anchor debt sustainability and market confidence on a durable basis. This must be supported by sustained efforts to advance the fiscal structural agenda, as evidenced by the critical role in strengthening public finances played by recent improvements in tax compliance and commitments controls.

49. The next **Article IV consultation** is expected to take place in early 2015.

Box 1. Labor Market Slack

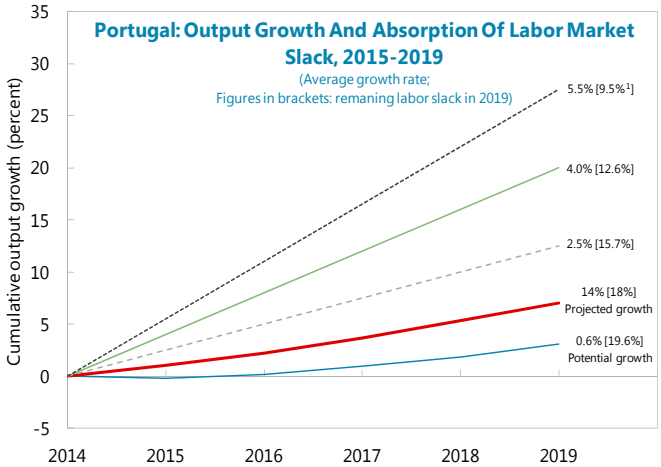
How big is economic slack in Portugal? The conventional answer relies on unemployment and output gaps, presently estimated at 1.7 percent (unemployment gap) and 3.6 percent (output gap), respectively, in 2014. With potential growth limited by a declining working-age population, low investment, and moderate total factor productivity growth, closing these gaps over the medium term puts tight a priori constraints on the growth outlook. In staff's baseline, the average projected GDP growth rate for 2015–19 is 1½ percent. With this growth outlook, by 2019 Portugal's GDP level would still not have reached the 2008 level.

These answers regarding the extent of slack, however, sidestep the realities of post-crisis countries that have inherited unusually large internal imbalances after stabilizing the economy. Labor market slack in particular is unlikely to be well captured by official unemployment rates and associated gaps. In the case of Portugal, a broader measure of labor slack that adds discouraged workers—which increased sharply during the crisis— to official unemployment and labor force, and adjusts for involuntary short-term work, is estimated to reach 20.5 percent in 2014, compared with only 9.5 percent before the crisis in 2008. Arguably, the large outward migration flows of workers since 2011 could be added to labor market slack as well, as many migrants would likely return to Portugal if jobs would become available.



1/ Includes discouraged workers (people that have no job, declare themselves to be available for work, but not actively looking for work) and adjusts for involuntary short-term work (the number of part-time workers who say that they would like to work more hours, multiplied by a factor of 0.5).
Sources: INE, Labor Force Survey and IMF staff calculations.

Against this backdrop, making serious inroads on the labor market slack left by the crisis would require much higher aggregate demand growth than presently projected. Using an Okun's law relationship, average growth of 1½ percent during 2015–19 would reduce labor market slack only to 18 percent by 2019 (see fan chart). In such a low-growth scenario, there is a serious risk that labor market slack will instead be eliminated by additional outward migration of workers or atrophy of skills of workers out of jobs for a prolonged period. With this in mind, closing output gaps is a low-ambition growth strategy. Instead, a more ambitious strategy should focus on maximizing the triangle spanned by projected potential and actual GDP growth in the fan chart. However, this would require tackling decisively the economy's medium-term growth bottlenecks: low external competitiveness and excessive corporate leverage.



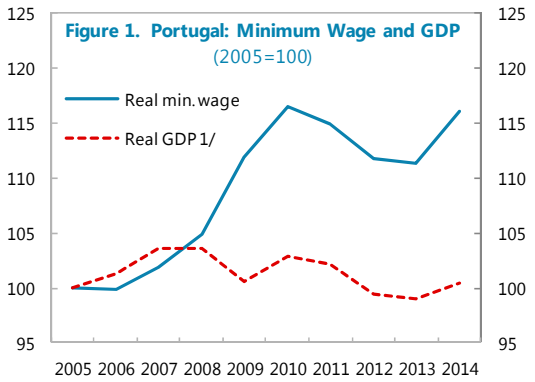
¹ Level of labor market slack in 2008.
Source: IMF staff estimates.

Box 2. Assessment of the Minimum Wage Increase

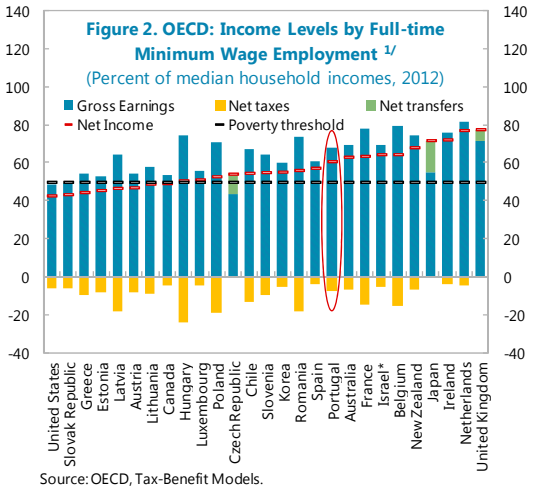
The government reached agreement with social partners to increase the minimum wage from €485 to €505 per month starting October 1, 2014. This box provides the analysis underlying the assessment that the increase is premature and may hurt vulnerable groups that it intends to support.

The increase of the minimum wage has been persistently beyond productivity gains as measured by real GDP growth adjusted for working-age population, and will hamper the restoration of competitiveness. While this measure of productivity has stayed virtually constant over the past decade, the real minimum wage has risen by some 16 percent over the same period (Figure 1). Such development translates into an annual growth of 1½ percent in the minimum wage in excessive of the output growth for the past decade.

Meanwhile, from a cross-country perspective, the previous minimum wage in Portugal was not at such a low level that would necessitate the current increase either. Figure 2 indicates that the net income of a minimum wage earner in Portugal, at the previous level of €485, was significantly higher than the poverty threshold given by the 50-percent-of-median-income mark, above many other OECD countries.

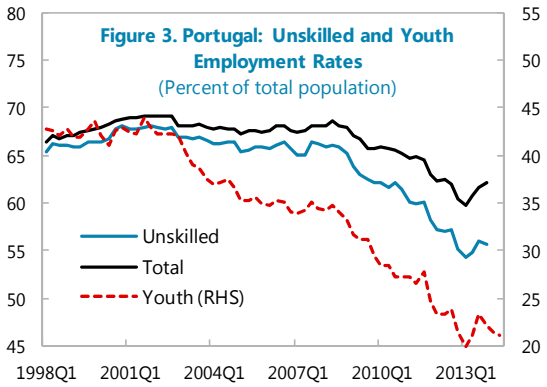


Sources: Eurostat; OECD; and Fund staff estimates.
1/ Adjusted for working-age population.

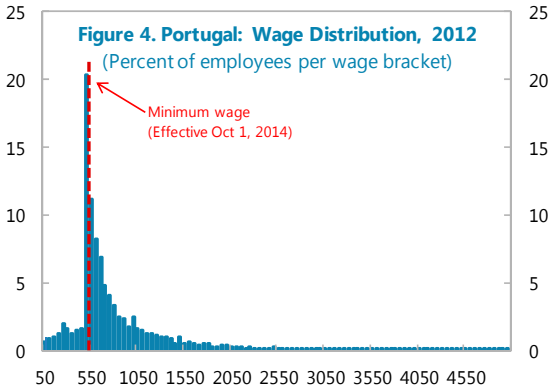


Source: OECD, Tax-Benefit Models.
1/ The comparison is based on single earners with no children.

Given the still high level of unemployment, the current increase of the minimum wage may indeed hurt the very group it intends to support. The impact of the crisis has been particularly felt by the unskilled workers and the young, largely concentrated at the low end of the wage distribution (Figures 3 and 4). Measures that increase the cost of employment for such workers, while raising the income of those with a job, will keep unemployment in these segments elevated for longer and delay the normalization of the labor market.



Sources: INE; and Eurostat.



Sources: Portuguese authorities; and IMF staff calculations.

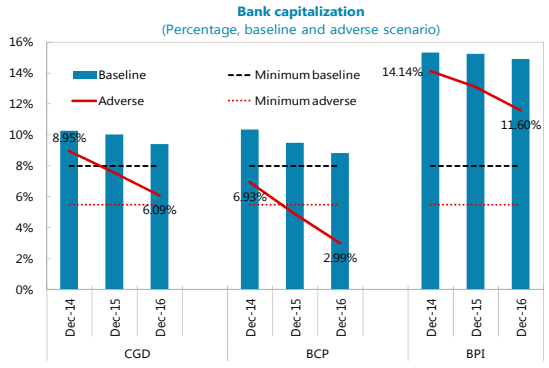
Box 3. Comprehensive Assessment of Portuguese Banks

On October 26, the ECB published the results of the Comprehensive Assessment (CA), comprising an asset quality review (AQR) and bottom-up stress test, using common definitions and a severe but plausible adverse scenario. Following the exclusion of Novo Banco from the detailed disclosures (see below), the Portuguese banking system was represented by three banks (together representing about 50 percent of total bank assets), i.e. Caixa Geral de Depósitos (CGD), Banco Comercial de Português (BCP) and Banco BPI (BPI).

Main variables of the macroeconomic and financial scenarios

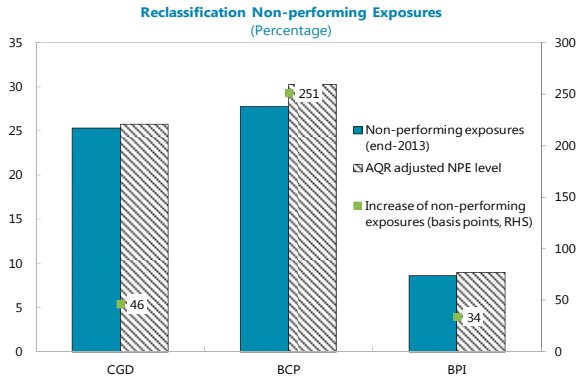
	Portugal			European Union		
Baseline scenario	**2014**	**2015**	**2016**	**2014**	**2015**	**2016**
GDP at constant prices (annual rate of change, %)	0.8	1.5	1.7	1.5	2	1.8
Unemployment (as a % of labor force)	16.8	16.5	14.5	10.7	10.4	10.1
Long-term interest rates (ten-year Treasury bonds, %)	5.1	5.4	5.5	2.9	3.2	3.3
Residential property prices (annual rate of change, %)	-5.6	-3.9	-1.3	0.9	2.7	3.8
Adverse scenario	**2014**	**2015**	**2016**	**2014**	**2015**	**2016**
GDP at constant prices (annual rate of change, %)	-0.8	-2.3	-1.1	-0.7	-1.5	0.1
Unemployment (as a % of labor force)	17.2	18.2	17.4	11.3	12.3	13
Long-term interest rates (ten-year Treasury bonds, %)	7.4	7.1	7.2	4.4	4.3	4.4
Residential property prices (annual rate of change, %)	-9.3	-7.5	-4.6	-7.9	-6.2	-2.1

The results of the AQR and the baseline scenario of the stress test confirm that Portuguese banks are adequately capitalized, with all of the three banks registering CET1 ratios above the threshold of 8%. However, the exercise also indicated that balance sheets remain susceptible to severe stress, with the adverse scenario pointing to a potential capital erosion of almost €7bn by end-2016 (about 50 percent of banks' CET1 capital at end-2013). BCP, Portugal's second-largest bank, is particularly affected by the adverse scenario, with a projected capital erosion of 727 basis points, on top of AQR adjustments of 197 basis points. Although CGD, the country's largest bank, complies with all threshold of the CA, its projected capital erosion still outpaces the CA's mean reduction of 3.4%. The number of reclassified non-performing exposures (NPE), triggered by reclassifications in line with new standards from the European Banking Authority, for the three Portuguese banks amounted to 17 percent, exceeding the CA mean of 12 percent. With BCP already having identified measures to fully cover the shortfall under the adverse scenario, none of the Portuguese banks will require support from the Bank Solvency Support Facility.



Common Equity Tier 1 with CRD IV transitional provisions

Source: European Banking Authority



Sources: European Central Bank

Box 3. Comprehensive Assessment of Portuguese Banks (Concluded)

Due to the resolution of Banco Espírito Santo in August 2014, it was not possible to complete the exercise for its successor institution, Novo Banco, within the timeframe set by the ECB. Results of the AQR are expected to be released in late 2014, based on the opening balance sheet for the bank which was released on December 4, 2014. Completion of the CA of Novo Banco and detailed disclosure of the results, as soon as practicable, is highly recommended as it could contribute positively to the firm's efforts to regain access to wholesale funding markets in anticipation of its sale.

Box 4. The Crisis and Resolution of Banco Espírito Santo

The resolution of Banco Espírito Santo (BES) posed a significant challenge to financial stability. While its handling is viewed as an early test case for the EU's Bank Recovery and Resolution Directive which will take effect by January 2016, the actions of the Portuguese authorities were shaped by a more complex set of factors, including current State aid rules and discretionary policy choices.

Financing the Resolution of BES. Shortly after announcing record losses in Q2 2014, BES had virtually exhausted its collateral buffer, having already received upwards of €3.5 billion in Emergency Liquidity Assistance (ELA), and faced imminent suspension of its counterparty status with the ECB. These developments forced BES into resolution. Equity and liabilities to subordinated debt holders were left behind in a bad bank that retained the name and banking license of BES. The rest of the balance sheet, including all senior debt obligations, was transferred into bridge bank Novo Banco, which received €4.9 billion in capital from the Portuguese Resolution Fund—which is inside the general government perimeter—and was in turn financed as follows:

Table 1. Portugal: Capitalization of Novo Banco, August 2014

(Millions of euros)	
Initial capital of Novo Banco (as of August 4, 2014)	4,900
Treasury loan to the Resolution Fund using Bank Solvency Support Facility resources	3,900
Syndicated bank loan to the Resolution Fund	635
Resolution Fund own funds	365

Source: Portuguese authorities.

Loss allocation. In line with current State aid requirements, affected BES' equity holders (€3.7 billion), outstanding claims of subordinated creditors (€927 million), and claims held by related parties were left behind in the bad bank. Readily identifiable bad assets, in particular claims on other parts of the Espírito Santo Group, and certain contingent liabilities were left behind as well. However, all other claims, including uninsured deposits, were transferred in full to Novo Banco. Subordinated debtors have filed a legal challenge to the resolution, but the courts have not yet ruled on the case.

Senior creditors and uninsured depositors were fully protected from losses, but significant costs to banks may yet materialize via the Portuguese Resolution Fund at the time of the sale. The part of the capitalization financed with Bank Solvency Support Facility resources was structured as a 24-month loan from the central government to the Resolution Fund, with escalating interest, to incentivize a prompt sale. However, if the eventual sale proceeds of Novo Banco are insufficient to reimburse the €3.9 billion senior loan received from the Portuguese government, banks face: (a) (partial) non-repayment of their subordinated loan (€635 million) to the Fund and/or (b) exceptional contributions to the Fund to supplement its resources.

While the authorities' efforts to minimize the cost of the BES resolution for taxpayers are in line with State aid rules, staff believes that the financing arrangement risks placing a considerable burden on a highly concentrated and still unprofitable banking system. A redesigned repayment schedule of the government's loan to the Resolution Fund could alleviate some of the pressure, allowing the banking industry to absorb any costs over a longer horizon.

Box 5. Fiscal Implications of the Recent Constitutional Court Rulings

In May and August 2014, the Constitutional Court struck down key measures required to meet the agreed fiscal targets for 2014 and 2015. Most importantly, the rulings severely hampered the authorities' plans to rebalance fiscal adjustment from revenue measures to spending reforms in pensions and public administration.

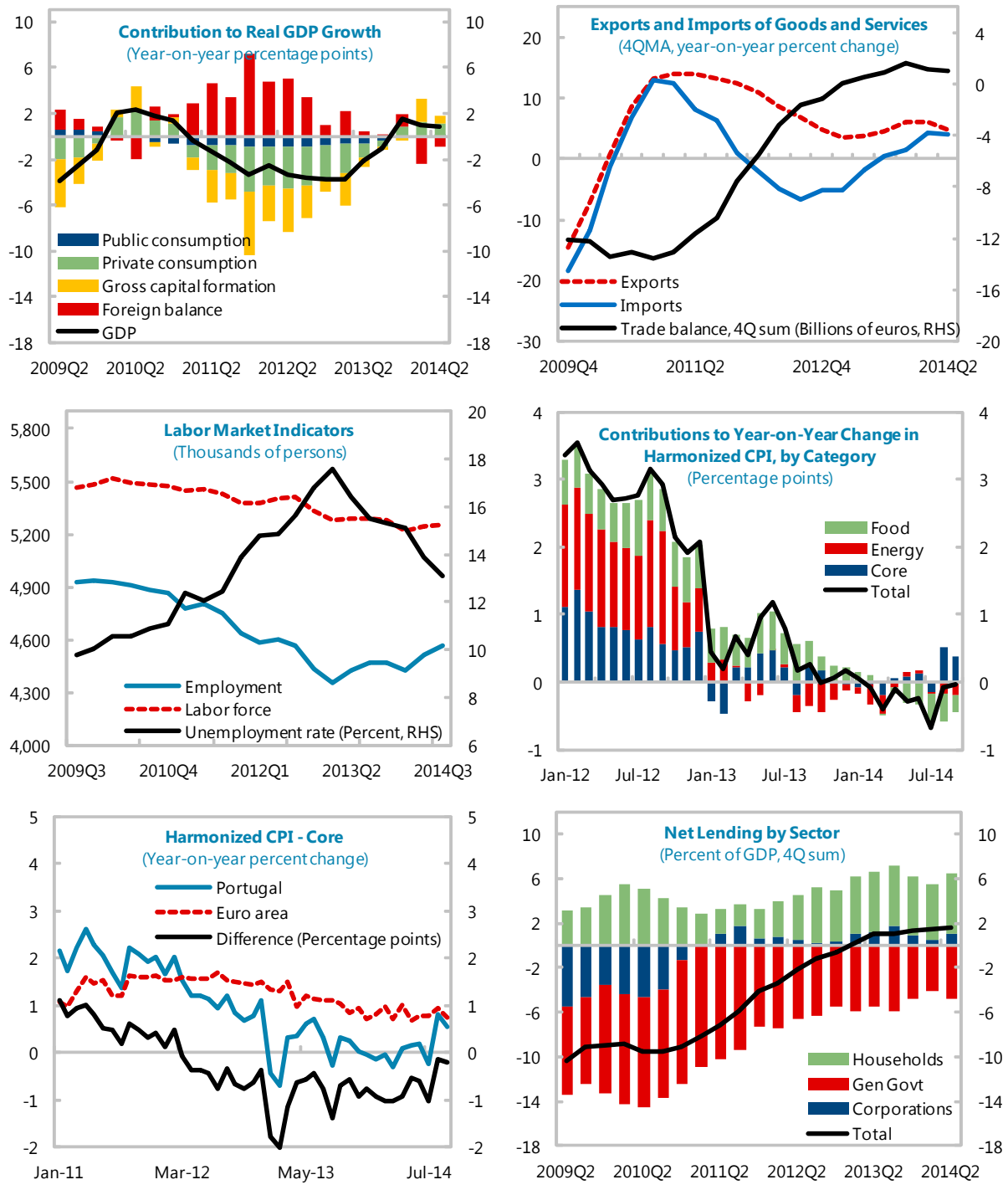
- Last May, the Constitutional Court ruled that three budgetary measures were unconstitutional, putting the 2014 fiscal target out of reach in the absence of offsetting measures. Based on the ruling, the public sector wage cuts introduced during the crisis had to be fully reinstated as of May 31, 2014. Moreover, means-testing of survivors' pensions as well as sickness and unemployment benefits had to be reversed, with retroactive effect as of January 1, 2014. The total impact of the May ruling, including any additional carryover in 2015, is estimated at around 0.5 percent of GDP in additional expenditure.
- The anticipation of a second ruling by the Constitutional Court on spending cuts included in the 2014 supplementary budget,[1] prompted the authorities to defer the announcement of measures to compensate for the decision in May. As a result, the EFF arrangement expired on June 30 without completion of the 12th and final review and release of the associated final tranche.
- In August, the Constitutional Court ruled in favor of the authorities' proposed reinstatement of the temporary wage cuts in the public sector (introduced back in 2011) for the remainder of 2014 (in full) and 2015 (80 percent of the cut). However, the Court struck down the new sustainability contribution on pensions, which was expected to replace the extraordinary levy on pensions (CES) starting in 2015 (estimated at around 0.3 percent of GDP).[2] The decision in effect ruled out any nominal cuts in wages or social benefits beyond 2015.

---

[1]These included the extraordinary levy on pensions (CES) and savings from the special health schemes. Both measures had been introduced in response to an earlier adverse ruling and were eventually deemed constitutional by the Court, notably given the temporary nature of CES.

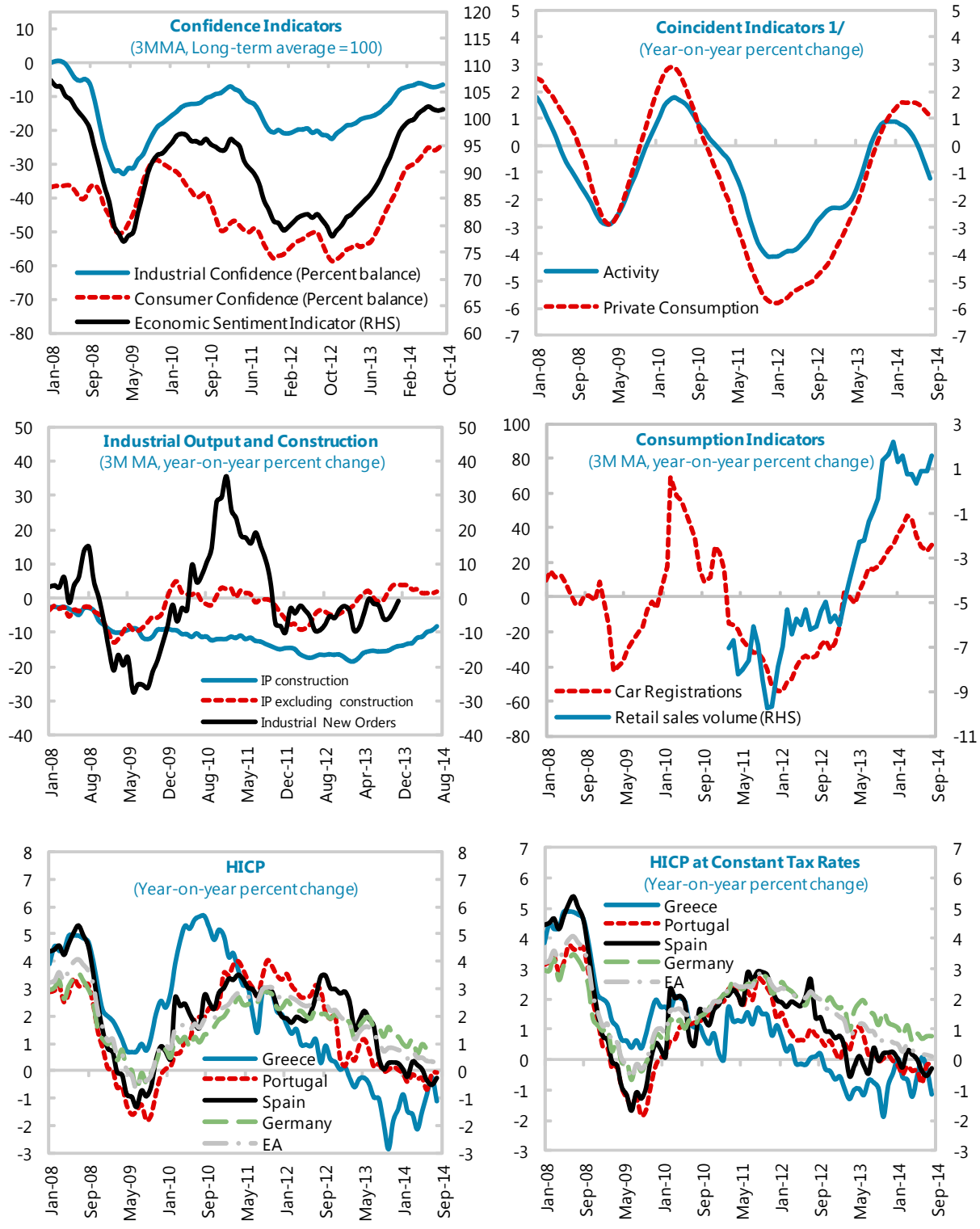
[2]The sustainability contribution on pensions was part of a package including limited increases in employees' social security contributions (0.2 percentage points) and in the standard VAT rate (0.25 percentage points).

Figure 2. Portugal: Recovery Momentum at Risk



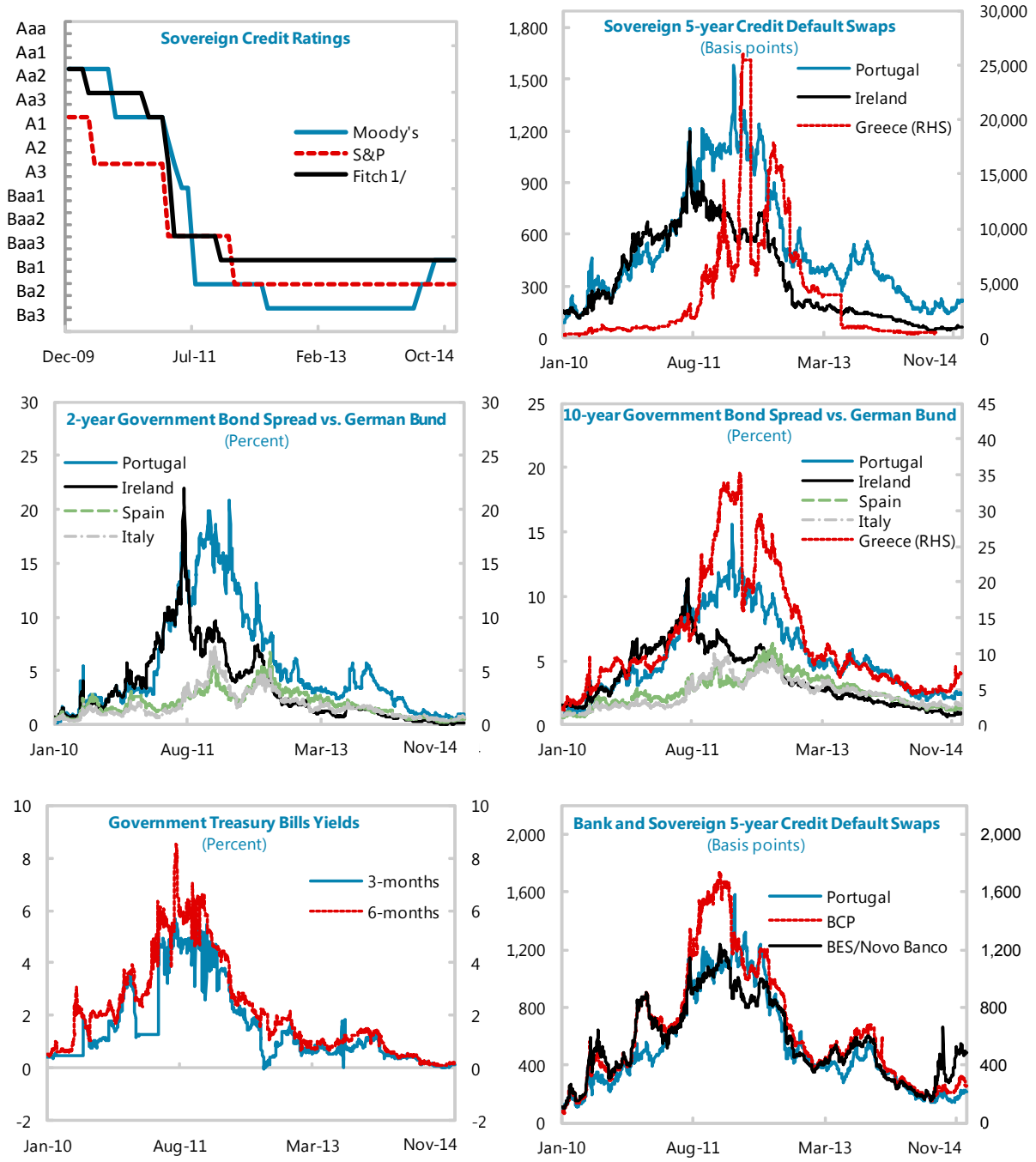
Sources: INE; Eurostat; and IMF staff calculations.

Figure 3. Portugal: High Frequency Indicators



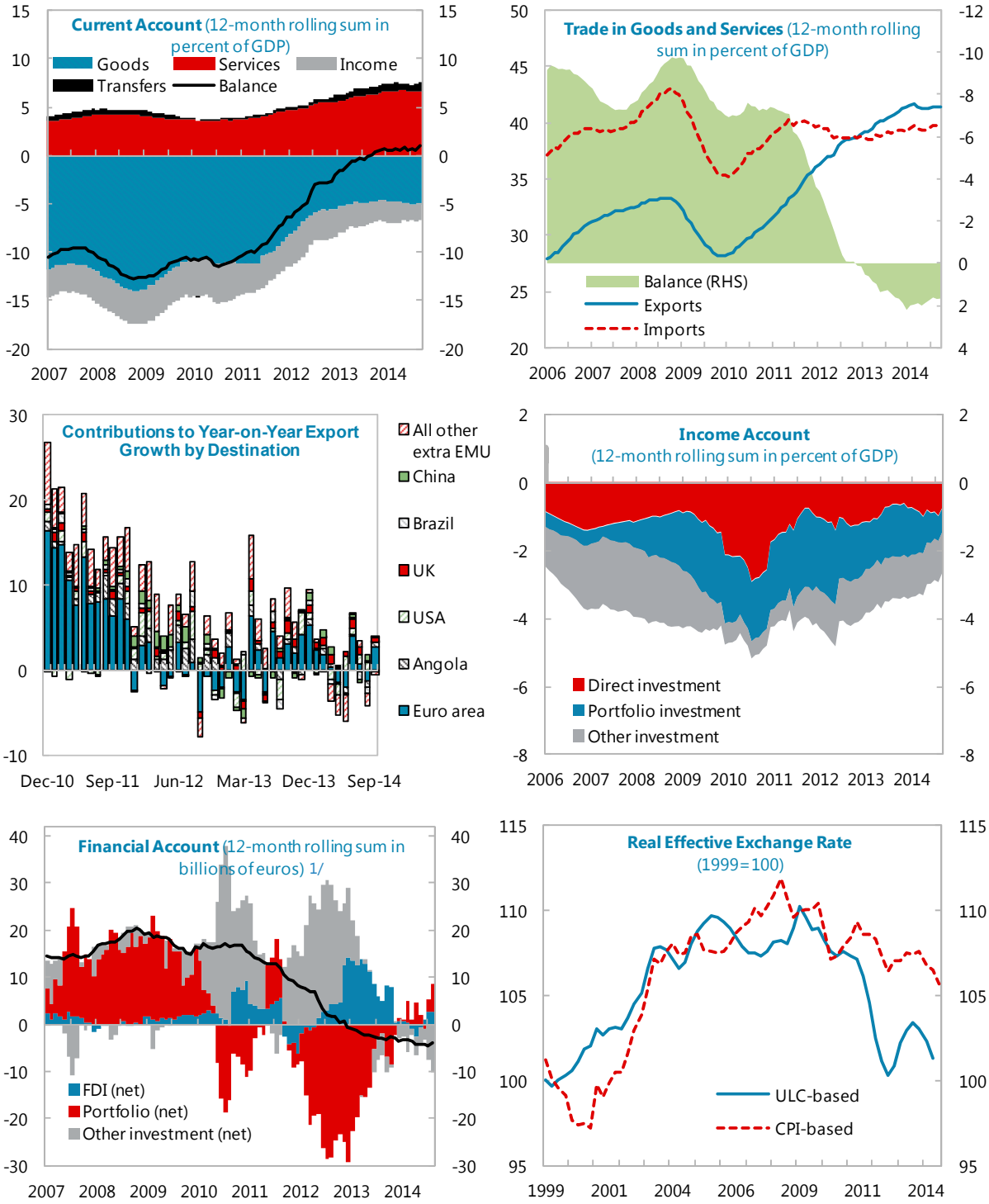
Sources: Eurostat; European Commission; Bank of Portugal; and IMF staff calculations.
1/ Calculated by the Bank of Portugal.

Figure 4. Portugal: Financial Market Indicators



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

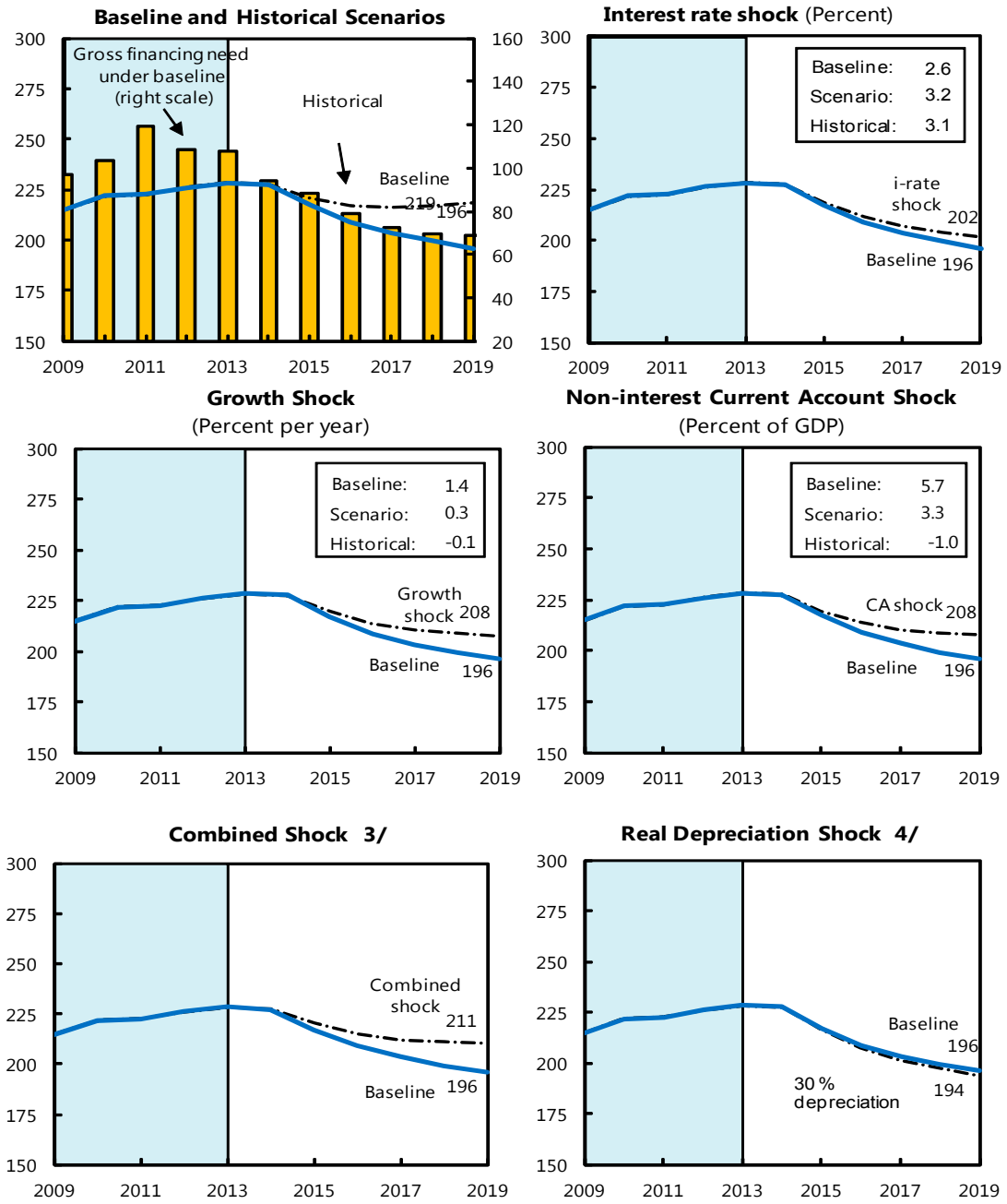
Figure 5. Portugal: Balance of Payments Developments



Sources: INE; Bank of Portugal; Eurostat; and IMF staff calculations.
1/ Figures still presented on the BPM5 basis.

Figure 6. Portugal: External Debt Sustainability: Bound Tests, 2008–2019 1/ 2/

(External debt in percent of GDP)



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

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

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

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

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

Table 1. Portugal: Selected Economic Indicators, 2011–19 1/

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

	2011	2012	2013	Projections 2/							
				2014		2015		2016	2017	2018	2019
				11th EFF 3/	1st PPM	11th EFF 3/	1st PPM				
Real GDP	-1.8	-3.3	-1.4	1.2	0.8	1.5	1.2	1.3	1.4	1.6	1.6
Total domestic demand	-5.7	-6.6	-2.3	0.7	1.3	0.8	1.1	1.2	1.3	1.4	1.4
Private consumption	-3.6	-5.2	-1.4	0.7	1.6	0.7	1.6	1.3	1.1	1.1	1.1
Public consumption	-3.8	-4.3	-1.9	-1.6	-0.6	-1.5	-0.5	0.0	1.0	1.0	1.0
Gross fixed investment	-12.5	-15.0	-6.3	3.1	1.4	3.8	1.8	2.2	2.4	2.7	3.0
Private	-4.6	-11.3	-5.5	2.7	-0.5	4.8	2.1	2.4	2.7	3.0	3.4
Government	-35.5	-30.7	-10.7	6.6	12.6	-4.2	0.5	1.1	1.0	1.0	1.0
Exports	7.0	3.1	6.4	5.5	3.5	5.5	4.5	4.5	4.5	4.7	4.7
Imports	-5.8	-6.6	3.6	4.0	4.5	4.0	4.4	4.4	4.4	4.2	4.2
Contribution to Growth											
Total domestic demand	-6.2	-6.9	-2.4	0.7	1.3	0.8	1.1	1.2	1.3	1.4	1.4
Private consumption	-2.4	-3.4	-0.9	0.5	1.0	0.5	1.0	0.9	0.7	0.7	0.7
Public consumption	-0.8	-0.8	-0.4	-0.3	-0.1	-0.3	-0.1	0.0	0.2	0.2	0.2
Gross fixed investment	-2.6	-2.8	-1.0	0.5	0.2	0.6	0.3	0.3	0.4	0.4	0.5
Foreign balance	4.6	3.6	1.0	0.6	-0.4	0.7	0.0	0.1	0.1	0.2	0.2
Savings-investment balance (percent of GDP)											
Gross national savings	10.9	14.0	15.2	16.7	16.3	17.6	16.1	15.8	16.1	16.9	17.4
Private	15.1	18.0	18.0	19.0	18.8	18.3	17.1	16.6	16.7	17.2	17.6
Public	-4.1	-4.0	-2.8	-2.2	-2.5	-0.8	-1.0	-0.8	-0.6	-0.3	-0.2
Gross domestic investment	18.6	16.6	15.4	15.9	15.7	16.4	15.9	15.7	16.0	16.5	16.9
Private	15.1	14.1	13.2	14.0	13.2	14.6	13.4	13.2	13.5	14.0	14.4
Public	3.5	2.6	2.3	1.9	2.5	1.8	2.5	2.5	2.5	2.5	2.5
Resource utilization											
Potential GDP	-0.8	-0.9	-0.5	-0.4	-0.5	0.2	-0.2	0.4	0.8	0.9	1.2
Output Gap (% of potential)	-1.6	-4.0	-4.8	-2.9	-3.6	-1.7	-2.3	-1.4	-0.8	-0.1	0.3
Employment	-1.5	-4.2	-2.8	0.7	2.3	0.7	0.8	0.6	0.6	0.6	0.6
Unemployment rate (%) 1/	12.7	15.5	16.2	15.7	13.8	15.0	12.7	12.2	11.6	11.1	10.5
Prices											
GDP deflator	-0.3	-0.4	2.3	0.8	1.2	1.0	1.0	1.3	1.4	1.7	1.4
Consumer prices (harmonized index)	3.6	2.8	0.4	0.7	0.0	1.2	0.4	1.0	1.2	1.4	1.5
Compensation per worker (whole economy)	-0.6	-2.0	3.4	-0.9	-0.9	1.0	1.0	1.2	1.2	1.2	1.2
Labor productivity	-0.3	1.0	1.5	0.5	-1.4	0.7	0.3	0.7	0.8	1.0	1.0
Unit labor costs (whole economy)	-0.3	-3.0	1.8	-1.3	0.6	0.3	0.7	0.5	0.4	0.2	0.2
Money and credit (end of period, percent change)											
Private sector credit	-1.5	-6.5	-5.2	-3.0	-3.2	-0.3	-0.4	1.0	1.5	1.8	1.8
Broad money	-1.3	-6.2	0.8	2.0	2.0	2.5	2.2	2.6	2.8	3.3	3.0
Interest rates (percent)											
Short-term deposit rate	3.5	3.0	2.1	...	...	...	...	...	...	...	...
Government bond rate, 10-year	10.2	10.6	6.3	...	...	...	...	...	...	...	...
Fiscal indicators (percent of GDP)											
General government balance 4/	-7.4	-5.5	-4.9	-4.0	-3.9	-2.5	-3.4	-3.3	-3.0	-2.8	-2.6
Revenues	42.6	43.0	45.2	42.8	44.5	42.8	44.4	44.4	44.2	43.9	43.6
Expenditures	50.0	48.5	50.1	46.9	49.5	45.3	47.9	47.7	47.2	46.6	46.2
Primary government balance	-3.0	-0.6	0.1	0.3	0.1	1.9	1.5	1.8	2.1	2.5	2.7
General government debt	111.1	124.8	128.0	126.7	127.8	124.8	125.7	125.5	125.0	124.1	123.3
External sector (percent of GDP)											
Trade balance (goods)	-8.1	-5.3	-4.4	-3.5	-4.2	-3.0	-4.0	-4.2	-4.3	-4.4	-4.5
Trade balance (G&S)	-3.5	0.1	2.1	3.0	2.3	3.8	2.7	2.8	2.9	3.1	3.3
Current account balance	-6.2	-2.1	0.7	0.8	0.6	1.2	0.4	0.2	0.2	0.4	0.6
Net international investment position	-101.0	-113.8	-116.2	-113.7	-111.9	-107.8	-107.6	-103.2	-98.8	-94.0	-89.4
REER based on ULC (1999=100)	106.3	101.2	102.9	101.4	102.6	102.1	102.5	102.5	102.3	101.6	100.9
(rate of growth)	-1.3	-4.8	1.7	-1.8	-0.3	0.7	-0.1	0.1	-0.2	-0.7	-0.7
REER based on CPI (1999=100)	108.7	107.3	107.4	107.2	106.9	107.3	106.2	106.0	105.9	105.8	106.0
(rate of growth)	0.9	-1.3	0.1	-0.1	-0.5	0.1	-0.6	-0.2	-0.1	-0.1	0.1
Nominal GDP (billions of euro)	176.2	169.7	171.2	168.9	174.6	173.1	178.5	183.2	188.3	194.5	200.3

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

1/ ESA 2010 basis, unless otherwise indicated.

2/ Projections for 2016 - 2019 reflect current policies.

3/ ESA 1995 basis.

4/ In 2013, includes the increase in the share capital of Banif (0.4 percent of GDP). For 2014, the 1st PPM projection does not include 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, 2012–19 1/

(Billions of euros)

			Projections 2/					
	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	72.9	77.4	77.7	79.3	81.2	83.3	85.3	87.3
Taxes	40.9	45.0	43.0	44.8	46.0	47.3	48.6	49.9
Taxes on production and imports	23.3	23.5	24.1	25.4	26.1	26.8	27.5	28.2
Current taxes on income, wealth, etc. and capital taxes	17.6	21.5	18.9	19.4	19.9	20.4	21.1	21.7
Current taxes on income, wealth, etc.	15.2	19.4	18.9	19.4	19.9	20.4	21.1	21.7
Capital taxes	2.4	2.1	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	19.5	20.4	20.7	20.7	21.1	21.5	21.8	22.0
Grants and other revenue	12.4	12.0	14.0	13.7	14.1	14.5	14.9	15.4
Property income	0.5	0.7	0.7	0.7	0.7	0.7	0.7	0.8
Sales of goods and services	6.6	6.9	6.9	6.9	7.0	7.2	7.5	7.7
Other current revenue	4.7	4.8	4.7	4.5	4.6	4.7	4.9	5.0
Capital transfers and investment grants	0.6	-0.3	1.7	1.7	1.8	1.8	1.9	1.9
Expenditure	82.2	85.7	86.4	85.4	87.3	89.0	90.7	92.6
Expense	79.3	83.0	83.2	82.2	84.2	85.9	87.5	89.5
Compensation of employees	20.0	21.2	20.3	19.7	20.3	20.7	21.0	21.5
Use of goods and services	9.5	9.8	10.1	10.5	10.6	10.7	10.9	11.1
Consumption of fixed capital	1.0	1.1	1.1	1.2	1.4	1.5	1.7	1.8
Interest (ESA95)	8.4	8.5	8.8	8.9	9.3	9.7	10.2	10.7
Subsidies	1.0	1.0	1.4	1.0	1.0	1.0	1.0	1.0
Social benefits	33.0	34.7	34.2	34.7	35.0	35.5	36.0	36.6
Grants and other expense	6.4	6.6	7.3	6.3	6.6	6.7	6.8	6.9
Other current expense	4.8	5.1	5.3	5.9	5.9	6.0	6.1	6.2
Capital transfers	1.6	1.5	2.0	0.4	0.7	0.7	0.7	0.7
Net acquisition of nonfinancial assets	2.9	2.8	3.2	3.2	3.1	3.1	3.1	3.1
Gross fixed capital formation	4.0	3.8	4.3	4.4	4.5	4.6	4.8	4.9
(-) Consumption of fixed capital	-1.0	-1.1	-1.1	-1.2	-1.4	-1.5	-1.7	-1.8
Acquisitions less disposals of other nonfinancial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-5.4	-4.5	-4.4	-1.8	-1.6	-1.1	-0.6	-0.3
Net lending (+)/borrowing (–) 2/	-9.3	-8.3	-8.7	-6.2	-6.0	-5.7	-5.4	-5.2
Net acquisition of financial assets	4.8	-0.3	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	...	...	...	...	...	...
Currency and deposits	1.2	1.6	...	...	...	...	...	...
Debt securities	6.4	-0.6	...	...	...	...	...	...
Loans	1.2	0.0	...	...	...	...	...	...
Equity and investment fund shares	-1.2	0.0	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	-0.2	0.0	...	...	...	...	...	...
Other accounts receivable	-2.6	-1.3	...	...	...	...	...	...
Net incurrence of liabilities	15.5	7.9	...	...	...	...	...	...
SDRs	0.0	0.0	...	...	...	...	...	...
Currency and deposits	-1.4	1.1	...	...	...	...	...	...
Debt securities	-6.8	-1.4	...	...	...	...	...	...
Loans	27.4	10.3	...	...	...	...	...	...
Equity and investment fund shares	0.0	0.0	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	...	...	...	...	...	...
Other accounts payable	-3.7	-2.1	...	...	...	...	...	...
Memorandum items:								
Primary balance	-1.0	0.2	0.1	2.7	3.2	4.0	4.8	5.4
Debt at face value (EDP notification)	211.8	219.2	223.2	224.3	229.9	235.5	241.3	247.1
Nominal GDP	169.7	171.2	174.6	178.5	183.2	188.3	194.5	200.3

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

Table 2b. Portugal: General Government Accounts, 2012–19 1/

(Percent of GDP)

			Projections 2/					
	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	43.0	45.2	44.5	44.4	44.4	44.2	43.9	43.6
Taxes	24.1	26.3	24.6	25.1	25.1	25.1	25.0	24.9
Taxes on production and imports	13.8	13.7	13.8	14.2	14.3	14.2	14.1	14.1
Current taxes on income, wealth, etc. and capital taxes	10.4	12.6	10.8	10.9	10.9	10.9	10.8	10.8
Current taxes on income, wealth, etc.	8.9	11.3	10.8	10.9	10.9	10.9	10.8	10.8
Capital taxes	1.4	1.2	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	11.5	11.9	11.9	11.6	11.5	11.4	11.2	11.0
Grants and other revenue	7.3	7.0	8.0	7.7	7.7	7.7	7.7	7.7
Property income	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Sales of goods and services	3.9	4.0	4.0	3.8	3.8	3.8	3.8	3.8
Other current revenue	2.8	2.8	2.7	2.5	2.5	2.5	2.5	2.5
Capital transfers and investment grants	0.3	-0.2	1.0	1.0	1.0	1.0	1.0	1.0
Expenditure	48.5	50.1	49.5	47.9	47.7	47.2	46.6	46.2
Expense	46.7	48.5	47.6	46.1	45.9	45.6	45.0	44.7
Compensation of employees	11.8	12.4	11.6	11.0	11.1	11.0	10.8	10.7
Use of goods and services	5.6	5.7	5.8	5.9	5.8	5.7	5.6	5.5
Consumption of fixed capital	0.6	0.6	0.6	0.7	0.7	0.8	0.8	0.9
Interest (ESA95)	4.9	5.0	5.0	5.0	5.1	5.2	5.2	5.3
Subsidies	0.6	0.6	0.8	0.5	0.5	0.5	0.5	0.5
Social benefits	19.5	20.3	19.6	19.4	19.1	18.9	18.5	18.3
Grants and other expense	3.8	3.9	4.2	3.5	3.6	3.5	3.5	3.4
Other current expense	2.8	3.0	3.0	3.3	3.2	3.2	3.1	3.1
Capital transfers	0.9	0.9	1.1	0.2	0.4	0.4	0.4	0.4
Net acquisition of nonfinancial assets	1.7	1.6	1.9	1.8	1.7	1.7	1.6	1.6
Gross fixed capital formation	2.3	2.2	2.5	2.4	2.4	2.4	2.4	2.4
(-) Consumption of fixed capital	-0.6	-0.6	-0.6	-0.7	-0.7	-0.8	-0.8	-0.9
Acquisitions less disposals of other nonfinancial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-3.2	-2.6	-2.5	-1.0	-0.8	-0.6	-0.3	-0.2
Net lending (+)/borrowing (–) 2/	-5.5	-4.9	-5.0	-3.4	-3.3	-3.0	-2.8	-2.6
Net acquisition of financial assets	2.8	-0.2	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	...	...	...	...	...	...
Currency and deposits	0.7	0.9	...	...	...	...	...	...
Debt securities	3.8	-0.3	...	...	...	...	...	...
Loans	0.7	0.0	...	...	...	...	...	...
Equity and investment fund shares	-0.7	0.0	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	-0.1	0.0	...	...	...	...	...	...
Other accounts receivable	-1.5	-0.8	...	...	...	...	...	...
Net incurrence of liabilities	9.1	4.6	...	...	...	...	...	...
SDRs	0.0	0.0	...	...	...	...	...	...
Currency and deposits	-0.8	0.7	...	...	...	...	...	...
Debt securities	-4.0	-0.8	...	...	...	...	...	...
Loans	16.1	6.0	...	...	...	...	...	...
Equity and investment fund shares	0.0	0.0	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	...	...	...	...	...	...
Other accounts payable	-2.2	-1.2	...	...	...	...	...	...
Memorandum items:								
Primary balance	-0.6	0.1	0.1	1.5	1.8	2.1	2.5	2.7
Structural balance (Percent of potential GDP)	-3.5	-2.8	-2.2	-2.5	-2.6	-2.7	-2.7	-2.7
Structural primary balance (Percent of potential GDP)	1.3	2.0	2.7	2.4	2.3	2.4	2.5	2.6
Debt at face value (EDP notification)	124.8	128.0	127.8	125.7	125.5	125.0	124.1	123.3

Sources: Portuguese statistical authorities; and IMF staff projections.

1/ GFSM 2001 presentation.

2/ For 2014, projections include one-off measures from SOE (Carris and STCP) and banking operations (BPN Credito), CIT credit, and the upfront costs of mutual agreements for 1.1 percent of GDP. Projections reflect current policies after 2015.

Table 3. Portugal: General Government Financing Requirements and Sources, 2013–19 1/

(Billions of euros)

	2013	2014	2015	2016	2017	2018	2019
Gross borrowing need	53.0	41.3	38.8	40.4	43.8	44.6	50.2
Overall balance	8.3	8.7	6.2	6.0	5.7	5.4	5.2
Amortization	41.7	40.2	34.2	34.9	38.2	38.8	44.4
M&LT	20.0	24.3	13.2	13.3	15.6	15.6	21.1
Residents	4.7	17.9	6.8	7.1	7.4	10.0	11.4
Of which within general government	0.6	1.1	0.9	1.0	1.8	1.9	0.7
Non-residents	15.4	6.4	6.4	6.2	8.1	5.6	9.7
ST 2/	21.7	12.8	20.6	19.0	19.0	19.0	19.0
Residents	21.1	11.5	15.5	14.7	14.7	14.7	14.7
Of which within general government	5.7	4.4	...	...	...	...	...
Non-residents	0.6	1.4	5.1	4.3	4.3	4.3	4.3
EU and IMF 3/	0.0	3.0	0.5	2.6	3.6	4.2	4.3
Other (net) 4/	2.9	-7.6	-1.7	-0.5	-0.2	0.5	0.5
Of which within general government	6.8	...	...	...	...	...	...
Gross financing sources	43.0	36.0	38.8	40.4	43.8	44.6	50.2
Privatization receipts	1.4	0.3	0.0	0.0	0.0	0.0	0.0
Market access	42.4	38.9	35.4	40.4	43.8	44.6	50.2
M&LT	29.6	18.4	16.4	21.5	24.8	25.6	31.2
Residents	20.0	6.8	6.6	8.3	9.7	10.2	12.7
Of which from general government	8.2	...	...	...	...	...	...
Non-residents	9.6	11.5	9.8	13.2	15.1	15.4	18.5
ST 2/	12.8	20.6	19.0	19.0	19.0	19.0	19.0
Residents	11.5	15.5	14.7	14.7	14.7	14.7	14.7
Of which from general government	4.4	...	...	...	...	...	...
Non-residents	1.4	5.1	4.3	4.3	4.3	4.3	4.3
Use of deposits 5/	-0.9	-3.2	3.4	0.0	0.0	0.0	0.0
Of which intra-government	0.6	...	...	...	...	...	...
Financing under the program 3/	10.0	5.2	0.0	0.0	0.0	0.0	0.0
European Union	6.6	3.5	...	...	...	...	...
IMF	3.4	1.8	...	...	...	...	...
Net placement (market access-amortization)	0.7	-1.2	1.1	5.5	5.6	5.9	5.7
Residents	5.7	-7.1	-1.2	-0.2	0.4	-1.8	0.2
M&LT	15.3	-11.1	-0.4	-0.2	0.4	-1.8	0.2
ST (net increase)	-9.6	4.0	-0.8	0.0	0.0	0.0	0.0
Non-residents	-5.0	8.9	2.3	5.7	5.2	7.7	5.5
M&LT	-5.8	5.1	3.1	5.7	5.2	7.7	5.5
ST (net increase)	0.7	3.7	-0.8	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/ Changes to IMF disbursements compared to initial programmed amounts reflect EUR/SDR exchange rate variations. Program financing from the EU includes the EUR 1.1 billion EFSF prepaid margin and EUR 0.1 billion in issuance costs (2011) and the roll-over of a EUR 1

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 4. Portugal: Balance of Payments, 2010–19

	2010	2011	2012	2013	Projections 2014	2015	2016	2017	2018	2019
					(Billions of euro)					
Current account	-18.3	-10.9	-3.5	1.2	1.0	0.6	0.4	0.3	0.7	1.2
Balance of goods and services	-12.8	-6.2	0.2	3.7	4.0	4.8	5.1	5.5	6.1	6.5
Trade balance	-19.3	-14.2	-9.1	-7.5	-7.3	-7.1	-7.7	-8.1	-8.5	-9.0
Exports fob	36.9	42.3	44.3	46.7	47.8	50.5	53.5	56.4	59.5	62.6
Imports fob	56.2	56.5	53.4	54.1	55.0	57.7	61.2	64.6	68.0	71.6
Services, net	6.5	8.0	9.3	11.1	11.3	11.9	12.8	13.6	14.5	15.5
Exports	17.2	19.3	19.9	22.0	22.9	24.3	25.9	27.5	29.2	31.0
Imports	10.8	11.3	10.6	10.8	11.6	12.4	13.1	13.9	14.7	15.5
Of which:										
Tourism	4.6	5.2	5.7	6.1	6.3	6.7	7.2	7.6	8.1	8.6
Exports	7.6	8.1	8.6	9.2	9.7	10.2	10.9	11.6	12.3	13.1
Imports	3.0	3.0	2.9	3.1	3.4	3.6	3.8	4.0	4.2	4.5
Primary income, net	-5.7	-5.3	-4.8	-3.7	-4.3	-5.4	-6.1	-6.5	-6.7	-6.6
Secondary income, net	0.3	0.6	1.1	1.3	1.3	1.3	1.4	1.4	1.3	1.3
Capital account	2.5	2.7	3.6	2.8	2.6	2.6	2.6	2.6	2.6	2.6
Financial account	-15.4	25.6	28.2	15.1	8.9	3.2	3.0	2.9	3.3	3.8
Direct investment	-9.2	6.5	-14.0	-0.4	-0.4	-0.2	-0.1	0.1	0.3	0.4
Direct investment assets	-2.9	11.4	3.8	6.2	6.3	6.5	6.8	7.0	7.3	7.6
Direct investment liabilities	6.3	4.9	17.7	6.6	6.7	6.8	6.8	6.9	7.1	7.2
Portfolio investment, net	11.3	2.2	29.3	-0.6	-6.1	-5.8	-9.5	-8.9	-11.3	-10.6
Financial derivatives	-0.4	-0.5	-0.1	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Other investment, net	-18.0	18.6	12.8	14.7	13.8	7.8	11.1	10.3	12.9	12.6
Reserve assets	1.0	-1.2	0.2	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Errors and omissions	0.4	-0.1	0.5	-0.5	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	-177.8	-193.1	-199.0	-195.3	-192.1	-189.1	-186.2	-182.8	-179.0
Direct investment, net	-39.4	-30.6	-45.3	-45.6	-46.0	-46.2	-46.3	-46.2	-46.0	-45.5
Portfolio investment, net	-49.7	-31.9	-16.0	-21.4	-27.4	-33.2	-42.7	-51.6	-62.9	-73.5
Financial derivatives	-1.1	-2.4	-3.6	-3.1	-2.1	-1.1	-0.1	1.0	2.0	3.0
Other investment, net	-113.2	-129.4	-145.3	-141.6	-133.0	-125.2	-114.1	-103.8	-90.9	-78.3
Reserve assets	15.7	16.5	17.2	12.7	13.2	13.6	14.0	14.5	14.9	15.3
Nominal GDP	179.9	176.2	169.7	171.2	174.6	178.5	183.2	188.3	194.5	200.3
					(Percentage of GDP)					
Current account	-10.1	-6.2	-2.1	0.7	0.6	0.4	0.2	0.2	0.4	0.6
Current account (including capital transfers)	-8.8	-4.6	0.1	2.3	2.1	1.8	1.6	1.6	1.7	1.9
Of which: Balance of goods and services	-7.1	-3.5	0.1	2.1	2.3	2.7	2.8	2.9	3.1	3.3
Net international investment position 1/	-104.3	-101.0	-113.8	-116.2	-111.9	-107.6	-103.2	-98.8	-94.0	-89.4
Direct investment, net	-21.9	-17.3	-26.7	-26.7	-26.3	-25.9	-25.3	-24.5	-23.6	-22.7
Portfolio investment, net	-27.6	-18.1	-9.4	-12.5	-15.7	-18.6	-23.3	-27.4	-32.3	-36.7
Financial derivatives	-0.6	-1.4	-2.1	-1.8	-1.2	-0.6	0.0	0.5	1.0	1.5
Other investment, net	-62.9	-73.5	-85.6	-82.7	-76.2	-70.1	-62.3	-55.1	-46.7	-39.1
Reserve assets	8.7	9.4	10.1	7.4	7.5	7.6	7.7	7.7	7.7	7.7

Sources: Bank of Portugal; and IMF staff estimates.

1/ End-of-period data.

Table 5. Portugal: External Financing Requirements and Sources, 2010–19

(Billions of euros)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Gross Financing Requirements	195.5	217.0	193.0	183.7	164.0	157.6	144.7	136.5	134.8	137.7
Current account deficit	18.3	10.9	3.5	-1.2	-1.0	-0.6	-0.4	-0.3	-0.7	-1.2
Medium- and long-term debt amortization	29.1	29.6	32.8	44.2	28.7	25.1	25.0	27.5	30.0	35.5
Public sector	7.1	8.9	7.2	15.4	6.4	6.4	6.2	8.1	5.6	9.7
Banks	18.5	16.7	18.6	19.5	16.9	13.2	14.2	15.7	19.8	20.0
Other private	3.5	4.1	7.0	9.4	5.4	5.5	4.7	3.7	4.6	5.8
Short-term debt amortization	148.1	176.5	156.7	140.6	136.3	132.6	117.4	105.7	101.3	99.1
Public sector	51.8	82.5	77.0	78.5	72.4	68.7	54.4	43.3	39.0	36.8
Central Bank	34.9	71.5	74.1	77.6	71.1	63.6	50.1	39.0	34.8	32.5
General government and SOEs	16.9	11.1	2.9	0.9	1.4	5.1	4.3	4.3	4.3	4.3
Banks	79.5	76.6	57.4	47.7	39.5	39.5	41.0	42.7	44.4	46.3
Other private	16.7	17.4	22.4	14.4	24.4	24.4	22.0	19.8	17.8	16.0
EU and IMF 1/	0.0	0.0	0.0	0.0	0.0	0.5	2.6	3.6	4.2	4.3
Sources of Financing	195.5	183.1	165.3	172.0	158.8	157.6	144.7	136.5	134.8	137.7
Capital account (net)	2.5	2.7	3.6	2.8	2.6	2.6	2.6	2.6	2.6	2.6
Foreign direct investment (net)	-9.2	6.5	-14.0	-0.4	-0.4	-0.2	-0.1	0.1	0.3	0.4
Inward	6.3	4.9	17.7	6.6	6.7	6.8	6.8	6.9	7.1	7.2
New borrowing and debt rollover	199.9	165.4	158.8	159.1	166.2	148.8	140.0	137.4	140.1	143.7
Medium and long-term borrowing	23.5	11.4	18.2	22.8	33.6	31.4	34.3	36.1	41.0	45.8
General government	15.1	4.3	1.9	9.6	11.5	9.8	13.2	15.1	15.4	18.5
Banks	2.8	1.4	2.1	6.2	16.1	14.9	15.4	17.0	21.0	21.6
Other private	5.5	5.7	14.1	7.0	6.0	6.6	5.6	4.0	4.6	5.8
Short-term borrowing	176.5	154.0	140.6	136.3	132.6	117.4	105.7	101.3	99.1	97.9
Public sector	82.5	74.3	78.5	72.4	68.7	54.4	43.3	39.0	36.8	35.3
Central bank	71.5	72.5	77.6	71.1	63.6	50.1	39.0	34.8	32.5	31.0
General government	11.0	1.8	0.9	1.4	5.1	4.3	4.3	4.3	4.3	4.3
Banks	76.6	57.4	47.7	39.5	39.5	41.0	42.7	44.4	46.3	48.2
Other private	17.4	22.4	14.4	24.4	24.4	22.0	19.8	17.8	16.0	14.4
Other (includes asset operations)	2.2	8.5	16.9	10.6	-9.6	6.4	2.2	-3.6	-8.2	-9.0
Of which: Net errors and omissions	0.4	-0.1	0.5	-0.5	0.0	0.0	0.0	0.0	0.0	0.0
Financing Gap	0.0	33.9	27.7	11.7	5.2	0.0	0.0	0.0	0.0	0.0
European Union (2/3 of total) 1/	...	20.9	19.4	8.2	3.5	...	...	...	...	...
IMF (1/3 of total) 2/	...	13.1	8.2	3.4	1.8	...	...	...	...	...
Rollover Rates										
General government	109.0	30.6	28.5	67.2	214.1	122.8	167.2	156.0	198.9	162.5
Private	86.5	75.7	74.4	84.7	99.7	102.4	102.0	101.7	101.4	102.1
Banks	81.0	63.0	65.5	68.0	98.5	106.4	105.2	105.2	104.7	105.2
Other private	113.1	130.8	97.5	131.6	101.8	95.5	95.3	93.1	92.1	92.6

Sources: Bank of Portugal and IMF staff estimates.

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

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

Table 6. Portugal: Selected Financial Indicators of the Banking System, 2008–2014Q1

	2008	2009	2010	2011	2012				2013				2014
					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
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
Capital to assets 1/	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
Asset composition and quality													
Nonperforming loans to total gross loans 2/	3.6	4.8	5.2	7.5	8.0	9.2	9.8	9.8	10.4	10.6	11.2	10.6	10.8
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
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
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
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
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
Nonfinancial corporations	31.6	31.5	30.7	31.0	30.6	30.0	30.3	30.2	30.5	31.5	32.2	31.5	32.1
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
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
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
Return on equity	5.6	7.3	7.5	-5.5	8.2	2.5	0.3	-5.4	-3.7	-8.0	-7.5	-11.0	-0.4
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
Noninterest expenses to gross income	58.0	58.3	58.9	63.9	58.2	55.0	57.0	59.6	66.2	66.7	68.5	70.4	59.5
Liquidity													
Liquid assets to total assets 3/	12.8	13.2	19.0	13.8	11.2	12.7	13.7	14.8	14.8	16.0	15.7	16.9	16.5
Liquid assets to short-term liabilities 3/	67.7	84.5	86.2	85.4	90.5	101.5	123.2	140.0	149.5	150.7	155.1	170.3	153.0
Loans to deposits 4/	160.3	161.5	157.8	140.2	136.9	136.3	133.3	127.9	124.0	122.6	122.6	116.9	117.2
Foreign-currency-denominated liabilities to total liabilities 5/	5.8	5.1	5.1	4.1	3.9	3.9	4.0	4.2	4.5	4.4	4.4	4.3	4.3

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

Table 7. Portugal: Monetary Survey, 2011–19

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

				Projections					
	Dec-11	Dec-12	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18	Dec-19
Aggregated Balance Sheet of Monetary Financial Institutions (MFIs) 1/									
Assets	472,496	457,423	427,944	406,042	404,541	409,866	412,444	417,462	420,547
Cash	1,606	1,605	1,622	1,150	815	578	410	291	206
Claims on Bank of Portugal	5,692	8,136	8,219	3,326	2,579	2,000	1,551	1,203	933
Claims on other FIs	53,526	46,870	46,693	40,946	39,155	40,946	39,155	39,746	39,596
Claims on non MFIs	307,347	296,034	282,503	268,919	267,277	269,919	273,762	277,947	282,041
General government	32,309	38,759	38,685	32,903	32,205	32,496	32,778	32,626	32,304
Central government (excluding SOEs)	19,115	27,109	27,678	21,914	21,554	22,376	22,723	22,636	22,511
loans	38	464	594	-5,758	-5,808	-5,858	-5,908	-5,921	-5,941
securities	19,078	26,645	27,084	27,672	27,362	28,234	28,631	28,556	28,452
Bonds	10,307	16,078	22,220	20,961	21,052	21,924	22,320	22,246	22,141
Tbills (up to 1 year maturity)	8,770	10,567	4,865	6,711	6,311	6,311	6,311	6,311	6,311
Regional and local government (excl SOEs)	6,405	5,592	5,496	5,593	5,593	5,622	5,622	5,683	5,690
SOEs	6,797	6,067	5,519	5,396	5,058	4,498	4,433	4,307	4,103
Private sector	275,038	257,275	243,818	236,016	235,072	237,422	240,984	245,322	249,737
Corporates	135,433	123,256	115,703	114,050	117,862	120,943	124,348	128,349	132,375
SOEs (non-consolidating)									
Households	139,605	134,019	128,115	121,918	117,062	116,286	116,402	116,693	117,037
Claims on non-residents	140,294	119,010	102,264	105,325	108,638	110,711	112,260	113,033	112,901
Other assets	-35,969	-14,232	-13,357	-13,623	-13,924	-14,288	-14,693	-14,757	-15,131
Liabilities	472,496	457,423	427,944	406,042	404,541	409,866	412,444	417,462	420,547
Liabilities to Bank of Portugal	46,928	53,724	48,810	37,124	32,906	29,167	25,853	25,595	25,339
Liabilities to other FIs	57,477	42,436	41,078	40,618	38,744	39,706	37,817	38,195	38,959
Deposits of non MFIs	179,701	175,061	176,840	177,741	180,775	187,447	191,363	196,140	198,843
General government	12,279	13,218	12,429	11,993	8,618	8,618	8,618	8,618	8,618
Private sector	167,422	161,843	164,411	165,748	172,157	178,829	182,745	187,522	190,225
Securities other than capital	53,345	46,343	37,858	34,737	35,983	35,800	35,494	34,824	34,209
Liabilities to non-residents	105,130	89,483	70,134	71,363	74,218	77,187	80,351	83,646	87,109
Other	349	326	313	317	299	307	315	326	335
Capital and reserves	81,212	100,122	105,382	96,584	102,175	110,159	115,463	115,171	114,985
Money and Credit									
Broad Money (M3)	172,547	161,855	163,144	166,396	170,072	174,522	179,470	185,362	190,889
Intermediate money (M2)	169,872	156,877	158,303	161,459	165,026	169,344	174,145	179,863	185,225
Narrow money (M1)	67,504	65,785	65,295	66,597	68,068	69,849	71,829	74,187	76,399
Private sector credit	275,038	257,275	243,818	236,016	235,072	237,422	240,984	245,322	249,737
Public sector credit	32,309	38,759	38,685	32,903	32,205	32,496	32,778	32,626	32,304
(Percent of GDP)									
Broad Money	97.9	95.4	95.3	95.3	95.3	95.3	95.3	95.3	95.3
Private sector credit	156.1	151.6	142.4	135.2	131.7	129.6	127.9	126.1	124.7
Public sector credit	18.3	22.8	22.6	18.8	18.0	17.7	17.4	16.8	16.1
(Percentage change)									
Broad Money	-1.3	-6.2	0.8	2.0	2.2	2.6	2.8	3.3	3.0
Private sector credit	-1.5	-6.5	-5.2	-3.2	-0.4	1.0	1.5	1.8	1.8
Public sector credit	-4.5	20.0	-0.2	-14.9	-2.1	0.9	0.9	-0.5	-1.0
Memorandum items:									
ECB access (percent of assets)	9.9	11.7	11.4	9.1	8.1	7.1	6.3	6.1	6.0
Credit to deposits (percent) 2/	146.1	148.9	141.4	134.2	130.0	127.4	127.0	126.3	126.2
Loan to deposits (percent) 2/	146.4	149.3	133.9	128.1	127.5	124.5	125.2	124.3	124.2
Wholesale market funding (percent of assets) 3/	29.5	26.0	21.3	22.7	23.7	23.9	24.3	24.5	24.8

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 8. Portugal: External Debt Sustainability Framework, 2009–2019

(Percent of GDP, unless otherwise indicated)

					Est.				Projections			
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Debt-stabilizing non-interest current account 6/
Baseline: External debt	214.9	221.9	222.7	226.3	228.3	227.5	217.3	209.0	203.5	199.4	196.0	4.1
Change in external debt	21.8	7.0	0.7	3.6	2.1	-0.9	-10.2	-8.3	-5.5	-4.1	-3.4	
Identified external debt-creating flows (4+8+9)	12.5	0.4	15.6	9.4	-3.5	-0.6	1.6	1.5	1.4	0.8	0.6	
Current account deficit, excluding interest payments	4.6	5.1	0.6	-4.7	-6.4	-5.6	-5.7	-5.4	-5.4	-5.8	-6.2	
Deficit in balance of goods and services	6.7	7.0	3.7	0.1	-2.1	-2.3	-2.7	-2.8	-2.9	-3.1	-3.3	
Exports	27.6	30.6	35.3	38.0	40.1	40.5	41.9	43.4	44.5	45.6	46.7	
Imports	34.3	37.5	39.0	38.1	37.9	38.2	39.3	40.6	41.6	42.5	43.5	
Net non-debt creating capital inflows (negative)	-1.7	-4.4	4.1	-0.9	-1.0	1.8	4.6	4.5	4.4	4.3	4.2	
Automatic debt dynamics 1/	9.6	-0.3	11.0	15.0	3.9	3.2	2.7	2.5	2.4	2.3	2.6	
Contribution from nominal interest rate	5.9	5.1	6.3	6.7	5.7	5.0	5.4	5.2	5.2	5.4	5.6	
Contribution from real GDP growth	5.9	-4.0	4.1	7.7	3.0	-1.9	-2.6	-2.8	-2.8	-3.2	-3.0	
Contribution from price and exchange rate changes 2/	-2.1	-1.4	0.6	0.6	-4.8	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	9.3	6.6	-14.9	-5.8	5.6	-0.2	-11.8	-9.8	-6.8	-4.9	-4.0	
External debt-to-exports ratio (in percent)	780.1	726.3	630.3	595.4	569.6	561.7	518.4	482.0	456.9	437.2	419.4	
Gross external financing need (in billions of Euros) 4/				183.9	184.6	164.0	157.6	144.7	136.5	134.8	137.7	
in percent of GDP				108.3	107.8	93.9	88.3	79.0	72.5	69.3	68.8	
Scenario with key variables at their historical averages 5/						227.5	221.1	217.0	215.9	217.3	218.9	2.0
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (percent)	-3.0	1.9	-1.8	-3.3	-1.3	0.8	1.2	1.3	1.4	1.6	1.6	
GDP deflator in Euros (percent)	1.1	0.6	-0.3	-0.3	2.2	1.2	1.0	1.3	1.4	1.7	1.4	
Nominal external interest rate (percent)	3.0	2.4	2.8	2.9	2.5	2.2	2.4	2.5	2.6	2.7	2.9	
Growth of exports (Euros, percent)	-15.3	13.7	13.2	3.7	6.3	3.0	5.8	6.1	5.7	5.8	5.5	
Growth of imports (Euros, percent)	-18.1	12.2	1.8	-5.9	0.4	2.6	5.1	6.1	5.6	5.4	5.4	
Current account balance, excluding interest payments	-4.6	-5.1	-0.6	4.7	6.4	5.6	5.7	5.4	5.4	5.8	6.2	
Net non-debt creating capital inflows	1.7	4.4	-4.1	0.9	1.0	-1.8	-4.6	-4.5	-4.4	-4.3	-4.2	

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 9. Portugal: Indicators of Fund Credit, 2011–19 1/

(Millions of euros, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Disbursements	13,052	8,220	3,407	1,773	...	...	...	...	...
(percent of quota)	1,117	670	289	152	...	...	...	...	...
(Projected debt service to the Fund, based on existing and prospective drawings)									
Total	14	152	171	239	1,484	3,509	4,385	4,810	4,785
Interest and charges	14	152	171	239	950	904	780	627	455
Repayments	0	0	0	0	534	2,605	3,605	4,183	4,330
Total debt service, in percent of									
Exports of goods and services	0.0	0.2	0.2	0.3	2.0	4.4	5.2	5.4	5.1
GDP	0.0	0.1	0.1	0.1	0.8	1.9	2.3	2.5	2.4
(Projected level of credit outstanding based on existing and prospective drawings)									
Outstanding stock	13,052	21,926	24,464	26,032	25,666	22,993	19,316	15,083	10,753
percent of quota	1,117.1	1,787.1	2,076.2	2,228.0	2,182.6	1,960.5	1,652.1	1,293.4	922.1
percent of GDP	7.4	12.9	14.3	14.9	14.4	12.6	10.3	7.8	5.4
Memorandum Items (billions of euros)									
Exports of goods and services	62	64	69	71	75	79	84	89	94
GDP	176	170	171	175	178	183	188	195	200

Source: IMF staff estimates.

1/ Exchange rate forecasts against the SDR as per WEO assumptions.

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 in 2015 and the outer years remains critical to anchor debt safely on a downward-sloping path, boosting policy credibility and strengthening the country's resilience to reversals in market sentiment.

A. Baseline Scenario

1. Debt is expected to start gradually declining in 2014 from its 2013 peak (Figure 3 and 4). While the recent debt management operation in selected SOEs with structural vulnerabilities and further ESA2010 reclassifications has led to a significant increase in general government debt (compared to the 11th review projections), the impact on the debt ratio has been significantly mitigated by the upward revision in nominal GDP also resulting from the recently introduced ESA2010 standards (see Annex II). The debt ratio is now projected to have reached its peak at 128 percent of GDP in 2013 and to start declining in 2014 to 127.8 percent of GDP. Nevertheless, debt would be around 123¼ percent of GDP by 2019, lacking further consolidation efforts. The baseline debt projections continue to hinge on sustained structural reform efforts over the medium term—given the high sensitivity of Portugal's debt dynamics to macro shocks—as well as further use of cash deposits and the ongoing reallocation of the Social Security portfolio from foreign assets to government securities. Portugal's debt net of government deposits is projected to stand at around 121 percent of GDP by end–2014.

B. Risk Assessment

2. Portugal's sizable debt burden and gross financing needs continue to pose significant risks to debt sustainability. As presented in Figure 1, Portugal's debt ratio exceeds the debt burden benchmark for advanced economies of 85 percent of GDP already under the baseline scenario. The same applies to Portugal's public financing needs which are above the relevant benchmark of 20 percent of GDP. However, the debt profile is subject to medium to low risks in terms of market perception, projected change in short-term debt, and the share of public debt held

by nonresidents.[1] 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. The attainment of potential growth assumed under the program has important implications for the debt adjustment path. Portugal's growth forecast track record tends to be relatively high compared to other countries with Fund-supported programs, especially during the pre-crisis period (Figure 2). The achievement of a growth rate of 1½ percent over the medium term, as per staff's updated projection, is consistent with moderate growth convergence, but remains subject to sustained structural effort and a successful rebalancing of the economy from the nontradable to the tradable sectors. If growth were to turn out lower than currently projected—for instance as a result of stalling or reversal of the reform effort—the rate of debt decline would significantly slow down, as also shown in Figure 4 and AI.5. Similarly, risks from a protracted period of negative inflation in Portugal could further impede the repair of already-weak private and public balance sheets, as highlighted by the customized deflation scenario in Figure 5.

4. Given Portugal's sizable debt burden and financing needs, the primary balance is expected to exceed its debt-stabilizing threshold over the projection period. Under staff's baseline scenario,[2] the fiscal primary balance is expected to reach nearly 3 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 quartile of the fiscal adjustments observed in other countries with debt greater than 60 percent of GDP. However, due to the 3-year rolling nature of the estimate, this largely reflects the country's fiscal efforts already achieved over 2011–14. Nevertheless, Portugal's debt profile remains highly vulnerable to a primary balance shock (Figure 4 and 5), as also highlighted by the asymmetric fan chart analysis in Figure 1, which shows the risks to the debt outlook if only negative shocks to the primary balance were to materialize. Moreover, the authorities' medium-term fiscal strategy is expected to target a more ambitious adjustment path than staff's current-policies baseline, consistent with the European Treaty on Stability, Coordination,

[1] 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.

[2] 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.

and Governance framework which establishes a minimum structural adjustment effort of ½ percent of GDP per year, until the medium term objective is achieved.

D. Stress Tests

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

- Under a *growth shock* that lowers output by over 4 percentage points in 2015–16 (and in turn inflation by a cumulative 1 percentage point), debt would peak at about 136½ percent of GDP in 2016, over 10 percentage points higher compared with the 2016 baseline. However, debt dynamics would be severely compromised under a *deflation scenario* where a sharper growth shock (that lowers output by 5½ percentage points in 2015-16) 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 peak at nearly 145 percent of GDP and stay around 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 2019 the debt-to-GDP ratio is about 2½ 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 (see Annex II), 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.[3] A contingent liabilities shock of this magnitude would push the 2015 debt ratio to about 131 percent of GDP.

- 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 peaking at 139 percent of GDP in 2016 and declining only slowly over the medium term.

[3] 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.

Authorities' views

6. The authorities took note of the risks highlighted by staff, but also stressed their divergence from staff's baseline scenario. The authorities emphasized the significant achievements under the program to secure the debt trajectory on a downward path starting already in 2014. They also noted that recent increases in gross debt have been largely due to the sustained build-up of central government cash balances and that the SOE debt management operation earlier in 2014 aimed at restoring the financial viability of these companies, thus significantly reducing fiscal risks. Finally, they stressed that their budgetary commitments for 2015 and under their medium term-strategy are expected to improve debt dynamics at a significantly faster pace than currently envisaged under staff's baseline scenario. In particular, the authorities considered that the forecasts underlying the 2015 State Budget Draft Law – according to which gross debt is expected to reach 123.7 percent of GDP by end-2015 – remained appropriate.

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

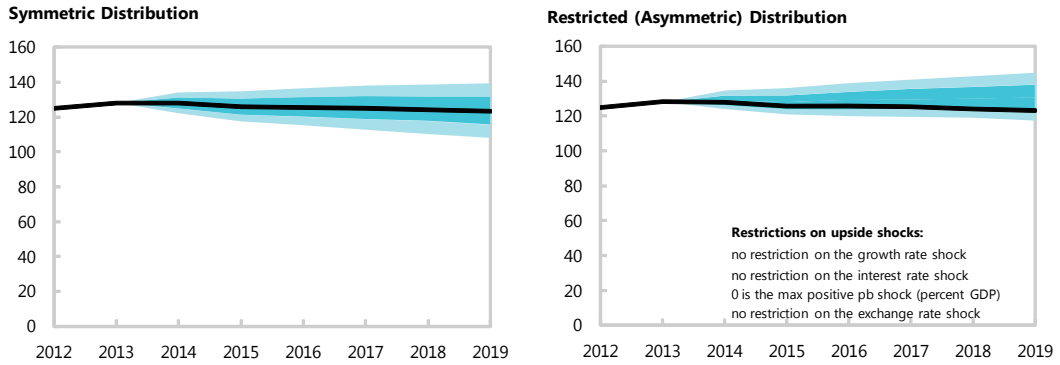
Heat Map

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

Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)

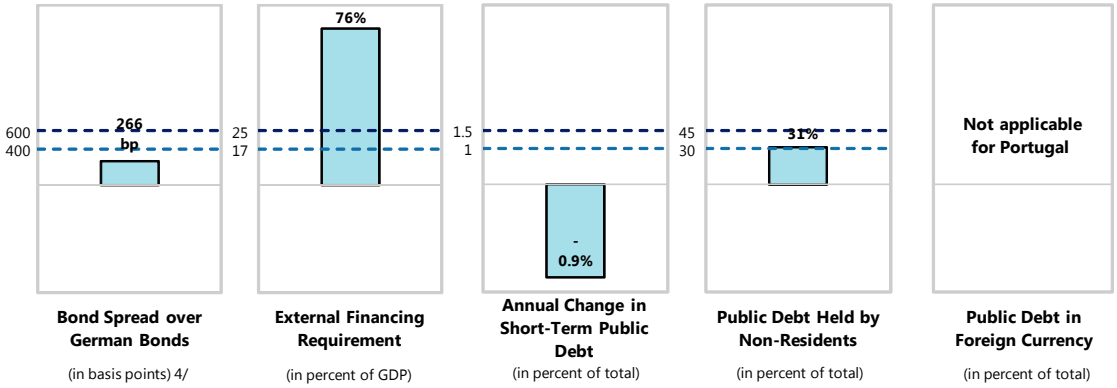
Baseline — Percentiles: 10th-25th, 25th-75th, 75th-90th



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)

Portugal — Lower early warning — Upper early warning



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.

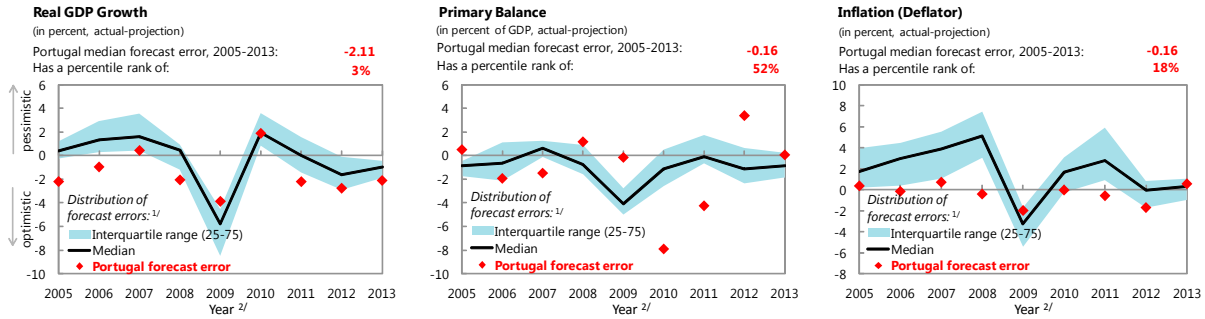
2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

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).

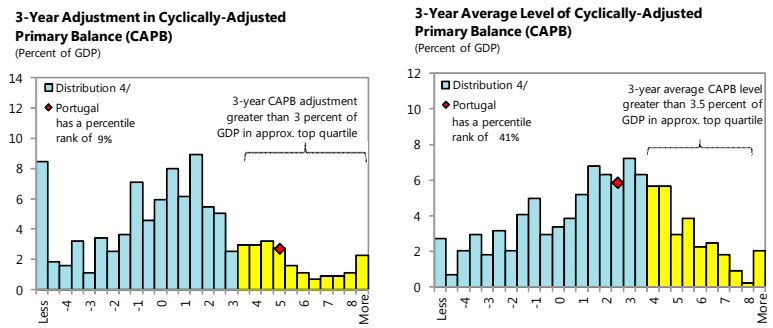
4/ An average over the last 3 months, 17-Jul-14 through 15-Oct-14.

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

Forecast Track Record, versus program countries



Assessing the Realism of Projected Fiscal Adjustment



Source : IMF Staff.

1/ Plotted distribution includes program countries, percentile rank refers to all countries. For the primary balance, Portugal forecast error for 2004-2009 was constructed using comparable WEO series.

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

3/ Not applicable for Portugal.

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

Figure 3. Portugal: Public DSA – Baseline Scenario, 2003–2019
(Percent of GDP, unless otherwise indicated)

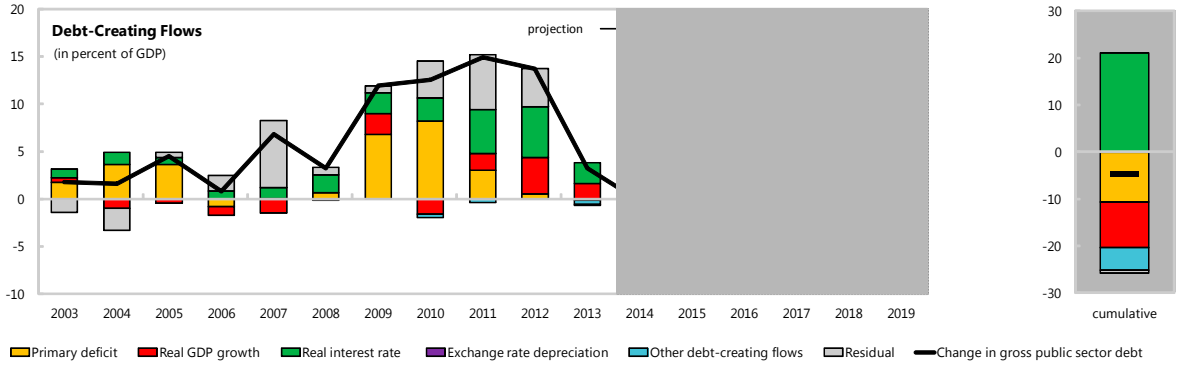
Debt, Economic and Market Indicators [1/]

	Actual	Prel.		Projections					
	2003-2011 [2/]	2012	2013	2014	2015	2016	2017	2018	2019
Nominal gross public debt	73.8	124.8	128.0	127.8	125.7	125.5	125.0	124.1	123.3
Public gross financing needs	...	26.8	23.2	20.8	20.0	18.7	19.8	19.2	19.4
Real GDP growth (in percent)	0.3	-3.3	-1.4	0.8	1.2	1.3	1.4	1.6	1.6
Inflation (GDP deflator, in percent)	2.1	-0.4	2.3	1.2	1.0	1.3	1.4	1.7	1.4
Nominal GDP growth (in percent)	2.4	-3.7	0.9	2.0	2.2	2.6	2.8	3.3	3.0
Effective interest rate (in percent) [4/]	4.6	4.3	4.0	4.0	4.0	4.1	4.3	4.3	4.4

As of October 15, 2014		
Sovereign Spreads		
Spread (bp) 3/	266	
CDS (bp)	195	
Ratings	Foreign	Local
Moody's	Ba1	Ba1
S&Ps	BB	BB
Fitch	BB+	BB+

Contribution to Changes in Public Debt

	Actual	Prel.		Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	6.5	13.7	3.2	-0.2	-2.1	-0.2	-0.5	-0.9	-0.8	-4.7	
Identified debt-creating flows	4.6	9.8	3.3	-0.4	-1.2	0.1	-0.4	-1.2	-1.0	-4.0	
Primary deficit	3.0	0.6	-0.1	-0.1	-1.5	-1.8	-2.1	-2.5	-2.7	-10.7	1.7
Primary (noninterest) revenue and grants	41.0	43.0	45.2	44.5	44.4	44.4	44.2	43.9	43.6	264.9	
Primary (noninterest) expenditure	44.0	43.5	45.1	44.4	42.9	42.6	42.1	41.4	40.9	254.3	
Automatic debt dynamics [5/]	1.7	9.2	3.9	2.5	2.2	1.9	1.7	1.3	1.7	11.4	
Interest rate/growth differential [6/]	1.7	9.2	3.9	2.5	2.2	1.9	1.7	1.3	1.7	11.4	
Of which: real interest rate	1.8	5.4	2.2	3.6	3.7	3.5	3.4	3.2	3.6	21.0	
Of which: real GDP growth	-0.1	3.8	1.7	-1.0	-1.5	-1.6	-1.7	-1.9	-1.9	-9.6	
Exchange rate depreciation [7/]	0.0	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	-0.1	0.0	-0.4	-2.9	-1.9	0.0	0.0	0.0	0.0	-4.8	
Privatization Revenue (negative)	-0.1	-1.3	-0.8	-0.2	0.0	0.0	0.0	0.0	0.0	-0.2	
Increase in deposits and other (- means drawn down of deposits)	0.0	1.3	0.4	-2.7	-1.9	0.0	0.0	0.0	0.0	-4.6	
Residual, including asset changes [8/]	1.9	4.0	-0.1	0.2	-0.9	-0.3	-0.1	0.3	0.2	-0.7	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Bond Spread over German Bonds.

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

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

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

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

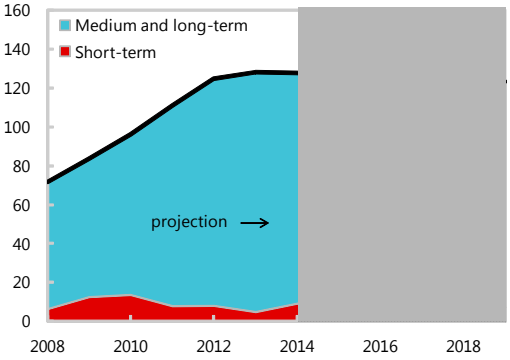
8/ For projections, this line includes exchange rate changes during the projection period.

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

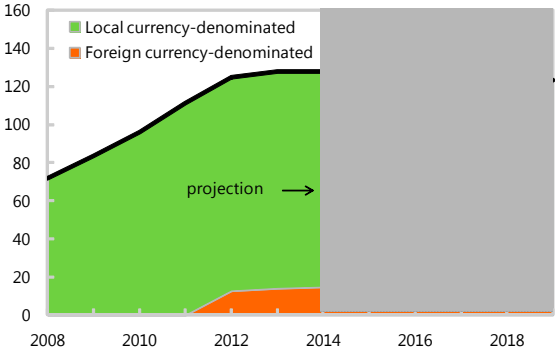
Figure 4. Portugal: Public DSA – Composition of Public Debt and Alternative Scenarios, 2008–2019

Composition of Public Debt

By Maturity
(in percent of GDP)



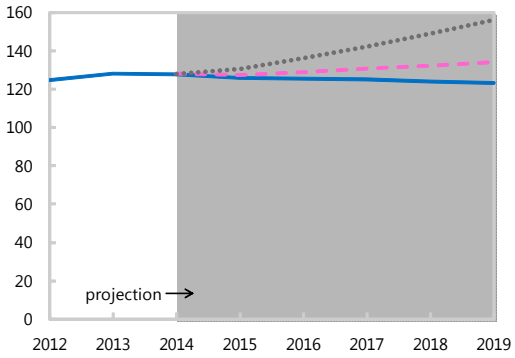
By Currency
(in percent of GDP)



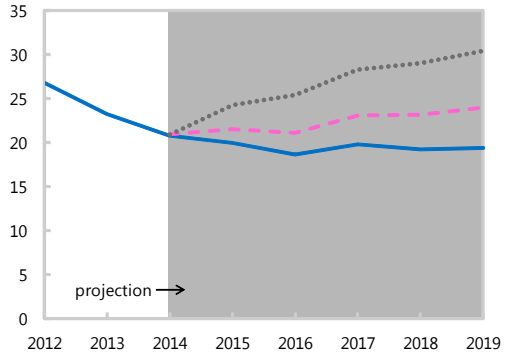
Alternative Scenarios

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)

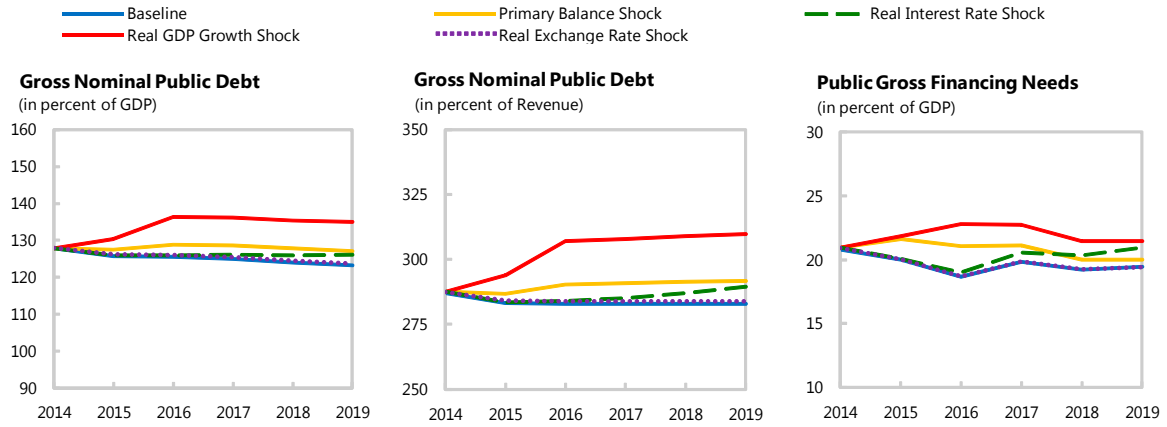
Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	0.8	1.2	1.3	1.4	1.6	1.6
Inflation	1.2	1.0	1.3	1.4	1.7	1.4
Primary Balance	0.1	1.5	1.8	2.1	2.5	2.7
Effective interest rate	4.0	4.0	4.1	4.3	4.3	4.4
Constant Primary Balance Scenario						
Real GDP growth	0.8	1.2	1.3	1.4	1.6	1.6
Inflation	1.2	1.0	1.3	1.4	1.7	1.4
Primary Balance	0.1	0.1	0.1	0.1	0.1	0.1
Effective interest rate	4.0	4.0	4.2	4.3	4.4	4.5

Historical, 2004-13	2014	2015	2016	2017	2018	2019
Real GDP growth	0.8	-0.1	-0.1	-0.1	-0.1	-0.1
Inflation	1.2	1.7	1.7	1.7	1.7	1.7
Primary Balance	0.1	-2.6	-2.6	-2.6	-2.6	-2.6
Effective interest rate	4.0	4.0	4.1	4.3	4.4	4.5

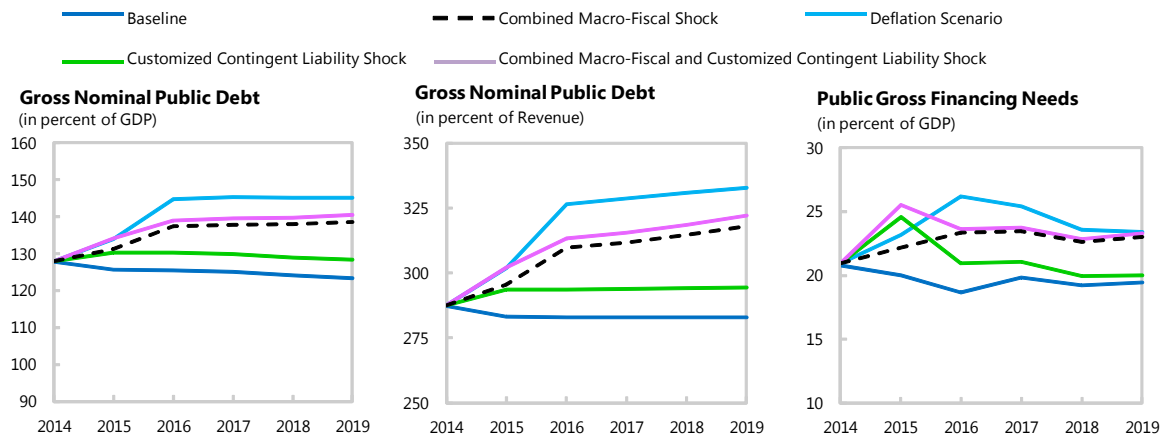
Source: IMF staff.

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

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2014	2015	2016	2017	2018	2019
Real GDP growth	0.8	1.2	1.3	1.4	1.6	1.6
Inflation	1.2	1.0	1.3	1.4	1.7	1.4
Primary balance	0.1	0.0	0.2	2.1	2.5	2.7
Effective interest rate	4.0	4.0	4.2	4.4	4.4	4.5
Real Interest Rate Shock						
Real GDP growth	0.8	1.2	1.3	1.4	1.6	1.6
Inflation	1.2	1.0	1.3	1.4	1.7	1.4
Primary balance	0.1	1.5	1.8	2.1	2.5	2.7
Effective interest rate	4.0	4.0	4.4	4.7	5.0	5.2
Combined Shock						
Real GDP growth	0.8	-1.0	-0.8	1.4	1.6	1.6
Inflation	1.2	0.5	0.8	1.4	1.7	1.4
Primary balance	0.1	0.0	-0.6	2.1	2.5	2.7
Effective interest rate	4.0	4.0	4.4	4.8	5.0	5.3
Customized Contingent Liability Shock						
Real GDP growth	0.8	1.2	1.3	1.4	1.6	1.6
Inflation	1.2	1.0	1.3	1.4	1.7	1.4
Primary balance	0.1	-3.0	1.8	2.1	2.5	2.7
Effective interest rate	4.0	4.0	4.2	4.3	4.4	4.5

Real GDP Growth Shock	2014	2015	2016	2017	2018	2019
Real GDP growth	0.8	-1.0	-0.8	1.4	1.6	1.6
Inflation	1.2	0.5	0.8	1.4	1.7	1.4
Primary balance	0.1	0.4	-0.6	2.1	2.5	2.7
Effective interest rate	4.0	4.0	4.2	4.4	4.5	4.5
Real Exchange Rate Shock						
Real GDP growth	0.8	1.2	1.3	1.4	1.6	1.6
Inflation	1.2	1.1	1.3	1.4	1.7	1.4
Primary balance	0.1	1.5	1.8	2.1	2.5	2.7
Effective interest rate	4.0	4.0	4.1	4.2	4.3	4.4
Deflation Scenario						
Real GDP growth	0.8	-1.5	-1.4	1.4	1.6	1.6
Inflation	1.2	-1.0	-0.7	1.4	1.7	1.4
Primary balance	0.1	-0.5	-2.4	2.1	2.5	2.7
Effective interest rate	4.0	4.0	4.3	4.8	4.7	4.8
Combined Macro-Fiscal and Customized Contingent Liability Shock						
Real GDP growth	0.8	-1.0	-0.8	1.4	1.6	1.6
Inflation	1.2	0.5	0.8	1.4	1.7	1.4
Primary balance	0.1	-3.4	1.0	2.1	2.5	2.7
Effective interest rate	4.0	4.0	4.5	4.8	5.1	5.4

Source: IMF staff.

Annex II. State-Owned Enterprise Restructuring Strategy

1. The consolidated operational balance of non-financial SOEs improved substantially under the program as a result of cost-reduction efforts. Nevertheless, legacy debt continued to weigh on the results of a number of SOEs, particularly in the transport sector. As part of ongoing efforts to restore the financial sustainability of transport SOEs and reduce fiscal risks, the government has launched earlier in 2014 a new comprehensive debt management strategy. Effective operational and financial restructuring of these firms is expected to pave the way for successful tendering of concessions. However, further efforts to close gaps in transparency and contain fiscal risks, notably for regional and local SOEs, remain critical going forward.

2. SOE restructuring was a core part of the adjustment program. Financial imbalances in SOEs, a legacy of years of off-budget social policies resulting in overspending (wages, pensions, investment) and underfunding (tariffs and transfers not fully covering costs and deficits, respectively), added to the challenges policymakers faced at the onset of the program. With a small operating deficit in 2010 (below 0.1 percent of GDP) and total debt of about 18 percent of GDP—about 38 percent of which guaranteed by the state—this sector posed a significant fiscal risk, while the diversion of resources towards inefficient firms in the non-tradable sector distorted competition.[1] One of the key objectives of the program was therefore to restore SOEs to financial health, in particular those in the transport sector that account for about half of total SOE debt and, together with SOE hospitals, for virtually all losses.

3. Cost savings and revenue recovery helped strengthen the financial condition of the sector as a whole. The consolidation efforts in SOEs were largely achieved through personnel cuts, input cost reductions, and price increases. On a consolidated basis, including health and transport SOEs, the sector recorded an EBITDA of about €2.3 billion in 2013, up from €1.1 billion in 2010. Transport SOEs cut staffing levels by some 20 percent, which, coupled with other efficiency gains and revenue recovery, successfully reduced the transport sector's EBITDA from a deficit of about €260 million in 2010 to €14 million in 2013. When excluding severance payments, it in fact reached a small surplus in both 2012 and 2013. The unwinding of about half of outstanding swap contracts (in mark-to-market terms) of SOEs in 2013 helped further reduce costs and risks.

4. Despite these actions, significant remaining structural imbalances in transport SOEs called for a targeted debt management strategy. While transport SOEs significantly reduced their operational deficits or even reached surpluses, the financial deficits of several companies are

[1] For more discussion, see Annex IV in IMF Country Report No. 11/127, Box 4 in IMF Country Report No. 12/77 and Section 3.3.2 of Portugal's Fiscal Transparency Evaluation (FTE) IMF Country Report No. 14/306.

sizable.[2,3] This was due to high debt levels, largely at short maturity, and rising funding costs, which led to a continued accumulation of domestic arrears. To address these challenges on a lasting basis, the authorities have initiated in 2013 a new debt management strategy for reclassified companies within the General Government, mainly in the transport and infrastructure sector, which includes their recapitalization, as follows: i) equity cash injections to pay for external debt service and investment needs; ii) debt to equity conversions of state loans. This process aims at reducing their elevated funding costs and at restoring their financial viability. Additionally, authorities have also launched in the beginning of 2014 a new debt management operation for specific SOEs, which at the time were outside the General Government perimeter (CP, Carris and STCP) [4]. As part of this operation, as of April 2014, the state started servicing the short-term financial debt at residual maturity of these SOEs. Since CP is now reclassified within the General Government— effective since 2010—, it is also to be recapitalized in the same terms as those presented above for reclassified companies, in line with EU rules. Thus, following equity cash injections and debt to equity conversion totaling €3.3 billion in 2014, the 2015 budget foresees further capital injections of up to €4.8 billion in 2015.

5. The debt management operation has had a front-loaded impact on general government debt in 2014. The operation has led to an overall increase in public debt, of about €1.2 billion in 2014 (or 0.7 percent of GDP). This includes additional financing needs to be financed by the Central Government as well as the statistical reclassification of the debt of the recapitalized SOEs that are outside the General Government perimeter.[5]

6. The operation has significantly reduced fiscal risks from SOEs, while improving privatization prospects. With most SOEs being reclassified within the general government, the contingent liabilities and future risks from this sector are being significantly reduced, with enhanced transparency in terms of staff's debt sustainability assessment. Moreover, while not included under

[2] All of these companies are expected to reach a balanced EBITDA by 2015.

[3] Comboios de Portugal (CP)'s financial deficit alone is estimated to have exceeded €200 million in 2013, while that of Metropolitano de Lisboa (ML) and REFER are estimated to have been around €60 million each.

[4] In parallel, the government launched a new strategy to address financial imbalances in SOE hospitals, with a view to arresting the accumulation of arrears and bringing them to operational balance by end-2014. As part of this strategy, budget transfers are being allocated to loss-making SOE hospitals conditional on restructuring efforts and compliance with financial targets.

[5] As the result of the entry into force of the ESA2010 rules, certain non-financial SOEs have been reclassified within the General Government, leading to an additional increase in GG debt. The impact of this reclassification is estimated at about €6 billion (out of an overall revision of €5.6 billion, net of other revisions). Nevertheless, the impact on the debt ratio has been mitigated by the upward revision of the GDP, also resulting from the adoption of the ESA2010.

staff's baseline scenario, the operational and financial restructuring of these companies is expected to pave the way for successful tendering of concessions.

7. The creation of a dedicated technical unit for SOEs within the Ministry of Finance is expected to strengthen oversight and avoid the reemergence of imbalances. With the appointment of a Director in August, UTAM is now operational. The unit is tasked to provide advice on the financial situation and performance of SOEs and assess the sustainability and efficiency of any new SOE. Nevertheless, as highlighted by the recent Fiscal Transparency Evaluation, the contingent liabilities from SOEs at the regional and local government level, outside the perimeter of the general government, call for stepped-up monitoring and reporting efforts.

INTERNATIONAL MONETARY FUND

COMMUNICATIONS DEPARTMENT

Press Release No. 15/23
FOR IMMEDIATE RELEASE
January 30, 2015

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

IMF Executive Board Concludes First Post-Program Monitoring with Portugal

On January 23, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the First Post-Program Monitoring with Portugal[1].

Following a prolonged recession, the economy is estimated to have expanded by 0.8 percent in 2014 with private consumption as its main driver and investment remaining subdued. With import growth picking up in line with domestic demand, the current account balance declined marginally in 2014. As strong revenue performance helped offset the impact of adverse legal rulings during the year and other spending pressures, the budget deficit target for 2014 is within reach, with an estimated deficit of about 3.9 percent of GDP, net of one-off items. The economic recovery helped unemployment decline to 13.1 percent at the end of the third quarter of 2014, well below the crisis peak of 17.5 percent. Financial stability has been maintained despite recent challenges. Banks' capital buffers have been strengthened with a Common Equity Tier 1 ratio of 10.6 percent and the loan-to-deposit ratio has been reduced to 114 percent from its pre-crisis peak of 140 percent. Regained policy credibility and benign market conditions have facilitated the resumption of market access at declining yields. Portugal issued close to €17 billion in debt in 2014, and the cash buffer at end-October was €10.5 billion, covering financing needs through the middle of 2015.

Looking ahead, the economy is expected to expand by 1.2 percent in 2015 and private consumption is expected to continue to be the main driver of growth. The current account

[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.

surplus is expected to decline marginally. Investment is expected to pick up gradually during the course of the year. Based on current policies, the budget deficit is projected at 3.4 percent of GDP in 2015, implying a procyclical loosening of the fiscal stance (by around 0.3 percent of potential GDP in structural terms). Notwithstanding the recent sharp fall in oil prices, the risks to the outlook are mainly tilted to the downside, as significant underlying vulnerabilities, including high public and private debt and lackluster growth prospects, render the economy susceptible to a range of domestic and external shocks. With significant fiscal adjustment needs still ahead, political and legal setbacks constitute a key domestic risk. On the external front, renewed global financial volatility or bond market stress could herald the end of exceptionally favorable financing conditions. This reinforces the need to press ahead with necessary reforms to unlock higher growth while safeguarding against these risks.

Executive Board Assessment[2]

Executive Directors noted that Portugal ended its EU-IMF supported program in June with restored access to sovereign debt markets and a strong record of policy implementation, having initiated reforms to remove long-standing structural impediments to growth and job creation. Directors observed that the economy has emerged from a deep recession and unemployment is declining rapidly from very high levels, while substantial fiscal consolidation has been achieved and the large pre-crisis current account deficit has turned into a surplus.

Notwithstanding these commendable achievements, Directors noted that Portugal continues to face significant challenges, heightened by a sluggish external environment. They cautioned against a weakening reform momentum and called for efforts to reinvigorate structural reforms to reorient the economy towards higher investment and exports, rebuild the economy's capital stock and absorb the significant labor slack, in order to lay the foundation for sustainable, inclusive growth.

Directors welcomed the authorities' strong commitment to achieving the fiscal deficit target of 2.7 percent of GDP contained in the 2015 budget. They stressed the need to keep fiscal consolidation on a firm path by monitoring developments and standing ready to adjust the strategy. In this regard, Directors advised mitigating medium-term fiscal risks stemming from

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

the Constitutional Court's decision to nullify public wage cuts, and encouraged the implementation of further revenue and expenditure reforms, including containing the wage bill and pension costs in line with the earlier recommendations of the Public Expenditure Review. Looking ahead, they called for continued fiscal consolidation over the medium term to help foster debt sustainability and build market confidence on a durable basis, and for advancement of the fiscal structural reform agenda.

Directors emphasized the need to press ahead with structural reforms to enhance external competitiveness and boost potential growth. They called for further labor and product market reforms to help tackle key bottlenecks to high growth and durable economic rebalancing, given low inflation in Portugal's key trading partners and the absence of an effective devaluation tool. They also advised reducing rents in the nontradeables sector, in part by improving energy sector efficiency; and adoption of a comprehensive and system-wide approach to corporate deleveraging, to free up resources for investment and job creation.

Directors considered that reducing corporate indebtedness is also central to improving the banks' operating environment and supporting the process of balance sheet repair. They welcomed the effective resolution of the Banco Espirito Santo and creation of the bridge bank, Novo Banco, to perform the critical functions and operations of the former. Directors stressed that the subsequent restructuring and sale of Novo Banco should aim to preserve financial stability while safeguarding public finances. Following the ECB's Comprehensive Assessment, they also encouraged efforts to continue to increase capital buffers to strengthen the resilience of the banking system. In particular, Directors underscored the need for banks to maintain robust risk management practices, and called for the reinforcement of supervisory competence by the Single Supervisory Mechanism and the national competent authority, Banco de Portugal, to help deter excessive risk-taking and/or a rise in concentration levels in response to competitive pressures within the Banking Union.

Portugal: Selected Economic Indicators, 2013–16 1/

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

		Estimated	Projections 1/	
	2013	2014	2015	2016
Real GDP	-1.4	0.8	1.2	1.3
Private consumption	-1.4	1.6	1.6	1.3
Public consumption	-1.9	-0.6	-0.5	0.0
Gross fixed capital formation	-6.3	1.4	1.8	2.2
Exports	6.4	3.5	4.5	4.5
Imports	3.6	4.5	4.4	4.4
Contribution to growth (percentage points)				
Total domestic demand	-2.4	1.3	1.1	1.2
Foreign balance	1.0	-0.4	0.0	0.1
Resource utilization				
Employment	-2.8	2.3	0.8	0.6
Unemployment rate (percent)	16.2	13.8	12.7	12.2
Prices				
GDP deflator	2.3	1.2	1.0	1.3
Consumer prices (harmonized index)	0.4	0.0	0.4	1.0
Money and credit (end of period, percent change)				
Private sector credit	-5.2	-3.2	-0.4	1.0
Broad money	0.8	2.0	2.2	2.6
Fiscal indicators (percent of GDP)				
General government balance 2/	-4.9	-3.9	-3.4	-3.3
Primary government balance	0.1	0.1	1.5	1.8
Structural primary balance (percent of potential GDP)	2.0	2.7	2.4	2.3
General government debt	128.0	127.8	125.7	125.5
Current account balance (percent of GDP)	0.7	0.6	0.4	0.2
Nominal GDP (billions of euros)	171.2	174.6	178.5	183.2

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

1/ Projections for 2016 reflect current policies.

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

Statement by Carlo Cottarelli, Executive Director for Portugal
and Ines Lopes, Advisor to Executive Director
January 23, 2015

I. Overview

We welcome this first post-program monitoring staff report, including staff's assessment of the achievements in regaining stable market access and actively managing the debt profile. At the same time, the report could have better reflected other key results achieved since 2011, notably in terms of external rebalancing and fiscal adjustment. We also feel that the repeated suggestion that the electoral cycle is hindering the reform process is inappropriate. Elections are a welcome feature of democratic regimes and should not be presented as disruptive events to reform processes.

Broadly, the economy's adjustment process has proceeded well. Strong compliance with the Economic and Financial Adjustment Program was crucial for securing a timely return to market access and pivotal to initiate the correction of long-standing economic imbalances. While public, private and external indebtedness is still high, decisive steps have been taken to address these issues and important progress was made in strengthening the primary budget balance and current account balance trajectories. Notwithstanding the stabilization results reached thus far, the Portuguese authorities remain committed to continuing the reform process and to implementing sound policies in the post-program period so as to foster further adjustment and secure the transition to more sustainable economic growth and job creation.

II. Economic Activity

Following the turnaround in early 2013, economic recovery continued in 2014. Given the abrupt adjustment in internal demand in the early stages of the Program, consumption decisions that had been delayed for a long period have now resumed, namely regarding durable goods. The subsequent strong pick-up in private consumption and imports led to a shift in growth composition, which is likely to be of a temporary nature and triggered by improved confidence following the most difficult period of the adjustment process. Nevertheless, the external adjustment is still proceeding. Indeed, recent data from Statistics Portugal (INE) confirm that Portugal's net lending position towards the rest of the world improved to 1.9 percent of GDP in the year ending in the third quarter of 2014, from 1.6 percent of GDP in the year ending in the

second quarter. Also, exports continue to grow, albeit at a somewhat slower pace than in previous years, remaining the single fastest growing component of aggregate demand.

National accounts' data for the third quarter of 2014 show that, in year-on-year terms, Portuguese GDP grew by 1.1 percent, accelerating from 0.9 percent in the second quarter and in line with the Government's projection of 1.0 percent for annual growth in 2014.

III. Fiscal Policy

While taking note of the risks highlighted by staff, the Government continues to stand by the fiscal forecasts underlying the 2015 State Budget, also in light of recent economic developments and the available data on 2014 budgetary execution.

Regarding 2014, the Government forecasts an overall General Government deficit of 4.8 percent of GDP (this includes some of the one off items not included in the General Government balance definition of Table 1 of the staff report) and remains confident that final data will confirm that this target has been met. Data on budgetary execution on a cash basis up to November – released after the conclusion of the IMF mission – indicates the deficit amounted to €6.42bn, confirming a €2.77bn decrease vis-à-vis the same period in 2013, due both to higher revenue and lower expenditure. On a national accounts basis, according to the latest INE data, the General Government deficit in the first three quarters of 2014 amounted to 4.9 percent of GDP, with a significant year-on-year reduction of 0.8 percentage points and in line with the Government's annual estimate. This figure does not reflect any impact from the capitalization of Novo Banco (NB) by the Portuguese Resolution Fund. INE will revisit the decision on the treatment of this capitalization in the fiscal accounts in March, with the next regular notification under the Excessive Deficit Procedure.

The Government also reaffirms its firm commitment to respect the 2015 deadline for Portugal to exit the EU's Excessive Deficit Procedure and maintains the 2.7 percent of GDP deficit target for this year. On this basis, economic and fiscal developments will continue to be closely monitored by the authorities so as to timely adjust the strategy if needed.

The staff report projects a larger fiscal deficit for 2015. We regard the staff's deficit projections as too pessimistic, among other things as they do not adequately take into account the improved revenue collection efficiency resulting from the structural reforms in tax administration introduced during the Program. The staff also argues that fiscal policy will be procyclical

in 2015, as the structural fiscal balance will weaken by 0.3 percent of GDP (Table 2b). In this respect, we note that staff reaches this conclusion only because to compute the structural balance, staff assumes that the potential growth rate of the Portuguese economy is extremely low, indeed negative (-0.2 percent in 2015; Table 1). In our view, the significant limitations in computing this variable in the current economic context would warrant some cautions in drawing such strong policy conclusions from this mechanistic result. For example, if the structural balance were to be computed using the medium-term potential growth rate, the structural balance would improve even in the staff's more pessimistic scenario (and a fortiori under the Government's fiscal projections).

IV. Financial Sector Policies

The stabilization of the financial sector was one of the main objectives of the Economic and Financial Adjustment Program that expired at end-June 2014. In fact, the program envisaged several measures to strengthen the levels of liquidity and solvency in the banking sector and to reinforce banks' supervision. Significant efforts were made to achieve these objectives, notably by reinforcing banks' capital ratios and by improving transparency and accuracy of valuations in banks' balance sheets, as well as by ensuring an orderly deleveraging process.

In terms of solvency, the Common Equity Tier 1 (CET1) reached 12.6 percent in the third quarter of 2014, for the Portuguese banking system as a whole (excluding NB) - well above the regulatory minimum. In the first three quarters of 2014, the aggregate profitability of the Portuguese banking system was significantly affected by the exceptionally large losses reported by Banco Espírito Santo (BES). Excluding BES/NB, profitability would have been positive (ROA of 0.2% and ROE of 2.2%). The strengthening in net interest income, the increase in profits related to financial operations and the reduction in operating costs have contributed to this positive result. In addition, a slight decrease in the flow of impairments has been observed during this period. Despite these positive signals, we recognize that the profitability prospects remain one of the main challenges faced by the banking sector in Portugal.

The deleveraging process in the banking sector continued in the first three quarters of 2014, with the loan-to-deposit ratio falling to 107 per cent in September 2014 (excluding NB), after levels as high as 158 per cent in December 2010 and 140 per cent at the Program's outset. Credit continues to decrease in residential mortgage market and in sectors most dependent on domestic demand, while exporting firms have been benefitting from increasing flows of credit. Deposits

continue to be the most important funding source for Portuguese banks and continue to show a remarkable resilience, which was not affected during the most volatile period that followed the resolution measure applied to BES. In the third quarter of 2014, Central Banks' financing, mostly comprised of Eurosystem monetary policy operations, decreased to minimum levels since the beginning of the Program. In particular, Eurosystem refinancing decreased by 13 percent during the third quarter of 2014 and by around 45 percent when compared with the peak recorded in July 2012. The significant reduction in Eurosystem refinancing was mostly based on the above-mentioned deleveraging process undertaken by the Portuguese banks, but also on a slight increase in market-based funding sources (essentially, secured money market funding and wholesale debt issuances).

Financial stability has been maintained despite the failure of a large and systemic banking group (BES), confirming the authorities' capacity to intervene decisively. Making use of the resolution powers conferred upon it, Banco de Portugal has created a bridge bank (NB) and transferred thereto the majority of the business of BES, while ensuring appropriate burden sharing, in line with current EU rules and internationally accepted principles.

On October 26, the ECB published the results of the Comprehensive Assessment. The results of the AQR and the baseline scenario of the stress test (2014-2016) showed the resilience of the Portuguese banks included in the exercise and the adequacy of their capitalization levels. In both cases, all banks registered capital ratios above the 8 percent threshold. Under the adverse stress test scenario, which is deemed unlikely, the CET1 ratio projected for Banco Comercial Português (BCP) in December 2016 falls short of the 5.5 percent threshold. The institution identified a set of measures to cover the shortfall detected, which were, in the meantime, approved by the ECB.

In spite of the positive signals reflected in the improved results reported by most of the main credit institutions – an improvement partly based on a restructuring and cost containment effort – some challenges still remain, in an economic context characterized by low growth and still high levels of indebtedness in both public and private sectors. Banks' profitability recovery must not involve excessive risk-taking, nor excessive concentration levels in certain activities or markets. It will be important for institutions to adjust their business models to a macroeconomic context that may involve low potential growth, low interest rates, and, in the specific case of the banking sector, increasing competition due to the creation of the Banking Union.

V. Structural Reforms

The authorities disagree with staff's assessment of a loss in reform momentum and reaffirm their commitment to pursue the structural reform agenda in the post-program period.

It should first be clarified that the dissolution of ESAME (paragraph 20 of the staff report) was the expected outcome of the Program's completion, as the entity had originally been set up to monitor and coordinate the Program's execution. The coordination of the structural reform agenda was then transferred to the Ministry of Finance, where a permanent dedicated team closely monitors all reforms.

More generally, important measures continue to be implemented in several areas – not only after the Program's completion, but also following the first post-program monitoring mission. The following paragraphs summarize the latest developments. They demonstrate that the implementation of structural reforms remains a key priority for the Portuguese authorities.

After the introduction of the Corporate Income Tax reform in 2014, two new tax reforms were put in place. The Personal Income Tax reform and the Environmental Tax Reform were approved in Parliament in December and entered into force, as initially foreseen, on January 1st, 2015. Altogether, these three reforms allow for increased stability and predictability of the tax system, thus playing an important role in the ongoing economic recovery.

Most of the 18 professional associations' by-laws under review are now in the final stage of approval by the Government and are expected to be submitted to Parliament soon. Progress has also been registered in the review of regulators' by-laws in accordance with the new framework law (Law 67/2013, of August 28th).[1]

It should also be noted that recent amendments to the housing lease law were a result of the recommendations of the independent Monitoring Committee established to supervise the reform. Given the magnitude of the reform introduced by Law 31/2014 of August 14th, it was necessary to perform an interim impact assessment of the law and subsequently introduce amendments, namely to improve procedures and to modify the transitional arrangements for non-residential lease agreements. In general, the strengthening of the protection of non-residential tenants

[1] Joining the previously approved by-law for the Transport Sector Authority (AMT), the following by-laws were recently approved by the Council of Ministers: Securities Market Commission (CMVM), Insurance and Pension Funds' Regulator (ASF, former ISP), Communications Regulator (ANACOM) and Civil Aviation Authority (ANAC).

reflected the need to ensure balanced rights and obligations of landlords and tenants and to protect the most vulnerable groups, while continuing to foster economic activity and employment, within the terms of the Memoranda. These adjustments did not affect negatively the goals of the Program.

The Government remains equally committed to energy sector and labor market reforms as during the Program.

Regarding the energy sector, the authorities continue to implement measures to address excessive rents, reduce the electricity tariff debt and limit price increases. The third package of measures, with an impact in all sectors (fuel, gas and electricity) is in fact already contributing to a reduction of energy prices both for corporations and households. The introduction of the new eligibility criteria and the increase in the discount applicable in the social tariff of electricity allowed a decrease in the prices paid by these beneficiaries up to 34 percent. The fuel sector is becoming more transparent and competitive with the low cost legislation and the reference prices. The Government is concluding the measure regarding the long term natural gas sale and purchase agreements (take or pay) which will lead to a decrease in the natural gas tariffs between 3 percent and 5 percent. Additionally, a review of the regulatory model was presented by the energy regulator (ERSE) in December, so as to accommodate recent developments in the legal framework and the features of the electricity market.

As for the labor market and in particular the survival period of collective agreements, the following amendments should also be noted: the minimum duration in which a collective agreement remains in-force after being denounced decreased from 18 months to 12 months (and 6 months after September 2015, depending on the social partners' agreement) and a maximum duration of 18 months for the negotiation process was also introduced. The expiration ("*caducidade*") of the collective agreement was reduced from 5 to 3 years (and, 2 years after September 2015, depending on the social partners' agreement). Moreover, the suspension of collective agreement is now allowed, under certain conditions, by agreement of the parties (trade unions and employers associations). Collective bargaining is more dynamic due to these amendments: new contracts have been negotiated, especially on overtime work payments in line with the conditions in force during the Program as a result of the temporary measures foreseen in the Memoranda. In the last two years the number of firm level agreements has increased within the collective agreements that have been negotiated. In addition, the authorities highlight

that the new option of extending agreements to the whole sector aims precisely at fostering improved collective bargaining. The existence of a sole criterion that defined a threshold of 50 percent of workers representation by employers' associations had stalled the collective bargaining process. In contrast, the new criterion (30 percent of micro and SMEs representativeness within the employer's association) is fostering the willingness of social partners to negotiate new collective agreements.

Regarding the minimum wage, we believe that there is no overall evidence that it has been growing persistently beyond productivity. The assessment presented by staff hinges on the specific base year chosen for the calculation, as well as on the benchmark used to assess the level of the minimum wage, namely the real GDP adjusted for working-age population, rather than (or at least together with) real productivity (see Box 2).

In conclusion, the structural transformation of the Portuguese economy arising from a wide range of reforms is not only ongoing, but also expected to continue.