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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/60-3

2:30 p.m., July 8, 2019

3. Portugal—2019 Article IV Consultation

Documents: SM/19/161 and Correction 1; and Supplement 1; SM/19/164

Staff: Cuevas Camarillo, EUR; Nolan, SPR

Length: 40 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	W. Nakunyada (AE), Temporary
	K. Carvalho da Silveira (AF), Temporary
	D. Vogel (AG), Temporary
	N. Heo (AP)
	P. Fachada (BR)
	P. Sun (CC)
	J. Montero (CE), Temporary
L. Levonian (CO)	
	S. Benk (EC)
H. de Villeroché (FF)	
	K. Merk (GR)
	P. Dhillon (IN), Temporary
D. Fanizza (IT)	
	T. Ozaki (JA), Temporary
	M. Daïri (MD)
	W. Abdelati (MI), Temporary
A. De Lannoy (NE)	
T. Ostros (NO)	
	S. Potapov (RU), Temporary
	F. Rawah (SA), Temporary
	S. Chea (ST), Temporary
	P. Trabinski (SZ)
	D. Andreicut (UK), Temporary
	S. Vitvitsky (US), Temporary

C. McDonald, Acting Secretary
E. Tsounta, Summing Up Officer
E. Mannefred, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
European Central Bank: A. Meyler. European Department: A. Cuevas Camarillo, K. Kirabaeva, A. Pienkowski, M. Pradhan, E. Vaccaro. Legal Department: N. Stetsenko. Strategy, Policy, and Review Department: S. Nolan. Alternate Executive Director: A. McKiernan (CO). Senior Advisors to Executive Directors: M.Gilliot (FF), M. Maidi (AE). Advisors to Executive Directors: W. Al Hafedh (SA), L. Cerami (IT), V. Djokovic (SZ), R.

Lopes Varela (AF), B. Parkanyi (NE), M. Shimada (JA), I. Skrivere (NO), M. Sylvester (CO), S. Alavi (MD), K. Lok (CC).

3. PORTUGAL—2019 ARTICLE IV CONSULTATION

Mr. Fanizza and Ms. Lopes submitted the following statement:

Overview

The Portuguese authorities would like to thank the IMF staff for the fruitful Article IV Consultation discussions. They take good note of the staff's policy advice and reiterate their commitment to economic, fiscal and financial policies that promote competitiveness, economic growth, social cohesion, and sound public finances.

We welcome the acknowledgement of improvements in the Portuguese economy fundamentals, and its fiscal position. These improvements stem from substantial progress in (a) fiscal consolidation; (b) deleveraging of both households and non-financial corporates; and (c) strengthening the banking system.

Economic Activity

After decelerating in the second half of 2018 GDP grew at 0.5 percent q-o-q, and 1.8 percent y-o-y in the first quarter of this year – broadly in line with the annual growth forecasts. Domestic demand played an important role in driving growth in the quarter, with a significant increase in gross fixed capital formation (GFCF, 11.6 percent in 2019Q1 y-o-y). Current leading indicators suggest that GDP growth has stabilized in second quarter of 2019.

With regards to trade, imports have been growing above exports mostly on the back of strong GFCF growth. Net exports are projected to slightly deteriorate because of weaker international demand; nevertheless, the weight of exports in GDP has now reached a historically high level of 48 percent, almost doubling its weight since 2000.

Consumer price inflation remained subdued and below the Euro Area average until May 2019. The Harmonized Index of Consumer Prices (HICP) annual average stood at 1.1 percent, compared to 1.2 percent in 2018 and 1.8 percent in the Euro Area.

The labor market has continued to improve. In the first quarter of 2019, employment grew at 1.5 percent y-o-y as a result of higher permanent job creation, while temporary employment decreased for the first time in the post-crisis period. The unemployment rate decreased to

6.8 percent, down from 7.9 percent the year before. Both youth and long-term unemployment contributed to this reduction.

Fiscal Policy

The general government headline deficit decreased to 0.5 percent of GDP in 2018, a new record-low in Portugal's modern democratic history! The Portuguese Government expects this deficit to shrink to 0.2 percent of GDP in 2019 – in line with the staff's projections – and to become a surplus 0.3 percent of GDP in 2020.

In the first quarter of 2019, Portugal achieved a general government headline surplus of 0.4 percent of GDP. This reflects, in part, strong labor market and economic activity. Tax revenue grew 5.1 percent, despite reductions in a wide range of tax rates. Social Security contributions increased 6.5 percent, which reflects the growth in employment and wages. Strict control of budgetary execution kept expenditure growth moderate (2.6 percent y-o-y), despite an increase in public investment of 12 percent y-o-y.

The public debt-to-GDP ratio remained on a downward trend in 2018, supported by a strong primary surplus and decreasing interest costs. The Portuguese authorities expect this ratio to reach 118.6 percent of GDP in 2019, down from 121.5 percent in 2018. The Portuguese Government is strongly committed to using any revenue windfalls to reduce its public debt.

Active and dynamic debt management strategies have been adopted to smooth the amortization profile and optimize financing costs. This has contributed to improve investors' perception of Portugal's credit risk. In the context of this strategy, the Portuguese authorities decided to repay the remaining € 5.51bn of the total € 26bn of the IMF loan in December 2018. Indeed, the IMF loan was the instrument that could generate greatest interest savings.

Structural Reforms

The Portuguese Government's structural reform agenda continues to be framed by the National Reform Programme with the objective to increase productivity, improve domestic savings, and enhance the business climate. Within this framework, strides have been made in several areas, and it is worth highlighting some of the most important recent developments.

On the labor market, a comprehensive set of policy measures have been taken aimed at (i) tackling the demographic challenge by fostering longer working lives, increased fertility rates, and positive net migration flows, (ii) reducing segmentation, and (iii) promoting Active Labor Market Policies.

With regards to education and skills, policy efforts are concentrated in reducing school failure and dropout rates as well as to reduce skills mismatches. There are ongoing efforts to make the vocational education and training system more aligned with labor market needs. Furthermore, the Portuguese authorities are, of course, aware that digital skills are highly demanded by the market, therefore, a strategy has been designed to improve population's average digital skills. Its main goal is to equip not only students, but also adults and workers, with digital skills.

Moving on to the judicial system, there have been important recent developments around insolvency proceedings. The Insolvency and Companies' Recovery Code was revised, which included changes to special revitalization proceedings, with the aim of making them more agile and efficient. Moreover, a new regime for out-of-court restructuring of companies has been created, which aims to facilitate agreement between debtors and creditors, with support from experts on company recoveries. In parallel, an Early Warning Mechanism was developed to inform companies on their global financial situation, and to provide relevant recommendations on their sustainability. The authorities expect these initiatives to contribute to reducing court workload and to improving the chances of viable companies to keep their activity going. New credit lines were also set up to stimulate SMEs and start-ups.

Finally, concerning the energy sector, the tariff debt continues in a downward trend and is expected to decline by further 12 percent in 2019 (or cumulatively by 37 percent from a € 5.1bn peak in 2015). Under the current baseline scenario, the energy debt is expected to be fully repaid by the end of 2022, which would reduce the overall burden on the energy price for consumers. Additionally, policy efforts focus on the promotion of investment in renewable capacity and the development of the electricity transport network.

Financial Sector Policies

The Portuguese economy proceeded with the long-lasting adjustment process which has contributed to strengthen its financial system. The debt ratios continued to decline for both non-financial corporations (NFC) and households. Non-financial corporations also increased capitalization and liquidity, fostering an overall reduction in the credit risk of the sector. However, for both NFC and households, the reduction in indebtedness levels in 2018 was mainly driven by the denominator effect. The adjustment of the non-financial private sector has occurred in a context of particularly favorable economic and financial conditions. It is of paramount importance that the adjustment continues even in the event of an economic slowdown.

Despite some recent signs of cooling off, prices in residential real estate markets have been growing steadily in recent years, supported by robust demand from non-residents and tourism; house supply factors might have also played a role. Signs of mild overvaluation surfaced from mid-2017. The Macroprudential Recommendation issued by Banco de Portugal on new consumer and housing loans[1], should contribute to mitigate the risk of interaction between the domestic credit and prices in the real estate market. Banco de Portugal's progress report on the implementation of this measure shows that institutions are converging towards the limits set in the Recommendation, with the exceptions scrutinized by Banco de Portugal. Additionally, developments in new housing loans seem to show that the Recommendation helped reduce the share of credit granted to borrowers with a higher risk profile. In regards NFC, the annual rate of change of credit granted by resident banks to NFC turned positive in 2018 and evidence shows that banks continued to differentiate NFC, both in terms of spreads and in terms of volumes, according to their risk profile.

Favorable developments in several domains were also observed in the Portuguese banking system in 2018, most notably the significant recovery of profitability and the continuing significant reduction of non-performing loans. Profitability improved because of both lower flows of impairments and operating costs. Banks continued to manage their NPL stock actively, which as result fell both in gross and in net terms: by the end 2018, NPL ratio was already below 10 percent and the net NPL ratio below 5 percent. This constitutes a decrease of NPL of around 50 percent since the July 2016 peak, mainly driven by NPL reduction associated to NFC. Banks' liquidity position stood at comfortable levels, while the own funds ratio stabilized. Recently, Portuguese banks made some issuances of debt eligible as own funds.

[1] With limits to Loan-to-Value ratios on mortgage loans, to Debt-Service-to-Income ratios and to maturity of loans, while setting amortization requirements.

Portuguese banks will continue to face challenges related to the low interest rate environment, which compresses interest-related net revenues. Together with continuing the implementation of the NPL reduction plans, banks will need to build on their achievements and progress with the increase of operational efficiency. This is especially relevant in the context of competition coming from new players equipped with innovative technologies that provide financial services digitally, such as Bigtech companies. Additional adjustment of the banking sector has a bearing to safeguarding access to international financial markets under favorable conditions; this is particularly important given the increasing regulatory demands, most notably those associated to the Minimum Requirement for own funds and Eligible Liabilities (MREL).

The New Financial Supervision Framework Bill

The bill proposes the creation of the National System of Financial Supervision (NSFS) with the purpose of improving the functioning of the financial supervision system, promoting the cooperation between the Portuguese authorities and fostering the financial stability. The NSFS comprises Banco de Portugal, the Portuguese Securities Market Commission, the Insurance and Pension Funds Supervisory Authority and also two new legal entities, the National Council of Financial Supervisors (NCFS) and the Resolution and Guarantees Authority (RGA). Furthermore, with the creation of a resolution authority separated from the banking supervisor, the Portuguese Government also aimed with the bill to limit the risk of conflicts of interest among supervision and resolution functions.

The Government believes that the proposal respects and strengthens the independence of the supervisors, is consistent with the European framework, is cost-efficient and fosters timely and well-informed supervisory decisions, with the relevant participation and contribution of all supervisors.

In the opinion of the Portuguese financial supervisory authorities, the bill may introduce complexity, uncertainty and generate costs for the supervisors and for the Portuguese financial market. Additionally, Banco de Portugal conveyed specific concerns regarding its central bank and SSM member's independence and autonomy. More recently, on 21 May 2019, the ECB issued an opinion (CON/2019/19) also raising several concerns regarding central bank independence, the macroprudential mandate and the resolution function.

The proposal is under discussion in the Parliament.

Conclusion

In line with its Stability Programme 2019-2023, the Portuguese Government is committed to sound public finances and to continue the ongoing positive trajectory of fiscal consolidation, in parallel with the implementation of the structural reform agenda to foster social cohesion and sustainable economic growth, as foreseen in the National Reform Programme.

The Portuguese authorities look forward to the next Article IV Consultation in 2020, which will constitute a good opportunity to continue closely working with the IMF, deepening the dialogue and promoting an even closer mutual understanding.

Mr. Obiora and Mr. Ismail submitted the following statement:

We agree with staff analysis and assessment, and welcome the continued, albeit moderated, growth of the Portuguese economy. The economy's strong performance in 2017 carried over into 2018 with real GDP growth and employment returning to pre-crisis levels. At the same time, private and public deleveraging have continued, with the government paying off all its credit to the Fund, as highlighted in the discerning buff Statement by Mr. Fanizza and Ms. Lopes. However, the slowdown in the second half of 2018, although largely due to exogenous factors, is a timely reminder of how tenuous recent gains still are. Against this background, we urge the authorities to press ahead with the needed macroeconomic policy adjustments and structural reforms to bolster inclusive and potential growth, address remaining legacy problems, and accelerate income convergence with peers in the Euro Area.

Although the fiscal balance has improved on the back of strict budget execution, falling interest payments, and structural adjustments, we are concerned that public debt remains high. We think that further, albeit gradual, fiscal tightening would be needed to reduce public debt and create policy space to respond in case of crystalizing downside risks. It is critical that while global financial conditions are still favorable, the authorities consider reducing tax exemptions, rationalizing spending, and improving public financial management as potential ways to reduce the public debt. Building up this fiscal space is particularly important to support growth and accommodate the expected increase in social spending due to an ageing population. We note, with concern, the recurrent buildup of hospital arrears and would appreciate staff comments on whether the authorities' recent measures to address accumulation of arrears have been effective. We would also welcome staff views on the fiscal implications of these measures going forward. Relatedly, we note that Portugal has the highest inequality of income distribution for people who are 65 years and older in the Euro Area (See page 16 of staff report). We wonder if staff could comment on the cause(s) of this inequality, and measures to address it.

While we positively note the decline in household and non-financial corporates (NFC) debt-to-GDP ratios, we underline the need to sustain this reduction as an insurance against interest rate and income shocks. To this end, we see scope for boosting household saving rates to spur deleveraging and increase resilience in the current low-interest environment. We urge the authorities to step up efforts towards strengthening banks' governance, internal controls, and risk management to address legacy assets and elevated non-performing loans (NPLs), while improving operational efficiency and profitability. Further, we welcome the bill that has recently been submitted to the Parliament, which seeks to reform the supervisory and resolution frameworks and improve coordination among sectoral supervisors. In this respect, we would appreciate staff elaboration on possible ways to address the concerns of supervisors on the viability of the bill in improving coordination among them while preserving their independence and compatibility with ECB requirements.

Pressing ahead with structural reforms is critical to support inclusive growth and speed up convergence in per capita income with the euro area average. We encourage the authorities to prioritize improving the regulatory environment with a view to fostering investment and raising productivity of both firms and labor. In this vein, we note that while Portugal ranks well in the OECD Product Market Regulation Indices relative to its European peers, the country's competitiveness has been constrained by high prices in the energy and transport sectors. We would appreciate staff comments on whether there is scope to reduce these prices to further improve competitiveness. Finally, addressing rigidities in the labor market, enhancing women participation, and strengthening legal and institutional framework for debt enforcement and insolvency remain critical to improve the business environment and bolster inclusive growth.

Mr. Sun and Ms. Lok submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Fanizza and Ms. Lopes for the helpful buff statement. Sound policies and reforms have successfully brought about recovery in Portugal. Although economic activity has moderated, and risks to the outlook have shifted to the downside amidst a less favorable global environment, the Portuguese economy will be navigating through challenges with stronger fundamentals. We broadly share staff's appraisal and would like to limit our comments to the following.

Portugal has made notable improvements on the fiscal front in recent years. In 2018, the general government headline deficit narrowed further to a record low, and public debt maintained its downward trend. Early repayment to the Fund has also generated savings and helped smooth the overall profile of maturities of Portugal's public debt. That said, Portugal's public debt level remains elevated, subjecting fiscal sustainability to potential risk. We therefore see merit in further efforts to consolidate the fiscal position and build buffers when conditions are still relatively favorable. Some structural measures on the expenditure side to raise efficiency, such as enhancements to the public health system and public employment system, may also be warranted. We welcome the authorities' commitment to policies that promote sound public finances and look forward to further strengthening of Portugal's fiscal position.

We take positive note of the favorable developments in Portugal's banking sector in 2018, including the recovery of profitability and continued reduction in NPLs. However, conditions remain delicate, and sustained efforts are needed to reduce legacy assets and further bolster the financial sector's resilience to risks and vulnerabilities. While recognizing the good intentions of the bill proposing the creation of the National System of Financial Supervision, we also note that concerns over some elements of the bill have been raised by Banco de Portugal, Portuguese financial supervisory authorities, and the ECB. Could staff provide more information on the timeline and process of the bill, and updates, if any, on the discussion underway in the Parliament?

To lift productivity and raise growth prospects in the longer term, further efforts to increase skill levels and promote private investment would be critical. To this end, we welcome the authorities' structural reform agenda under the National Reform Programme, which seeks to raise productivity, improve domestic savings, and enhance the business climate. We take positive note that the authorities are actively enhancing the population's digital skills, and Figure 6 in the main text of the Staff Report suggests that Portugal is above the OECD average in terms of technological readiness. Could staff share more on the authorities' efforts in harnessing the benefits from rapid technological development while managing potential risks, including in the area of fintech?

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Ozaki and Mr. Shimada submitted the following statement:

We thank staff for the comprehensive report and Mr. Fanizza and Ms. Lopes for their informative statement. We commend the authorities for maintain economic growth above potential growth rate and paying the IMF credit five years ahead of schedule. We broadly concur with the staff’s evaluation and appraisals, we will limit our comments to the following points.

Fiscal Policy

We welcome that the authorities cleared the outstanding balance of IMF credit, five years ahead of schedule, and the public debt ratio remains on a downward trajectory. We appreciate the general government headline deficit decreased to 0.5 percent of GDP in 2018, which we learned a new record-low in Portugal’s modern democratic history, according to the buff statement. Nevertheless, we take note that the public debt ratio is still high, and the economy is vulnerable to the negative effect of the world economy. We encourage the authorities to continue the fiscal consolidation effort to reduce the public debt ratio and create more fiscal space to deal with weaker-than-expected world economy.

Financial Sector

While we positively take note that NPL ratio has been decreasing and capital ratio has been increasing, we take note that further action is needed to address their still large stock of legacy assets and low profitability. NPL ratio is still among the highest in euro area, and bank’s capital ratio could decline under the level of 2010 considering the severe scenario. We encourage the authorities to continue the effort to reduce NPL and accumulate capital buffer.

We also take note with concern that the bill to reform the financial sector supervisory and resolution frameworks has some issues including the independence of central bank. We concur with the staff’s opinion that Banco de Portugal should continue to play central role on macroprudential policy, considering its expertise, efficiency, and the bank-dominated financial sector in Portugal. Even though the bill has already sent to the Parliament, we strongly encourage the government to continue the discussion with the Banco de Portugal and ECB, to build appropriate supervisory framework.

Structural Reform

While we welcome that real GDP returned to pre-crisis levels in 2018, following a five-year expansion, it is necessary to foster soundly financed investment and raise productivity of firms and labors for strengthening medium-term growth. Even though the structure of economy has been improved for 10 years, GDP per capita remains 40 percent lower than the euro area average. While we positively take note that reform has been proceeding in labor market, education and skills, judicial system and energy sector, further action is needed to accelerate income convergence with the euro area economics. In this regard, staff's research on household savings in Selected Issues is helpful. Staff points out many reasons to affect low household savings in Portugal such as lower disposal income, higher government spending on pensions and social protection benefits, and education levels. We encourage staff to advice the authorities regarding combination of policies and sequencing to address low household savings.

Mr. Tombini, Mr. Fachada and Ms. Hennings submitted the following statement:

We thank staff for the detailed reports and Mr. Fanizza and Ms. Lopes for their helpful statement. The Portuguese economy continues its recovery process, notwithstanding some moderation in activity since the second half of 2018. Subdued inflation, low unemployment and progress on fiscal consolidation support the positive macroeconomic outlook. However, Portugal continues to struggle with legacies of the 2011-2014 financial crisis, including high private sector indebtedness, excessive public debt and weaknesses in the banking sector. Moreover, as a small open economy, Portugal is vulnerable to external shocks and changes in global macroeconomic and financial conditions.

Economic dynamism in recent years has been supported by domestic demand, with net exports contributing negatively to growth. We take note that staff projects growth to converge to a more moderate level over the medium-term, whereas the authorities remain more optimistic about the economy's prospects. Challenges associated to private sector deleveraging, weak productivity, and adverse demographics are factors that limit the medium-term growth path going forward. We welcome that the Portuguese authorities remain committed to structural reforms and agree with staff's recommendations on improving the regulatory environment, enhancing competition, fostering innovation, improving the insolvency framework, and increasing labor skills, all of which would impact positively private investment and productivity growth.

Fiscal consolidation efforts have shown positive outcomes, but the public debt ratio remains relatively high. We welcome the budget outturns in recent years, despite continued ‘one-off’ spending associated with recapitalization and capital transfers to banking institutions. Given the lack of fiscal space, we agree with staff that, under the baseline, the target for the structural balance should be treated as a floor, since it would help reduce the public debt ratio more quickly. Should risks to the outlook materialize, the authorities should adopt a more neutral stance and allow automatic stabilizers to operate.

Vulnerabilities are still present in the banking sector despite improvements in non-performing loans (NPLs). We take positive note of the substantial reduction in NPLs. Portuguese banks nevertheless have one of the lowest capital ratios in Europe and relatively high operational costs. In this regard, further steps are needed to ensure that banks achieve their NPLs reduction target and strengthen their corporate governance, internal controls and risk management. Although households and non-financial corporates continue to deleverage, their debt stock remains elevated, which exposes the banking sector to shocks. Amid signs of mild overvaluation in the real estate market, we encourage the authorities to ensure that lending practices remain sound to safeguard financial stability.

Finally, we take note of the differing views with respect to the bill for the creation of the National System of Financial Supervision (NSFS). From the statement of Mr. Fanizza and Ms. Lopes, we note the government’s views that the NSFS strengthens the independence of supervisors, is consistent with the European framework and cost-efficient, and fosters timely and well-informed supervisory decisions, with the relevant participation and contribution of all supervisors. We are mindful that there are diverging views on issues including the independence of supervisors and consistency with the Euro area framework. That said, we fully agree with staff that different supervisory and resolution architectures can achieve their intended objectives, but must preserve the independence of the supervisory authorities, facilitate coordination, and ensure sound and prompt decisions when needed. This notwithstanding, the bill is under discussion in the Parliament and we look forward to the outcome.

Mr. Geadah and Ms. Abdelati submitted the following statement:

We commend the authorities for the persistence of strong macroeconomic policies. Even though growth moderated from the strong performance of 2017, the headline fiscal balance improved as well as the structural primary balance. Credit growth slowed consistent with continued deleveraging. Nevertheless, banking sector performance improved, and labor market indicators continued to strengthen.

The Portuguese economy is vulnerable to external factors given its small size, openness, and integration in European and global trade. The Risk Assessment Matrix (pages 46-47) identifies several sources of risk, all of which are assessed to have a high impact. We note that the authorities' own medium-term projections are higher than those of staff, justified by structural changes in the economy, including strides made in improving education levels. The staff report identifies labor skills as a key structural constraint and acknowledges recent improvements in education and in the labor market. We would like to hear why staff considers the impact on medium-term growth to be more muted than expected by the authorities.

The debt stock of households and nonfinancial corporates continues to be elevated, above the euro area average in spite of steady deleveraging. Banks continue to address legacy assets, and while NPLs are among the highest in euro area, the NPL ratio declined by half from a peak of 18 percent in early 2016 to around 9 percent at the end of 2018. Bank profitability, liquidity, and capital adequacy also improved. Nevertheless, we join staff in calling on supervisors to encourage banks to further improve asset quality and profitability. We take note of the new bill on financial sector supervisory and resolution framework that was recently sent to Parliament, which will be highly consequential for the stability of the financial system. We trust that the substantive concerns expressed by the relevant supervisory entities will be duly addressed.

We note the continued rise in home prices in Portugal, especially in the high-end market due to investment by non-residents. Staff does not see a need for immediate policy action. However, housing market developments should be carefully monitored, and the authorities should be ready to adjust macroprudential policies if needed. We appreciate staff's box on real estate price developments, and would like to ask the drivers for foreign investment in the sector and if it has to do with differential tax treatment or other factors?

We commend the progress in improving the fiscal position and in reducing public debt, but at over 120 percent of GDP, further debt reduction remains a high priority. The fiscal balance and the structural primary balance have improved significantly and are consistent with a declining debt trajectory. There has also been a decline in the government bond rate to 1.8 percent in 2018. The 2018 fiscal outcome is less than what staff had called for last year, when they asked the authorities to overperform their budget by 1 percent of GDP, but the overperformance was limited to 0.2 percent of GDP. Staff again advises the authorities to overperform by 1 percent of GDP in order to speed up the pace of debt reduction, avoid a future tightening that may be procyclical, and further differentiate Portugal from other high-debtors. Consistent with staff's advice, we note that the authorities expect the structural balance to overachieve the Medium-Term Objective set under the SGP, and that will provide sufficient fiscal space to allow automatic stabilizers to fully operate in the case of a slowdown without jeopardizing debt sustainability.

We welcome the discussion of structural issues and the general agreement between staff and the authorities on the need to further improve skill levels and productivity to facilitate convergence with the euro area economies. Figure 6 provides a useful visual summary of the areas of structural reforms where Portugal is ahead of the OECD, and those where it remains behind. Are these indicators up to date (e.g. reflect 2018 status) and are they updated regularly? If so, they provide a useful score sheet for tracking progress.

With these remarks, we wish the authorities continued progress.

Mr. De Lannoy submitted the following statement:

We thank staff for their informative report and Selected Issues paper in the context of Portugal's Article IV consultation and Mr. Fanizza and Ms. Lopes for their informative buff statement.

The dynamic economic performance and positive fiscal developments of recent years underscore the improving trend in the Portuguese economy. Past policy efforts and structural reforms have put the high stock imbalances (e.g. high private, public and external indebtedness) on a downward path. Acknowledging that a durable reduction in said vulnerabilities will take time and perseverance in increasing the savings rates of households and the public sector, we agree with staff that continued efforts will be needed to sustain the adjustment in public finances, to increase the productive capacity of the economy and to further reduce rigidities in the labor market.

Macroeconomic developments

Despite some moderation in growth, Portugal's economic performance remains broadly favorable and short-term risks appear limited, mostly linked to the unfavorable external environment. Growth is likely to moderate towards potential, pointing to the need of higher investment to support productivity growth. We take positive note that unemployment now stands below levels immediately prior to the crisis, but the level of underutilization remains elevated. The current account turned into a small deficit in 2018 and is set to slowly deteriorate further. This is partly due to an expected but welcome rebound in investments, which is pushing up imports. Complemented by policies that raise the savings rate of households and the public sector, policies that support productivity and increase the low public and private investment rates are needed to strengthen the external position and achieve a higher and more balanced growth path.

Fiscal policies

The headline deficit continues to improve on the back of the authorities' fiscal efforts and favorable economic and financing conditions; however, it would be important to also maintain the structural effort going forward. The headline deficit declined to 0.5 percent of GDP in 2018, along with an improvement in the structural balance, on the back of buoyant cyclical revenue, decreasing interest expenditure, and under-execution of public investment. At the same time, more attention needs to be paid to the expenditure side of the budget. Continued fiscal efforts remain necessary to sustain the rapid decline in public debt, which is currently still elevated at 121.5 percent of GDP. We agree with the rationale for staff's recommendation to build policy space for negative macroeconomic shocks and public investments; especially in view of diminishing structural fiscal effort in the baseline projection. We note however that the proposed one percent tightening of fiscal policies over two years would imply a substantial overachievement of the medium-term objective that was set in agreement with the EU. It could be considered prudent to accelerate debt reductions in view of sizeable windfall gains from decreasing interest payments and high revenue buoyancy.

We encourage the authorities to keep up efforts for a more efficient use of public resources and rebalancing of the composition of public spending towards investments. We recognize the numerous efforts the authorities have put into improving the efficiency of public spending. The staff report mentions the renegotiation of PPP contracts, efficiency gains from an ongoing spending review and an enhanced governance framework for public hospitals. At the same time, public investment is well below pre-crisis and EU averages and should increase to safeguard the level of the public capital stock. To create space for such investment, it would be useful to broaden the scope of the ongoing public expenditure review. Moreover, there is continued pressure on compensation of employees (driven by both headcount and wages) and on pension spending. Despite sizeable discretionary clearance of arrears, the public health system continues to face structural challenges and the stock of hospital arrears has not yet been reduced in a durable manner.

Financial market policies

We welcome the continued reduction of non-performing loans (NPLs) by Portuguese banks and their increase of capital buffers. While declining, still elevated NPL ratios constitute a vulnerability of the Portuguese banking sector and therefore banks should continue to ensure that these ratios are reduced further. Bank profitability has improved in recent years, but it could be put under pressure by rising funding costs due to MREL issuances and corporate weaknesses. Borrower-based measures seem to be effective in improving the risk profile of household borrowers; however, households' indebtedness and banks' exposure to the real-estate sector remain high.

We broadly concur with staff that the financial supervision reform bill has some positive elements and objectives but has also raised some concerns. In particular, the Portuguese financial supervisor and the ECB have raised legitimate concerns regarding several aspects of the bill that merit careful consideration in Parliament before being approved. For instance, according to the ECB Opinion, the new rules for removal from office and replacement of the Governor of BdP are not compatible with EU law. Furthermore, the observance of the Basel Core Principles should be ensured.

Structural policies

There is a strong case for structural policies to boost income convergence with the rest of the EU and to strengthen the resilience of the economy. We concur with staff that strengthening medium-term growth will require fostering investment and raising productivity, including by continuing the efforts to reduce red tape, foster product market competition and improve skills in the labor force, enabling Portugal to tap into higher value-added sectors and activities. It is critical to channel investment and associated policies towards boosting research and innovation activities, infrastructure (maritime ports and railways), and facilitating the low carbon and energy transition through investments in resource efficiency and climate mitigation and adaptation. We welcome in this regard the authorities' commitment to the Paris Agreement. We support the view that stronger domestic saving rates are needed to sustain higher investment rates without aggravating external imbalances, for example by exploring options to encourage complementary second- and third-pillar pension schemes.

We concur with staff that it would be beneficial to review the labor code for permanent contracts with a view to increase the adaptability of the labor market. We see the recent parliamentary approval of some of the measures included in the tripartite agreement as a positive development. However, it is critical to maintain a proper balance between limitations to fixed-terms contracts and incentives to open-ended hiring, as penalizing temporary contracts could reduce investment and job creation, particularly in sectors with high seasonality.

Mr. Ostros and Ms. Skrivere submitted the following statement:

We thank staff for an insightful set of reports and Mr. Fanizza and Ms. Lopes for the helpful buff statement. We broadly share staff's appraisal and agree that while Portugal's recovery has continued, the balance of risks has tilted to the downside. We associate ourselves with the statement by Mr. De Lannoy, and we offer the following remarks on fiscal policy, financial sector supervisory framework, and structural adjustment for emphasis.

Given the still high public debt levels and remaining fiscal vulnerabilities, we share staff's recommendation on the need for greater fiscal effort to accelerate the pace of debt reduction. While we recognize the authorities' sound fiscal policies over the past years, the public debt remains very high and is not expected to decrease below 100 percent of GDP over staff's forecast horizon. Therefore, we see merit in speeding up the pace of debt reduction, which would make Portugal better prepared for the next downturn and help to avoid a possible pro-cyclical tightening, as well as help to accommodate the fiscal costs associated with an ageing population over the medium to long-term. We encourage the authorities to pay due attention to the expenditure side of the budget, particularly wage and pension spending, maintain their commitment to strict control of budgetary execution, and resist pressures to relax policies or reverse past reforms.

We share the concerns raised by the ECB, the Banco de Portugal, and the securities market and insurance supervisors over the proposed financial supervision reform bill. We stress the importance of the independence of the central bank and the supervisory authorities. The supervisory framework needs to be compatible with the Euro Area institutional framework and consistent with the Basel Core Principles for Effective Banking Supervision. We encourage the Portuguese Parliament to pay due attention to these concerns when finalizing the reform bill.

As the economy decelerates towards its medium-term potential, the authorities should reinvigorate their structural reform agenda to lift productivity and enhance growth prospects. Measures to reduce labor market segmentation, improve the business environment, reduce red tape, ensure tax and regulatory certainty, and improve the effectiveness of the judicial system, are important to stimulate private sector activity. Education reforms, in particular on vocational education, would boost workers' skills and align them with employers' needs. This would help to improve Portugal's human capital and raise productivity growth over the medium and long term.

Mr. de Villeroché, Mr. Castets and Ms. Gilliot submitted the following statement:

We thank staff for their interesting set of documents and Mr. Fanizza and Ms. Lopes for their informative buff Statement. The continued economic expansion for several years now has contributed to favorable developments in the labor market and the financial system, even if the stock of imbalances inherited from the crisis remains elevated, including public debt. Strengthening further medium-term growth potential and fostering the income convergence to the rest of the Euro Area will require to preserve the fruits of past reforms and to proactively deal with the remaining structural reform gaps including human capital, labor market efficiency and innovation. Shortcomings in financial market development and supervision as well as in credit market regulations should be tackled promptly to restore banks' profitability, ensure resilience against abrupt rises in sovereign risk premia to which Portuguese banks are particularly exposed. We associate ourselves with Mr. De Lannoy's statement and would like to provide some additional remarks.

Outlook and risks

Growth has decelerated since 2017 along with decelerating economic performances of the Euro Area. Private consumption and gross fixed investment should however continue to remain the main drivers of growth supported by subdued inflation and continued hikes in the public sector wage bill and in minimum wages (which concerns 22,6 percent of total employment). The deterioration in the current account balance reflects a recovery in domestic demand. While not worrying at this stage as the NIP continues to decrease even if starting from a large negative position, this evolution should be closely monitored in view of the downside risks related to sharp tightening of interest rates and domestically to adverse demographic trends. In the meanwhile, measures to step up household saving rates as suggested in the interesting Selected Issues Paper, investment rates and productivity growth through higher firms' competitiveness in tradable sectors could help mitigate potential negative outcomes while maintaining efforts to reduce public debt. Regarding staff's recommendation to better align wage expansion and productivity developments we would have appreciated more information about overall wage growth beyond public sector wage bill.

Fiscal policy

Public finances have continued to improve significantly while the public debt remains elevated. We agree with staff that windfall gains from decreasing interest expenditure and tax buoyancy should be used primarily to accelerate the path of debt reduction and preserve market access. Indeed, despite a sizable primary surplus expected over the next five years, Portugal remains vulnerable to a growth shock which could translate into a steep increase in the cost of borrowing. Adjustments in expenditure composition including a moderation of public sector wage bill and enhanced sustainability of the public health and pension systems will certainly result in efficiency gains contributing all the while to the buildup of fiscal space. Accordingly, the clearing of hospital arrears and the reform of the public pension system are essential to maintain the sustainability of public finances while the budgetary strategy should put more emphasis on increasing public investment to its pre-crisis level and the preservation of the level of the public capital stock.

Financial system

We commend the progress made to reduce further NPL ratios and encourage the authorities to proceed further with this strategy as low bank profitability remains a concern. Consequently, efforts should be heightened to further address high operating costs given the upcoming rise in funding costs related to MREL issuances. As underscored in the report, disappointing economic outcomes could, along with high concentrated exposures, could threaten the financial system stability and impact negatively the asset quality and the capital ratios where adverse scenario materialize. As staff, we see the need for further discussions about the bill sent to Parliament to reform the financial sector supervisory and resolution frameworks. We urge the authorities to ensure that the new rules are compatible with EU legislation and preserve the Bank of Portugal's independence, in particular in relation to the inspection and audit functions. We also share the ECB's concerns regarding the new liability regime and its impact on the Central Bank's ability to perform correctly its supervisory tasks.

Structural reforms

Higher growth and productivity are needed to accelerate the income convergence with the Euro Area economies. Employment and labor force participation need to be restored to their pre-crisis' peak levels while skill mismatches and gender gap should be addressed by allocating more resources to education, training and the promotion of equal pay and job opportunities for women. Raising productivity and potential growth requires sustained greater investment not only in higher-quality education and more flexible labor market but also in product market regulation with the improvement in the regulatory environment for businesses and competition. In line with the above, the development of a private pension coverage could moreover contribute to an increase in household savings which in turn would help channel funding to private and public investment. In this respect, we would be interested in staff's view on the optimal design for Portugal of the complementary second and third-pillar pension schemes.

Mr. Trabinski and Mr. Djokovic submitted the following statement:

For the past six years Portugal's economy has been steadily growing, surpassing the pre-crisis output and unemployment levels. However, still high public debt calls for strong and sustained policy effort over an extended period to bring it to a less risky level. While the income gap remains large, further structural measures to boost growth potential are warranted. We thank staff for the candid set of papers, and Mr. Fanizza and Ms. Lopez for their helpful buff statement. We broadly concur with staff's view and provide the following comments for emphasis.

Portugal's economy is moderating along with the maturing economic cycle in the euro area. Over the medium term growth will decline towards its estimated potential. Downside risks to the outlook are increasing but remain mainly external, as listed in the RAM. We agree with the staff that in these circumstances the role of adequate domestic policy choices is becoming increasingly important. We note the non-marginal differences between the near-term GDP growth estimates of the authorities and staff for both 2019 and 2020. Could staff provide more details on the discrepancy of these projections?

Bringing public debt down to more sustainable levels should remain a policy priority. Under the current policies, debt will fall to 100 percent of GDP only by 2024. The current fiscal stance should be seen as a minimum, and we concur with staff that there would be merit in further fiscal tightening in the near term. Could staff provide an assessment of the impact of a tighter policy stance on GDP growth? Additional revenue should be used to reduce public debt faster and increase resilience, while accommodating the fiscal impact of adverse demographics over the medium term.

Shifting public expenditure towards capital spending would be warranted to preserve the capital stock and bolster growth. Public investment rates in Portugal have been persistently low, weighting on potential output growth. However, any increase in investment spending should not jeopardize the ongoing adjustment.

We welcome the continuous improvement in the soundness of the financial system, as reflected in the move of relevant indicators in the right direction. However, the quality of assets is still relatively low, and the profitability is hampered by deficiencies in internal governance, risk management and low interest rates. Supervisors should ensure that the process of addressing stock legacies from the past is continued. In addition, could staff already comment on the possible capital shortfalls resulting from the prospective introduction of output floors under Basel III and the IFRS 9?

Household and corporate indebtedness, although declining, remain elevated in an international comparison. Additionally, financial stability risks stem from rising housing prices and real estate exposures, which continue to represent a significant share of total bank loans. Developments in mortgage markets should be closely monitored, and the authorities should stand ready to adjust macroprudential policies and tackle vulnerabilities in the housing and corporate sectors in a timely manner. In this context, it is important to stress that bank-based tools cannot properly address risks related to non-bank lending. A proactive use of borrower-based measures would be needed to limit the systemic risk related to corporate and household exposures. We also side with staff regarding the proposed reform of banking supervision and the resolution framework.

The considerable income gap with the euro area average calls for a set of policies to bolster growth. This could be addressed by measures aimed at stimulating private investment and improving the business and regulatory climate, as Portugal continues to compare unfavorably against several OECD structural indicators.

Mr. Di Tata and Mr. Vogel submitted the following statement:

We thank staff for the excellent set of reports and Mr. Fanizza and Ms. Lopes for their insightful buff statement. We especially welcome the staff's analysis of the natural rate of interest in Portugal included in Annex VII, as well as the Selected Issues Paper chapter on household saving.

Portugal has made significant progress in recent years, posting satisfactory growth rates since 2014 and a five-year decline in the unemployment rate. As noted in the buff statement, the economy has benefitted from improvements in fundamentals stemming from fiscal consolidation, continued deleveraging of households and non-financial corporates, and a strengthening of the banking system. The country has obtained an investment grade rating from all major rating agencies, which reduces the burden of interest payments. Notwithstanding these improvements, economic prospects are not exempt from substantial downside risks, including weaker-than-expected global growth, negative spillovers from a disorderly Brexit, and a sharp tightening of global financial conditions, especially if combined with domestic policy slippages.

Real GDP growth slowed in 2018 owing mainly to lower growth of exports and investment expenditure. At the same time, inflation remained subdued, while the external current account balance shifted to a small deficit after remaining in surplus for several years. The general government debt is expected to decline to below 119 percent of GDP in 2019, or 10 percentage points lower than in 2016. Going forward, one of Portugal's main challenges is to address its low growth potential, which is constrained by modest productivity growth, insufficient investment, and unfavorable demographic trends. Staff estimates economic growth at 1.4 percent over the medium term, while the authorities have a more optimistic estimate of above 2 percent. We would appreciate further elaboration from staff on the main reasons behind this difference in the medium-term growth projections.

We acknowledge the authorities' efforts at fiscal consolidation but concur with staff on the need for a greater fiscal effort to accelerate the pace of debt reduction. The headline fiscal deficit was reduced to 0.5 percent of

GDP in 2018, from 3 percent in 2017, and is expected to decline further to close to zero in 2019, mainly because of lower-than-budgeted capital outlays, higher revenues, and falling interest payments. Assuming unchanged policies, the debt would fall to 101 percent of GDP by 2024. Nonetheless, the debt ratio remains high, which justifies the need for further efforts to reinforce fiscal sustainability. In this regard, we support the staff's recommendation to further tighten the structural primary balance over 2019-2020 by reducing exemptions and preferential rates on the VAT, as this would provide additional buffers to help accommodate unanticipated shocks and the fiscal impact of an aging population over the medium to long term. We also agree with the staff on the need to pay due attention to the composition of expenditures, especially with respect to capital spending, which needs to be increased to support potential growth; the recurrent accumulation of hospital arrears; the still expensive public pension system, which requires further reforms to contain spending and improve equity; and mounting pressures on the wage bill, which call for a comprehensive review of the level, composition and rules of public employment. Could staff comment on the government's intention to further reduce the penalty on early retirement for very long careers?

We agree with staff on the importance of addressing remaining macro-financial vulnerabilities. Although the household and nonfinancial corporate sectors have continued to deleverage, their debt stock remains elevated, making them vulnerable to adverse shocks and possible increases in interest rates. Regarding the banking sector, significant progress has been made in reducing banks' legacy assets, but NPL ratios are still among the highest in the Euro area. Going forward, further efforts are necessary to ensure that banks comply with NPL reduction targets, strengthen governance and risk management, and continue to improve their operational efficiency and profitability. Supervisors should also seek to ensure that banks' capital ratios are resilient to a sharp rise in government bond yields. In addition, although house prices do not appear to be substantially misaligned, the authorities should monitor closely developments in mortgage markets and be prepared to strengthen macroprudential policies if necessary. Could staff elaborate on the heightened competition faced by banks from non-bank institutions and its implications for banks' profitability?

Regarding the bill sent to Parliament to reform the financial sector supervisory and resolution frameworks, we take note that three sectoral supervisors, including the Banco de Portugal (BdP), have expressed substantive concerns and that both the BdP and ECB authorities see some provisions as inconsistent with the European institutional framework. We would appreciate an update from staff on the status of this reform and the likelihood of changes to address these concerns.

The report recognizes notable improvements in Portugal's economic structure in recent years, but strengthening medium-term growth calls for further efforts aimed at fostering investment, raising productivity, reducing the gender gap, and addressing rigidities in the labor market. Increasing the investment rate, which remains relatively low, and improving productivity require enhancing the regulatory framework, strengthening competition, and raising the quality of education and vocational training. Although we welcome recent legislation on equal pay, further progress is also necessary to reduce the gender gap in labor force participation. Moreover, making permanent contracts more flexible would enhance the flexibility of the labor market. In addition, options should be explored to stimulate corporate and household savings, which are below Euro area averages. In this regard, we encourage the authorities to enact the regulations needed for the complementary second-tier occupational pension schemes. Could staff comment on the prospects of approval of the reform of the labor code, which is still in Parliament?

With these comments, we wish Portugal and its people every success in their future endeavors.

Mr. Gokarn and Ms. Dhillon submitted the following statement:

We thank staff for the well-written reports and Mr. Fanizza and Ms. Lopes for their informative buff statement.

Spanning six years, economic conditions in Portugal have improved commendably. Real GDP is now above pre-crisis levels, with progress on fiscal consolidation, employment has picked up and the Portuguese banking system has strengthened. As growth moderates in the medium-term, the outlook for the small open economy is vulnerable to headwinds from global growth and financial conditions, protectionism, and the Brexit outcomes. Moving ahead, we are reassured by the authorities' commitment to strong macroeconomic policies and structural reform for boosting growth.

Further fiscal consolidation and sustained debt management remain paramount. We positively acknowledge the efforts of the authorities on active and dynamic debt management strategies and commend the increase in tax revenues, the downward trend in public debt-to-GDP ratio and the decrease in the general government headline deficit to a new record-low in Portugal's modern democratic history. Faced with a rapidly ageing population, the authorities' reforms to the health system and pensions must continue to be balanced with supporting the most vulnerable and social cohesion. Broadening the tax base and efficiencies attained through rationalized spending will complement efforts to build fiscal space. In particular, to buttress the ability to respond to economic vulnerabilities and reduce risks emanating from a debt overhang, the still-high public debt necessitates continued robust supervision.

Sustained improvements in the health of the financial system must consolidate the recovery accomplished. To this end, we support the reform of the financial supervision and resolution institutional framework and early consensus on the elements of the proposed Bill, to reach a strong, cost-efficient and independent architecture. Could staff offer perspectives on the processes involved and the related timelines? The significant recovery of profitability and decline in the debt ratios for both non-financial corporations and households is appreciable. Relatedly, non-performing loans have declined, but the ratio of NPLs to total loan exposures remains on the higher side amongst OECD countries. Like staff, we too call for continued monitoring of NPLs and translating performance to improved operational efficiency and profitability.

Finally, productivity-enhancing measures and an improved business climate will lift competitiveness and deliver inclusive growth. We commend the strides made by Portugal in various fields including in the labor market, education, skilling, judicial system and the energy sector, all being crucial for more convergence with other OECD countries. We align with the Staff suggested recommendations on fostering product market competition and stronger domestic saving rates. We would like more details on the stock of foreign direct investment when compared to the euro area average and the potential in this area. We invite staff comments.

With these comments, we wish the authorities continued success in their endeavors.

Mr. Tan and Mr. Chea submitted the following statement:

We thank staff for the comprehensive set of reports for Portugal and Mr. Fanizza and Ms. Lopes for their informative buff statement.

Portugal's medium-term economic growth is projected to decelerate further on the back of weaker growth in the Euro Area and lower domestic demand. Against challenging macroeconomic conditions, we note positively the authorities' efforts in ensuring fiscal sustainability and financial stability, which have supported employment and fiscal outturn. With growing external risks and lingering legacy issues, further efforts are needed to sustain fiscal consolidation, improve financial sector resilience and strengthen banking supervision practices, along with supportive structural reforms to help promote productivity and improve competitiveness. In this regard, we agree with the broad thrust of the staff appraisal and offer the following comments for emphasis.

Continuing efforts to enhance public expenditure effectiveness and to mitigate debt overhang over the near term are vital. We welcome the authorities’ commitment to sound public finances and further fiscal consolidation in line with its Stability Program 2019-2023. Supportive monetary conditions offer a window of opportunity for the authorities to sustain its prudent fiscal policy through budgetary discipline and expenditure prioritization efforts. Despite the significant decline in the public debt-to GDP ratio, it remains high and unsupportive of debt sustainability in the long run. We therefore agree with staff to speed up the pace of debt reduction to rebuild fiscal buffers for unanticipated shocks as well as the fiscal impact of Portugal’s aging population.

Ensuring sound macroprudential policy is crucial in preserving financial sector stability. We welcome the authorities’ progress toward its non-performing loans (NPLs) reduction strategy and in securing stability in the banking system. However, challenges related to high NPLs, weak profitability and limited capital buffers remain significant sources of macro-financial vulnerability. Hence, further efforts are needed to enhance financial sector resilience through strengthening banks’ balance sheet and exercising effective supervision. In line with staff’s recommendations, the authorities are strongly encouraged to ensure that banks follow through on their NPL reduction targets, strengthen risk management and corporate governance, as well as improve operational efficiency and profitability. Given the concerns raised by the European Central Bank (ECB) on the recently proposed financial sector supervisory and resolution frameworks, we would appreciate staff’s comments on the consistency of the proposed legislation with the Basel Core Principles and the prospect of the bill in the near term.

Strong commitment to structural reforms will be key to strengthen growth and boost productivity and investment. While we commend the authorities’ progress in restructuring the economy, improving educational attainment and ongoing structural reforms, Portugal’s level of productivity and investment remain low in comparison with the rest of the region. As such, continuing efforts to promote a business-friendly environment and foster skills upgrade remain essential to achieve internal balance and improve competitiveness in the market. We share staff's view in encouraging the authorities to further improve the legal and institutional framework for debt enforcement, develop human capital, boost productivity of firms and labor, and foster soundly financed investment and innovation.

With these remarks, we wish the authorities continued success in their policy endeavors.

Mr. Merk and Ms. Lucas submitted the following statement:

We thank staff for its candid set of reports and Mr. Fanizza and Ms. Lopes for their helpful buff statement. While the Portuguese economy has performed well in recent years, it started to decelerate in 2018, and the growth momentum is projected to decline further. Constraints for medium-term growth prospects largely reflect subdued productivity growth, insufficient investment, adverse demographics and stock legacies from the past, including high public and private debt. Moreover, risks to the outlook are tilted to the downside, driven largely by external factors as well as by vocal stakeholders advocating for the relaxation of policies and past reforms. Therefore, it is essential to maintain strong fiscal, macrofinancial and structural domestic policies to mitigate risks and address vulnerabilities. We broadly concur with staff's analysis and recommendations and associate ourselves with the statement by Mr. De Lannoy. The following remarks are offered for emphasis:

We take positive note of Portugal's near-balanced budget target for 2019 and improved market confidence. At the same time, we encourage the authorities to progress on their multi-year fiscal consolidation efforts. We welcome the authorities' plan to decrease public debt from 122 percent of GDP in 2018 to around 100 percent by 2024. While this would be a significant decline, we take note that staff cautions against remaining risks associated with the still high public debt overhang. We therefore echo staff's call to build fiscal space by reducing the high public debt more rapidly and an overachievement on MTO. This could be considered prudent in view of sizeable windfall gains from decreasing interest payments and high revenue buoyancy and would also help to free up resources to be prepared in case of unanticipated shocks in the near term and avoid potential pro-cyclical tightening further down the road, as well as to mitigate the fiscal impact of the ageing population.

Issues of expenditure composition need attention in the context of structural developments. As staff outlines, capital spending is well below pre-crisis and EU averages, compromising potential growth. Against this backdrop, we are somewhat surprised that according to staff the government's budget target for 2019 will also largely be achieved by lower-than-budgeted capital investments. Staff comments on whether this composition is appropriate would be welcome. In addition, we note the analysis that the public pension system remains expensive and does little to correct old-age income inequality. Therefore, we concur with staff that a tight control on the trajectory of pension spending remains important and stress staff's considerations on how to improve equity in the system. Despite some progress, we echo staff's assessment that the public health system continues to face significant challenges, in particular, its financial management and call on the authorities to address its underlying weaknesses (e. g. weak monitoring, enforcement practices, etc.).

Portugal has made significant improvements in the structure of the economy in recent years. However, medium-term growth will depend on strengthening investment and raising productivity. Staff's analysis shows that GDP per capita remains 40 percent below the Euro Area average and the share of low-skilled workers is among the highest in the EU. Despite the decline in unemployment to the lowest level since more than a decade, employment is still below its pre-crisis peak level. We agree with staff that education and vocational training should continue to be fostered to increase skill level and productivity. Moreover, enhanced investments are crucial, albeit keeping an eye on soundly financing these investments given the low corporate and household saving rates.

Stronger domestic saving rates would also facilitate higher investment rates without creating additional external imbalances. Taking into account Portugal's weaker external position and the projections for the next several years, higher domestic savings will be key to sustain investor confidence.

Finally, we agree with the staff's assessment that Portugal's financial sector stability has been strengthened. At the same time, we encourage the authorities to remain vigilant with regard to vulnerabilities emanating from the low profitability of the banking system and from the still high ratio of NPLs. Regarding the bill to reform the financial sector supervisory and resolution framework, we concur with staff that it should be consistent with the European institutional framework and the Basel Core Principles for Effective Banking Supervision. We take note of the Banco de Portugal (BdP)'s concerns that the current draft bill might potentially undermine the independence of the central bank and could weaken macroprudential supervision. In this context, according to the ECB Opinion, the new rules for removal from office and replacement of the Governor of BdP would not be compatible with EU law.

Mr. Heo and Mr. Kikiolo submitted the following statement:

We thank Mr. Fanizza and Ms. Lopes for their helpful buff statement and staff for the comprehensive report. Economic recovery in Portugal has benefited largely from the authorities' strong commitment towards sound macroeconomic policies. Growth outlook is expected to moderate to 1.4 percent over the medium term. We note this is lower than the authorities' growth outlook of 2.0 percent. Unemployment has bettered pre-crisis level. Nevertheless, risks pointed to the downside particularly from a weaker global growth and rising protectionism. The authorities are urged to accelerate structural reforms to enhance competitiveness and prevent a reversal in policy gains. We broadly agree with staff assessments and include the following comments for emphasis.

We agree with staff that the authorities should build more policy space by reducing the still high public debt. We are impressed with the authorities for clearing their outstanding IMF credit in December 2018, five years ahead of schedule. While we understand the rationale for staff to lower the medium-term objective of structure balance to 0.0 percent of GDP from 0.25 percent, the authorities viewed this new floor set by staff as too cautious considering recent strong fiscal outcomes and expectations that the authorities would exceed the target with 0.3 percent of potential GDP in 2020. We invite staff comments on the authorities' and staff's conflicting views on the MTO as well as the different medium-term growth assumptions. We welcome the decline in public debt but at the same time note that debt remains elevated and could be a source of vulnerability if downside risks materialize. In this regard, we welcome the authorities' plan to use any revenue windfalls to repay debt.

The banking system is in a much better situation now than before though stocks of legacy assets remain high. We welcome the authorities' NPL reduction strategy that resulted in the NPL ratio falling to single digits at 9.4 percent. The capital ratio for Common Equity Tier 1 also declined by 1.9 percentage points to 13.2 percent in 2018 Q4. We urge the households and non-financial corporates to continue deleveraging to reduce undesirable future exposures. We also echo staff in urging the authorities to closely monitor developments in the mortgage market since real estate prices are on the rise and take appropriate measures when needed. Box 1 (p.11) states that "a significant part of transactions driving real estate prices up in key locations are linked to the strong growth in the tourism sector and director investments by non-residents." We welcome staff's analysis on non-residents' property investment such as its cause, composition and possible future effects on the macro-critical vulnerability of the banking system.

While we understand the government's rationale for introducing the new Financial Supervision Framework Bill, we also note the concerns raised by the three agencies that the FSFB does not only undermine the autonomy of the central bank but introduces complexity, uncertainty and additional costs for the supervisory authorities. We urge the government and the supervisory agencies to continue their inter-agency dialogue to come up with an amicable bill. Mr. Fanizza and Ms. Lopes indicated in their buff that the proposal is now being discussed at the Parliament. Can staff shed some light on the legislative process in Portugal with respect to the FSFB and what are the chances that this Bill will be passed in its proposed form? We invite staff's view.

Structural reforms have paid off for Portugal so far but more needs to be done to improve competitiveness and narrow the income gap with OECD peers. We take positive note of the commendable strides the authorities have made under the National Reform Program framework on the labor market front, education and skills, judicial system, and in the energy sector as highlighted by Mr. Fanizza and Ms. Lopes in their buff. Despite that, Portugal still lag behind some of its OECD peers as highlighted in Figure 6 (p.27) on business regulation, labor market efficiency, innovation, human capital and credit market rigidity. Accelerating structural reforms to address weaknesses in these areas would boost Portugal's competitiveness and convergence to OECD income level. We also took note that the minimum-to-median wage ratio in Portugal is one of the highest in Europe and 22.6 percent of total employment contracts are at the minimum wage. We welcome staff's view on what role such minimum policy has played so far in the context of Portuguese economy to diminish income inequality while enhancing domestic consumption.

Mr. Moreno and Mr. Montero submitted the following statement:

We thank staff for its set of insightful reports and Mr. Fanizza and Ms. Lopes for their useful buff statement. We associate ourselves with Mr. De Lannoy's statement and would like to offer the following comments for emphasis.

The Portuguese economy continued to display a healthy growth rate, despite a marked deceleration over the second half of 2018, reflecting lower external demand and investment expenditure. The current account deteriorated slightly on the back of weak foreign demand, while inflation remained subdued, the headline fiscal balance continued to improve, and the banking system sustained its efforts to repair balance sheets and strengthen fundamentals. Moreover, at the end of 2018, Portugal paid off the balance of its IMF credit, 5 years ahead of schedule.

This positive performance continued to be underpinned by the implementation of sound policies and the impact of previous structural reforms. However, the economy is still vulnerable as stock legacies from the past remain high—e.g., high public and private indebtedness and still elevated banks' bad assets—while adverse demographics and weak productivity growth dampen potential output and income convergence. As we highlighted in the past, the authorities should take advantage of this conducive environment to rebuild fiscal buffers and persevere with structural reforms to address longer-term challenges and ensure a faster convergence to euro area living standards.

From a broader perspective, after a 5-year expansion, real GDP returned to pre-crisis levels only in 2018, while employment and labor force participation are still below their pre-crisis peaks. Moreover, observed real GDP in 2018 is still around 12 percent below the counterfactual level resulting from the extrapolation of GDP since 2008 with average growth for 1980–2008. These facts suggest the presence of strong hysteresis effects from the crisis that may have reduced Portugal's productive capacity, but that also make it difficult to estimate the degree of slack in the economy. Could staff share its view on the implications of these hysteresis effects for the design of the appropriate policy mix, as well as for the estimation of Portugal's output gap?

The headline fiscal balance will be close to zero in 2019 and positive going forward, while the structural primary balance will stabilize around 3.6 percent of GDP, helping to significantly bring down the debt ratio—though it will remain at around 100 percent of GDP by 2024. We welcome authorities' commitment to use revenue windfalls to accelerate public debt reduction. We take note of staff's recommendation to increase by 1 percent of GDP the structural primary balance over 2019–20, up to 4.6 percent, to speed up the debt reduction pace and build fiscal buffers. In view of the expected reduction in the pace of growth, the increasing downside risks and the uncertainty on the degree of slack in the Portuguese economy, this may not be the right moment for this recommendation. Has staff estimated the impact of such proposal on Portugal's GDP growth? We see merit, however, in the proposal to improve expenditure composition, particularly by boosting public capital spending, along the lines suggested by staff.

We take note of the substantial decrease in the stock of NPLs since its peak in 2016, although it still remains relatively high, while bank profitability is low, as in other AEs, despite its recent recovery. Like staff, we see merit in closely monitoring banks' NPL reduction plans, which so far has been strong, while strengthening their governance, internal controls and risk management. Relatedly, it would be helpful to continue adopting further measures to improve debt enforcement and insolvency, such as enabling public creditors to participate more fully in debt restructuring and addressing conditions that allow non-viable businesses to delay liquidation. We note that the financial supervision reform bill has some positive elements that could improve the cooperation of financial supervisors and limit conflicts of interest between oversight and resolution, and thus foster financial stability. However, the Banco de Portugal, the securities market and insurance supervisors and the ECB have raised some concerns regarding several aspects of the bill that merit careful consideration in Parliament before its approval.

Regarding structural reforms, authorities' reform agenda is well oriented towards increasing productivity, improving the business climate and raising domestic savings. This latter element is of the essence to tackle high household and non-financial corporations leverage, which expose the economy to negative shocks to income and interest rates. Thus, it is important to boost their net saving rates to deepen their deleverage process and, additionally, improve external accounts. In this vein, the SIP contains some useful suggestions related to the pension system and taxation. It is also important to channel investments towards resource efficiency and climate mitigation and adaptation, especially to comply with the authorities' commitment to the Paris Agreement. Finally, we share staff's view that further efforts to close the gender gap in the labor market would help improve productivity and mitigate the impact of ageing.

Mr. Benk and Mr. Reininger submitted the following statement:

We thank staff for their informative reports, and Mr. Fanizza and Ms. Lopes for their helpful buff statement.

Portugal continues to show remarkable success in reforming its economy, regaining and sustaining growth and gradually overcoming the legacy of the past. This has led to real GDP surpassing pre-crisis level, the lowest unemployment rate in more than a decade, a balanced external current account and a generally improved structure of the economy. We commend the authorities for their achievements particularly with respect to fiscal consolidation, implying a decline in the public debt-to-GDP ratio, and banking sector clean-up. However, there is no room for complacency, as further efforts to address the legacy of high public debt, a largely negative net international investment position and still elevated NPL levels are required. Moreover, a proactive policy approach in view of the longer-term implications of an aging population is advisable. We associate ourselves with the statement by Mr. De Lannoy and would like to provide the following comments for emphasis.

While economic growth has moderated recently, it is still well balanced, with both domestic and foreign demand continuing to render a substantial positive contribution to GDP growth. Against this backdrop, external risks stemming from trade tensions or disorderly Brexit will need to be monitored vigilantly, and the authorities should stand ready to act if downside risks materialize.

Fiscal performance has been solid overall, with the structural deficit having been further reduced close to zero and the structural primary surplus increased to 3.4 percent of GDP in 2018. We note that for 2019 a structural surplus and a further modest rise in the structural primary surplus are expected, despite a higher capital transfer to Novo Banco than in 2018. Having said that, we recognize that buoyant revenues have been contributing to these positive results. With the structural balance likely to exceed the medium-term objective (MTO) of 0 percent in 2020, we encourage the authorities to consider using this opportunity to speed up debt reduction, foster structural reforms and enhance public infrastructure investment, with a focus on energy and railway networks. Moreover, we invite the authorities to consider taking up staff’s recommendation to re-examine the public employment scheme and the public pension system, with a focus on enhancing equity. As for the public health system, we commend the authorities for their recent reform steps to enhance governance of public hospitals and address accumulated arrears.

We commend the authorities for their strong financial market policies that have significantly advanced the clean-up in the banking sector, with markedly lower NPL ratios, higher provisioning and improved capitalization ratios. Noting that Novo Banco continues to need capital transfers from the budget, we wonder to what extent the overall situation of the banking sector is marked by this single large bank and what the perspectives are of this idiosyncratic risk factor. Staff comments are welcome.

We encourage the authorities to closely monitor the developments in the residential real estate market and stand ready to activate the appropriate macro-prudential tools. We share the concerns expressed by the European Central Bank with respect to the bill to reform the financial sector supervisory and resolution frameworks submitted to parliament recently, while we are also aware of the positive elements in this proposal.

On structural reform policies we support the authorities' focus on further developing human capital. In this context, targeted investment in education and training of skills is paramount, including by stronger active labor market policies. The corresponding Selected Issues Paper underscores the positive association between higher education and stronger domestic saving rates, which in turn are needed to sustain higher investment rates without creating excessively large external imbalances. Finally, we wonder about the development of labor force participation, particularly in selected age-groups and for women, as measures to raise labor supply may become more relevant given the sustained decline of unemployment and the looming aging issue. Staff comments are welcome.

Ms. Levonian, Ms. McKiernan and Mr. Sylvester submitted the following statement:

We thank staff for their comprehensive set of papers, which points to the continued strengthening of Portugal's economic fundamentals. As we largely concur with staff's appraisal and recommendations, we limit ourselves to the following comments for emphasis.

We commend the Portuguese authorities for their strong economic management in recent years. Supported by prudent polices and reforms, Portugal's economic expansion is in its sixth year, coupled with improvements in other macroeconomic fundamentals. Looking ahead, with risks to the outlook tilted to the downside and challenges persisting, continued sound policies and reforms are needed. In this context, we welcome the authorities' continued commitment to prudent policies and reforms, as highlighted in the insightful buff of Mr. Fanizza and Ms. Lopes.

Portugal has made notable progress in strengthening its fiscal position and in reducing debt vulnerabilities. Additionally, it is noteworthy that, assuming unchanged policies and no adverse surprises, the fiscal situation will continue to improve and public debt will remain on its downward trend. While we commend the authorities for these achievements, further efforts are needed to address the still elevated debt levels and to build fiscal resilience. Accordingly, we share staff's recommendation for greater fiscal effort to accelerate the pace of debt reduction to build resilience and to create fiscal space to scale up critical investments to support potential growth. The authorities' commitment to sound public finances and to continue the ongoing positive fiscal consolidation is therefore welcome.

The authorities have made significant progress in reducing banking sector vulnerabilities but efforts should be sustained. We commend the authorities for the continued progress in reducing banking sector vulnerabilities. However, with high NPLs and low profitability plaguing the banking system, further efforts are warranted. We urge the authorities to continue with the implementation of the NPL reduction strategy to help bolster financial sector stability.

Further progress on structural reforms would serve Portugal well. The Portuguese authorities have made important economic and social progress in recent years. However, Portugal lags Euro area average on a number of structural indicators related to business climate, labor market efficiency, innovation, human capital, and credit market efficiencies. Continued progress on structural reform would help support higher and more inclusive growth and support income convergence with the Euro area economies. We welcome the authorities' commitment to policies and reforms aimed at, inter alia, increasing productive investments, improving the efficiency of the public sector, and supporting the development of human and social capital. The authorities' commitment to boost domestic savings to support scaling up of investments is appropriate to prevent the exacerbation of existing imbalances.

Mr. Daïri and Mr. Alavi submitted the following statement:

We thank staff for their well-articulated papers and Mr. Fanizza and Ms. Lopes for their insightful buff statement. We broadly concur with the staff appraisal and limit ourselves to the following points for emphasis.

Following five years of consecutive economic recovery Portugal's real output in 2018 has outmatched the pre-crisis level. The pace of recovery, however, has moderated relative to the preceding year-reflecting a less supportive external environment-and is projected to decelerate further in the near and medium term. We commend the authorities for their sound macro-stabilization policy and reforms efforts which have led to a significant improvement in the country's economic performance and in the health and stability of the financial sector. Nonetheless, the economy's outlook remains constrained by an anemic productivity growth and is subject to significant global and regional risks. Against this backdrop, authorities are encouraged to continue with sound policies and reforms over the medium term, focused on supporting growth, improving competitiveness, shoring up confidence, and further strengthening the resilience of the economy and the financial system.

We welcome the authorities' continued fiscal adjustment efforts and congratulate them for achieving a record low headline deficit in 2018, as indicated by Mr. Fanizza and Ms. Lopes. Nevertheless, despite the declining trend in debt ratios, the high public debt remains a source of vulnerability. In this context, we concur with the staff that tightening policy in the near term would be appropriate, and would support the authorities' debt reduction efforts that will create the needed policy space in the event of a material slowdown. In this regard, we welcome the early repayment of the remaining €5.5 billion of the IMF loan in December 2018, which also attests to the authorities and investors' confidence in the strength of the Portuguese economy. We are encouraged by Mr. Fanizza and Ms. Lopes' indication of the authorities' commitment to using any revenue windfalls to reduce public debt. We share the view that given Portugal's lower capital spending relative to the pre-crisis level and to EU average, a rebalancing of expenditure composition is imperative to maintain public capital stock at a level that supports potential growth.

The authorities' sound policies have contributed to strengthening the resilience of the financial sector. We commend the authorities for the important progress made in deleveraging households and non-financial corporates, as highlighted by Mr. Fanizza and Ms. Lopes. We also recognize Portuguese banks' strides in addressing the stock of legacy assets, reducing NPLs, and restoring profitability, and welcome their high compliance with the borrower-based macroprudential measures. We also support the authorities' planned reforms to bolster financial sector oversight and resolution architecture and are comforted by their assurances-as echoed by Mr. Fanizza and Ms. Lopes—that these reforms are consistent with the European Framework while strengthening the independence of Portugal's supervisory institutions.

Portugal's economy has rebalanced towards the tradable sector, supporting productivity growth and resulting in a record low unemployment rate. However, the investment to GDP ratio, labor force participation, employment rate, and GDP per capita are all below the euro area average. In this context we support the authorities' comprehensive reform agenda to spur investment, reform labor market to increase supply and upgrade skills, foster competitiveness, and promote social cohesion and sustainable economic growth, as outlined in their National Reform Program.

We wish the authorities further success.

Ms. Pollard and Mr. Vitvitsky submitted the following statement:

We thank staff for an interesting Article IV report and Selected Issues Papers and Mr. Fanizza and Ms. Lopes for the helpful buff statement. Portugal has made impressive progress in reducing external and internal imbalances, improving banking sector stability, and strengthening household and corporate balance sheets. We encourage the authorities to build on this progress by taking further steps to boost productivity growth and resilience, particularly as downside risks to the outlook have increased. We broadly agree with staff's appraisal in the report.

Fund staff estimate relatively low potential growth (around 1.4 percent) in Portugal, and no convergence in GDP per capita to the euro area in the next five years. While the authorities have implemented structural reforms aimed at enhancing growth potential, we agree with staff that more is needed. Staff comments on specific structural reform recommendations and sequencing would be welcome including what reforms have the most potential to boost productivity growth.

Fiscal performance in recent years has been sound, with public debt-to-GDP declining and an estimated modest improvement in the structural primary balance in 2018. Nonetheless, staff call for further fiscal consolidation of at least 1 percent of GDP over 2019-2020 relative to 2018, and a neutral fiscal stance in the event of a faster-than-expected slowdown. While some fiscal prudence is warranted, particularly given the upcoming parliamentary elections, we caution against calling for substantial additional fiscal tightening under the baseline given the weaker European growth outlook, Portugal's recent strong fiscal record, and its large public investment needs. Shifting expenditure composition to be more investment-oriented, as staff recommends, should be given priority in the near term.

While the banking system appears well capitalized and liquid, financial institutions are still addressing legacy non-performing loans (NPLs). That said, banks have been successful in reducing the stock of NPLs by almost a half in recent years. We would appreciate more details from staff on how the authorities were able to do so.

Mr. Ronicle and Mr. Haydon submitted the following statement:

We thank staff for the papers, and Mr. Fanizza and Ms. Lopes for their informative buff statement.

We commend Portugal for their continued successful economic performance, following the crisis at the beginning of this decade. While growth moderated last year, largely due to external factors, progress continues to be made on the fiscal adjustment and in strengthening the banking system. Significant challenges remain, however. We agree with staff that strong macroeconomic policies should be sustained, including through the multi-year fiscal consolidation and by delivering important structural reforms.

We associate ourselves with the statement by Mr. De Lannoy, and would like to add the following comments.

Macroeconomic developments. Labor market outcomes are particularly positive, which is welcome. Unemployment is now below pre-crisis levels. As Mr. Fanizza and Ms. Lopes highlight, in the first quarter of 2019 employment growth was driven by higher permanent job creation, with temporary employment decreasing for the first time in the post-crisis period. The Beveridge curve suggests that matching efficiency in Portugal is better than in the Euro Area as a whole, and unlike the Euro Area has not deteriorated markedly. In addition, we welcome staff's analysis of the natural rate of interest (r*). This could be usefully replicated in other relevant surveillance work, and we await the working paper on the subject with interest.

Fiscal policy. The Portuguese authorities have managed an impressive fiscal adjustment, delivering the narrowest deficit in recent history. Debt is projected to decline by a remarkable 20 percentage points of GDP over the forecast period. As in past statements, we congratulate the authorities on repaying the Fund several years ahead of schedule.

External sector. Recent developments around Portugal's NIIP are welcome. It has stabilized, and has improved in each year since 2014. Given it remains large and negative, we agree with the authorities' view that a continued improvement of the NIIP as a share of GDP is both desirable and welcome.

Structural issues. We welcome the particularly rich coverage of structural issues by staff in the report. The return of TFP growth to pre-crisis levels is a positive development, but labor productivity growth has remained persistently below the euro area average in recent years. Staff's comment that no significant convergence to Euro Area average GDP per capita is envisaged in the next five years is disappointing. This underscores the importance of the further structural reforms, including those set out in the report, in boosting Portuguese living standards over the long term.

Mr. Raghani, Mr. Sylla and Mr. Carvalho da Silveira submitted the following statement:

We thank staff for the set of comprehensive papers and Mr. Fanizza and Ms. Lopes for their insightful buff statement.

We commend the Portuguese authorities for their sound policy implementation and ownership, which helped sustain the country's economic expansion for the sixth consecutive year. Economic activity continued to expand, albeit at a slower pace, with real GDP growth reaching 2.1 percent in 2018 underpinned by private consumption and investment. The momentum has led the unemployment rate to reach its lowest level at 6.5 percent while inflation remains low. Moreover, we are pleased to note that the fiscal position has strengthened significantly with the nominal fiscal deficit declining from 3 percent in 2017 to 0.5 percent of GDP in 2018. In addition, the country managed to clear its outstanding balance with the IMF ahead of schedule. Conversely, on the external front, the current account turned into a slight deficit of 0.6 percent of GDP owing to lower exports. While the outlook remains favorable, we note that the balance of risks to the outlook is still tilted to the downside, stemming notably from external factors, private and public debt overhangs and the quality of bank portfolio. Against this background, policy priority going forward should focus on preserving fiscal sustainability to reduce public debt and strengthening the resilience of the financial sector. Moreover, it is critical to address existing structural bottlenecks to boost long-term inclusive growth.

We broadly agree with staff's analysis and policy recommendations and will confine our remarks to the following issues.

Additional fiscal efforts could help create space and accelerate the debt reduction in the near-term. We praise the authorities for their discipline and encourage them to capitalize on the current favorable conditions to tighten policy in the short-term by phasing out exemptions and preferential rates on VAT. This could help mobilize resources to absorb unexpected shocks as well as accommodate age-related spending. However, in case of sooner-than-expected slowdown in economic activity, consideration should be given to a neutral stance while keeping public debt on a downward path. On the fiscal structural front, attention should be paid to controlling spending in the public health and pension systems and wage bill. The recurrent accumulation of arrears of hospitals and the generous pension system by OECD standards, despite the recent reforms, calls for further actions. Could staff elaborate on the additional measures that are being considered by the authorities to address the issues related to recurrent arrears in the public health system? Also, we would welcome comments on the potential impact of reducing the penalty on early retirement on the already expensive pension system. Given the growing burden of the wage bill, a full review of the public employment, including levels, composition, and rules is imperative to safeguard its sustainability.

While the banking sector balance sheet has strengthened, it remains important to address existing vulnerabilities to safeguard financial stability. The steps taken to implement the non-performing loan (NPL) strategy are noteworthy. Despite these efforts, household and nonfinancial corporate debt remain elevated at about 70.6 percent and 131.1 percent of GDP in 2018 respectively. In this view, we agree with staff that increasing saving rates could support the deleveraging process. Additionally, the NPL ratio in the banking sector is still ranked among the highest in the Euro area in an environment of low interest rates, as indicated in the report. Going forward, emphasis should be given to ensuring banks continue to reduce their NPL while exploring ways to enhance profitability and operational efficiency. Could staff also provide comments on the regulatory landscape for Fintech and crypto assets in the country? Are banks exploring the use of fintech in Portugal to help address the issue of efficiency and profitability? Concerns over the reform of the financial supervisory and resolution institutional framework should be clarified appropriately.

Finally, we welcome the authorities' commitment to addressing structural challenges to make growth sustainable and speed up the convergence with the Euro Area. In this context, the progress made in implementing reforms envisaged under the National Reform Program are promising, particularly the ones associated with labor market, education, judicial system and energy. For instance, the improvements to the insolvency proceedings and out-of-court restructuring regimes as well as the introduction of a credit line for start-ups and small and medium enterprises represent an important step into the right direction. Looking ahead, we encourage the authorities to advance the still-needed reforms to enhance labor market efficiency while closing gender gaps, promote competitiveness, and bolster investments. We appreciate the analysis of the Selected Issues paper that indicates that an increase in private savings carries macroeconomic advantages, namely in financing higher private investment and mitigating the impact of the aging population. We would like to inquire about the state of the authorities' reflection on the recommendations given to spur complementary second-tier and third-tier occupational pension schemes.

With these remarks, we wish the Portuguese authorities success in their future endeavors.

Mr. Mouminah, Mr. Alkhareif and Mr. Rawah submitted the following statement:

We thank staff for a well-focused set of reports and Mr. Fanizza and Ms. Lopes for their helpful buff statement. We are in broad agreement with staff's analysis and policy recommendations and would limit our remarks to a few issues.

Fiscal efforts need to be sustained to continue building resilience. We take positive note that the headline fiscal deficit is expected to decline further and be close to zero by end of this year and that the public debt ratio is expected to continue on its downward trajectory, supported in part by the authorities' strict budget execution. In our view, efforts should continue to further improve the fiscal position, and possibly, freeing up resources for priority spending and boosting investment. This could be supported by, and not limited to, further rationalization of spending in the health sector and containing wage bill growth. In addition, we take note that Portugal has been upgraded to investment grade by major rating agencies.

Efforts to further improve banks' balance sheet, profitability and resilience should continue. In particular, we take positive note of the continued strengthening of banks' balance sheet, resulting in a steady decline in the NPL ratio since 2016, underpinned by the authorities' NPL reduction strategy. Here, continued progress is important given that the NPL ratio remains among the highest in the euro area. In addition, we take positive note of the progress made in improving capital adequacy ratio in 2018. We also agree with staff that protecting capital buffers from erosion would be important to ensure banks' resilience to potential shocks. Together with further enhancement of operational efficiency and profitability, this could help in better strengthening the banks' overall health.

We see merit in staff's view regarding boosting savings to further reinforce deleveraging. We take note of the decline in the household and nonfinancial corporates (NFC) debt-to-GDP ratio in 2018. As these ratios remain elevated, we would encourage the authorities to consider staff's recommendation outlined in the SIP to boost saving rate, especially for the household, as it is currently lower compared to the average of other European countries. This would be also important to support the resilience of households and NFC against the vulnerability to potential income and interest rate shocks.

Finally, we take positive note of the economic expansion over the past years and would like to emphasize the importance of boosting growth going forward. This could be achieved including through further enhancing the business environment, competition as well as human capital to improve skills.

With these remarks, we wish the authorities further success.

The representative from the European Central Bank submitted the following statement:

We would like to thank Staff for their report and Mr. Fanizza and Ms. Lopes for their buff statement. We associate ourselves with the statement by Mr. De Lannoy.

Following a sustained period of above potential economic expansion, GDP growth in Portugal is likely to decrease gradually towards its medium-term potential, largely reflecting a less supportive external environment and moderating cyclical elements. In this context, boosting medium-term growth prospects by addressing structural rigidities (such as subdued productivity growth, insufficient investment, unfavorable demographic trends) is critical. Domestic demand, in particular private consumption growth, is likely to be supported by the strong decline in the unemployment rate and wage growth. However, risks are tilted to the downside and have increased since last year. Portugal is exposed to an unfavorable external environment, characterized by decelerating export demand, the possibility of a disorderly Brexit, rising protectionism, and geopolitical risks. The still high private and public sector indebtedness are important vulnerabilities. As noted by Staff, the impact of these external risks can be mitigated by maintaining strong domestic policies.

The significant improvement in bank asset quality, declines in NPLs and increases in bank profitability are welcome developments, but ongoing efforts are required. Recent declines in NPLs have been bolstered by sales of NPL portfolios against the backdrop of positive investor sentiment generally but also some bank-specific factors. While declining, NPL ratios are still elevated constitute a vulnerability of the Portuguese banking sector and therefore banks should continue to ensure that these ratios are reduced further. Bank profitability has improved in recent years, but there are some headwinds to sustaining this. For example, the scope for further reductions in provisions and impairments is likely to be more limited and funding costs may increase due to MREL issuances, in particular for those banks that have MREL gaps and weaker investment ratings.

Bank of Portugal (BdP)'s macro-prudential measures appear to have had their intended impact on lending standards, but vulnerabilities remain and risks stemming from the real estate sector merit further attention. An analysis by the BdP suggests that banks comply with the limits for LTVs, DSTIs and maturities stipulated in their July 2018 recommendation for lending standards. Thus, these borrower-based measures seem to have been effective in achieving their objective of improving the risk profile of borrowers in the household sector. At the same time, however, there is evidence of strong competition in the lending market and there is pressure to move into activities with a higher risk-return profile, such as consumer lending and riskier types of NFC lending. The housing market itself has experienced a very strong recovery since 2013 with limited but increasing signs of overvaluation, despite recent signs of moderation in residential real estate prices. Banks strongly compete for new customers and interest rates on housing loans remain among the lowest in the euro area. A key risk to real estate valuation is a possible reversal in demand by non-residents as a result of an abrupt increase in risk premia. In this context, the net benefits of existing incentives to attract foreign demand to the real estate sector should be carefully considered.

We are very concerned about the draft law on the Portuguese financial supervisory system, which we consider raises concerns about the independence of the BdP and the functioning of the envisaged supervisory framework. Moreover, there are significant questions regarding its compatibility with EU legislation. In our formal legal Opinion[2], we raise, inter alia, concerns regarding the proposed audits and inspections by the General Inspectorate of Finance (IGF) given that the IGF is an administrative body within the Ministry of Finance and is under the control of the Minister. In addition, the Opinion considers that the new rules for removal from office and

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[2] Opinion of the European Central Bank of 21 May 2019on the revision of the legal framework of the Portuguese financial supervisory system (CON/2019/19)

https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2019_19_f_sign.pdf replacement of the Governor of BdP are not compatible with the Statute of the ESCB. Furthermore, it highlights that the new liability regime may have a particular impact on the BdP staff performing supervisory tasks and suggests maintaining the present liability regime which is aligned with the Basel Core Principles and whereby liability claims may be brought against the BdP only (and not individual staff).

The firm downward trajectory of the general government debt ratio is welcome, but the still high level and economic risks call for continued strong medium-term plans. The fiscal balance perceptibly improved in 2018, although, as Staff highlight, this largely reflects continued high cyclical revenue buoyancy, interest savings and under-execution of public investment, while the structural improvement was more limited. Additional fiscal effort could be considered prudent to help reduce faster the still very high public debt and therefore build more resilience and create fiscal space for the event of an economic downturn. We also agree with Staff that a rebalancing of the composition of public spending to prioritize public investment would be beneficial for growth potential. Fiscal space for such investment could be created by significantly strengthening the scope and depth of the ongoing public expenditure review, which has so far yielded only very limited savings. Given recent pressures on the wage bill (including on account of a perceptible increase in employment – even when adjusted for the conversion of part-time into regular work contracts) and the gradual unfreezing of career progressions, a comprehensive review of the level, composition, and rules of public employment – as recommended by Staff – could indeed be useful.

To strengthen the resilience of the economy, we agree with Staff that there is a strong case for further structural policy efforts, particularly in the areas of energy, labor markets, and the judicial system. A still segmented labor market, together with ageing of the population, low capital levels per worker, lack of skilled workers and persistent rigidities in the product and services markets weigh on potential growth. We concur with Staff that strengthening medium-term growth will require boosting investment and raising productivity, including by reducing red tape, fostering product market competition and continuing to improve skills in the labor force. Higher domestic saving rates would help sustain higher investment rates without aggravating external imbalances. We would highlight a number of areas for focus. First, while the liberalization of the energy markets is progressing and some cost factors (e.g., related to the financing of tariff debt) should fade out over the coming years, the energy tariffs consumers and firms are facing are still among the highest in the euro area. Second, we concur with staff that it would be beneficial to review the labor code for permanent contracts with a view to increase the adaptability of the labor market. Lowering labor market segmentation by penalizing temporary contracts is likely to have an adverse impact on employment. In contrast, there is a strong case for reviewing the legal framework for permanent contracts to make them more attractive. Third, we see merit for further assessment of the limited options for firms to opt out from collective agreements and their economic impact. Improving such options would allow for more differentiated wage setting in line with productivity differentials, which would be particularly relevant in the context of a turn in the business cycle or an adverse shock. Lastly, we would emphasize the functioning of the judicial system as an important area for focus. Portuguese firms cite the limited efficiency of the judicial system as one of the most important factors constraining business. The disposition time of court cases and the backlog of court cases has declined due to earlier reforms undertaken, yet it still takes around three years on average to resolve cases. Additional policy actions in this area could be helpful.

The Acting Chair (Mr. Furusawa) made the following statement:

The Portuguese economy has performed well in the past years, and real GDP has now surpassed its pre-crisis level. The unemployment rate declined to its lowest level in more than a decade, and structural reforms have paid off. However, recently the economic growth has moderated partly due to a less favorable external environment. Against this background and in light of the economy’s vulnerability to external shocks, Directors’ gray statements recommended greater fiscal efforts, reducing debt, and further strengthening the financial sector, including ongoing discussions by all relevant parties on the financial supervision reform bill. Directors also underscored the need for structural reforms to support income convergence with the euro area countries.

Finally, Directors praised Portugal for clearing all of its outstanding IMF credit well ahead of schedule.

Mr. Fanizza made the following statement:

I thank Directors for their gray statements, which provide an excellent base for discussion. I wanted to say a few things to provide input for the discussion. I will start by saying that Portugal’s recent strong economic performance tells us that the program has proved to be an unqualified success. The economic reforms have paid off. That is the basic message. This was not so clear until a few years ago. Even the just-completed conditionality review called the program with Portugal a case of partial success, and if we look at the Article IV consultations of two or three years back, they had a very different tone from the one we are discussing today. They were quite skeptical of the quality of the policies and also of the economic prospects of the countries. Things have gone differently. One can understand that at the end of the program in mid-2014, there were still some doubts, but my Portuguese authorities have stayed the course of economic reforms. Moreover, after concluding the program, they followed policies that foster growth and social cohesion while making sure to comply with their fiscal consolidation targets. This managed to build the necessary consensus and confidence that unlocked a virtuous cycle. In the words of Prime Minister Costa: The success is not any longer an issue for discussion. It is a matter of fact.

Let me just remind the Board of some of these facts. Portugal has grown more than 2 percent over the period from 2015 to 2018 and started to converge to the euro area per capita income level in 2016. The international investment position has improved significantly. Public debt over the same period dropped by 9 percentage points of GDP. The first-quarter data for 2019 augur well for the fiscal outcome for this year, which should be a very small deficit. The unemployment rate has finally halved since 2014. After making early repayment to the Fund, Portugal is ready to make early repayment to its European partners for an amount of US$2 billion, substantial repayment.

This does not mean that all the vulnerabilities are gone and that the legacies from the crisis have been addressed, by no means. Portugal needs to grow steadily at a faster pace to converge to the euro area average per capita income level. The authorities will continue to further push reforms on the fiscal, financial, and structural fronts.

With another quote from my Portuguese authorities, Minister Centeno this time, summarized their policy: Turning the page on budgetary austerity does not mean adopting policies should become less rigorous or less ambitious without constraints. To the contrary, it means being fully aware of the challenges the country faces but also brave enough to make the needed choices to address them.

That said, I will just touch upon two issues. The first is the extent of the needed fiscal effort in the short-term. The second is the issue concerning the recently proposed financial supervision framework bill. On the first one, the success of the Portuguese experience stems from a delicate balance between fiscal responsibility and restoring pre-crisis income levels for the Portuguese households. The Portuguese government is committed to continue its path of fiscal responsibility and to use revenue windfalls to reduce the still-high public debt. However, my authorities believe that the staff's call for a significant further adjustment in the baseline does not seem appropriate at this stage, and that we need to agree with Ms. Abdelati and Mr. Rosen in their gray statements.

On the second point, it was clear that the issue of this proposed law has attracted the attention of all chairs. Only four statements did not mention it. We explain the differences in position between the government and Banco de Portugal, and we go into details, so I will spare you the excruciating details. But at this point I would like to add some information on the process. The bill was sent to parliament and now is under discussion at the parliamentary committee level. The committee will hear all the stakeholders that are going to be affected by the bill, either directly or indirectly, and then it will be sent to the plenary session for approval. However, the timeline is currently extremely tight, as the legislature is almost over. Any bill currently under discussion at the parliament needs to be approved by the end of the month to make it. Otherwise, everything will have to start from scratch after the October elections.

The staff representative from the European Department (Mr. Cuevas), in response to questions and comments from Executive Directors, made the following statement:[3]

There were several questions about the discussion in parliament of the Financial Supervision Framework Bill and the prospects for amending this bill in a way that could accommodate some of the concerns put forward by the European Central Bank (ECB), the Banco de Portugal, and other domestic supervisors. Concerning the timelines on the legislative process, as Mr. Fanizza has explained, time is running short. In Portugal, a bill typically has an initial vote in its generality, which is often seen as a political signal. The bill then needs to be discussed, amended, and approved in the relevant commission in its specialty; and lastly, the bill needs a final global approval by parliament as a whole. The initial vote of the bill in its generality was initially scheduled for June 7, but this vote was omitted at the request of the socialist party. In fact, the bill was sent directly to the relevant parliamentary commission. The bill was received by this Parliamentary Commission on June 7. Since then, the press has not reported on any updates on the discussion and analysis of this bill, so we have no information on how advanced the work of the Commission might be at this point. Also, the public agenda for the activities of the Commission does not list discussion of this bill this week. July 19 is the last date that the bill with any amendments incorporated along

[3] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

the way could be presented for a final global vote by the parliament as a whole. This is the date of the last plenary session of parliament before the end of the current legislature. If the bill is not approved before the current legislature ends, it will get discarded along with any other unfinished work of this parliament.

The whole process can begin anew once a new parliament is seated after the October elections. At that point, the new government could resubmit the bill, either in its original form or with modifications. In an interview with a major newspaper published last Friday, Finance Minister Mario Centeno commented that it would be difficult for parliament to finish its work on this bill by July 19. Nevertheless, he also indicated that should parliament leave this work unfinished, the reform of the financial supervision framework would be included in the economic program of the socialist party for the next legislature.

Regarding the prospects for the incorporation into the bill of the comments offered by domestic supervisors and the ECB, it is difficult to venture a view. Looking from outside, it would seem that the views expressed by the ECB on certain incompatibilities between the reform bill and the European institutional framework would be the most difficult to ignore. The areas in question have mostly to do with the rules for appointing and dismissing the Governor of the Banco de Portugal and the type of external supervision the Banco de Portugal can be subjected to. As noted, there are no reports either in the press or the Commission’s work page on whether these observations or others are being incorporated into the bill; so we will be hard pressed to speculate on what an amended bill could eventually look like.

Some Directors also invited views from the staff on whether the draft law follows closely the Basel Core Principles. As we have stressed, the staff is of the view that many different institutional arrangements can be effective provided that they incorporate several key principles, such as ensuring the independence of supervisors, as explained in the staff report. The Monetary and Capital Markets Department (MCM) and the Legal Department (LEG) performed the desk study of the bill having in view the opinions of the sectoral supervisors. This exercise is not a substitute for the type of work MCM does in its technical assistance (TA) or its Financial Sector Assessment Program (FSAP) mission. In particular, MCM was not in a position to undertake a full analysis of whether or to what extent the draft bill is consistent with the Basel Core Principles or with the standards and codes for the supervision of the securities markets and the insurance and pension fund industries. Still, the desk study, together with the discussions held by the mission in Lisbon and Frankfurt, does permit the drawing of some preliminary conclusions, including the following.

The implementation of the bill could be subject to transitional uncertainty and complications, including capacity building challenges, as it calls for the creation and staffing of new institutions. The bill risks the emergence of overlaps in the functions and responsibilities of the Financial Stability Commission, chaired by the Minister of Finance, the National Supervisors Council, with its own president, and the domestic supervisors themselves. This could complicate or delay decision-making and risk undermining the independence of sectoral supervisors.

The new liability regime for officials of Banco de Portugal could leave them personally exposed to litigation even when they act in good faith in the discharge of their official duties. This can affect their willingness to act. The bill creates a risk that Banco de Portugal may not consistently play a central role in macroprudential policies. This would be unfortunate in view of Portugal's bank-dominated system. On the other hand, the bill does have positive aspects. It increases the financial and operational autonomy of the insurance industry and the securities markets regulators, aims to strengthen the exchange of information among supervisors, and explicitly includes the pursuit of financial stability as the main objective of supervisors.

Concerning the other point that Mr. Fanizza raised, the extent of the needed fiscal effort, I would just like to reiterate a point we made in the report, which is that when you look at aging of the population in the coming decade and what it means for the budget—and this is an estimate that we took from the budget annexes themselves—you will see an extra cost of about a point of GDP just building up. Staying where the government is would necessitate an additional structural effort of about 1 percent of GDP to offset that additional cost. The Fiscal Council also estimates that about 1 and a quarter points of GDP would come as a result of the impact of aging on the cost of health services. We see some pressures building up there over time gradually. They are not imminent, but we think this is a good moment to make some headway in preparing the public finances to face those structural pressures.

Mr. De Lannoy made the following statement:

On behalf of my European colleagues, I would like to highlight a couple of points.

The Portuguese economy experienced a period of dynamic economic performance driven by structural reforms and strong policy efforts. As a result, private, public, and external indebtedness declined markedly, and unemployment currently stands below pre-crisis levels. Short-term risks to the outlook appear limited and are mostly linked to the external environment. A durable reduction in vulnerabilities will take time and perseverance, while growth is slightly to moderate toward potential. We therefore agree with the staff that continued efforts will be needed to sustain the adjustment in public finances to increase the productive capacity of the economy and to further reduce rigidities in the labor markets.

The fiscal deficit continues to improve on the back of the authorities' determined fiscal efforts, the favorable economic conditions, and decreasing interest payments. Going forward, it remains important to maintain the fiscal effort and rebuild policy space. Using windfall gains from decreasing interest payments to accelerate debt reduction would be prudent. In addition, it is important to rebalance the composition of public spending toward more public investment, while excessive pressures on compensation of employees and pension spending will need to be contained. I would like to make three remarks with regard to the financial sector.

First, we welcome the continued reduction of nonperforming loans (NPLs) by Portuguese banks and their increasing capital buffers. Going forward, as NPLs are still high, banks should continue to reduce them.

Second, borrower-based measures help improve the risk profile of household borrowers, but household indebtedness is still high.

Third, we broadly concur with the staff that the financial supervision reform bill has some positive elements and objectives but has also raised some concerns. The Portuguese financial supervisor and the ECB have raised issues that merit careful consideration, including on the new rules for removal from office and replacement of the Governor of the Bank of Portugal.

Lastly, structural policies can boost income convergence with the rest of the euro area and strengthen the resilience of the economy. We agree with the staff that this will require fostering investment and raising productivity, including by continuing to reduce red tape, fostering product markets competition, and improving skills. This would enable Portugal to tap into higher value-added sectors and activities. It is critical to channel investment toward R&D, infrastructure, and energy transition. Stronger domestic saving rates would be needed to sustain such higher investment rates without aggravating external imbalances.

We also agree with the staff that it would be beneficial to review the labor code for permanent contracts. This could increase the adaptability of the labor market. The recent parliamentary approval of some of the measures included in the tripartite agreement is a positive development. However, it is critical to maintain a proper balance between fixed and flexible contracts, as penalizing temporary contracts could reduce investment and job creation, particularly in sectors with high seasonality. With that, I wish the authorities the best of luck.

Mr. Montero made the following statement:

We associate ourselves with Mr. De Lannoy’s statement and would like to offer some comments for emphasis.

Let me first start by highlighting Portugal’s recent positive performance with the economy displaying a healthy growth rate despite a marked deceleration over the second half of last year, reflecting lower external demand and investment expenditure. Moreover, the current account deteriorated slightly on the back of weak foreign demand, while unemployment fell to pre-crisis levels, and inflation remains subdued. The situation of the fiscal accounts continues to improve and the banking system sustained its efforts to repair balance sheets and strengthen fundamentals. Moreover, as highlighted by Mr. Fanizza, it is also worth remembering that Portugal paid off the balance of its IMF credit five years ahead of schedule and is going to begin paying back the European loans. This positive performance continues to be underpinned by the implementation of sound policies and the impact of previous structural reforms. However, the economy is still vulnerable due to high stock legacies such as the high public and private leverage and still-elevated bank balance sheets, while adverse demographics and weak productivity growth, like in other advanced economies, will dampen potential output and income convergence.

As we have highlighted in the past, the authorities should take advantage of this conducive environment to sustain their fiscal efforts and persevere with the structural reforms to ensure a faster convergence to euro area living standards.

I would like to focus my remaining intervention on a very specific staff recommendation, which has been also highlighted by Mr. Fanizza, which is the proposal to increase by 1 percent of GDP the structural primary balance over the next two years, which would take the primary balance up to 4.6 percent of GDP with the aim of speeding up debt reduction and building fiscal buffers. Some fiscal prudence is warranted, not the least because this is an electoral year. However, we should be cautious when calling for such a big additional tightening. In the current context in which the expected pace of growth will moderate, there are increasing risks to the downside, and Portugal still has large public investment needs. Moreover, as the staff rightly acknowledges in its responses to technical questions, in a situation in which there is uncertainty on the degree of slack in the Portuguese economy, this would suggest caution when planning budgets and additionally a need to persevere with supply-side structural reforms. In both cases, we fully share this prudent approach.

As a priority, we will favor using revenue windfalls to accelerate debt reduction and to improve expenditure composition, particularly by boosting public capital spending along the lines suggested by the staff.

Mr. Merk made the following statement:

We associate ourselves with the statement by Mr. De Lannoy.

We take positive note of Portugal's near balanced budget target for 2019 and improved market confidence. At the same time, we encourage the authorities to make progress on their multi-year fiscal consolidation efforts. We welcome the authorities' plan to decrease public debt from 122 percent of GDP in 2018 to around 100 percent by 2024. While this would be a significant decline, we take note of the staff's cautions about remaining risks associated with the still-high public debt overhang.

In view of the sizeable windfall gains from decreasing interest payments and high revenue buoyancy, and to be prepared in case of unanticipated shocks, we echo the staff's call to build fiscal space by reducing the high public debt more rapidly. Furthermore, we concur with the staff that a tight control on the trajectory of pension spending remains important.

Lastly, we positively acknowledge that Portugal has made significant improvements in the structure of the economy in recent years. However, medium-term growth will depend on strengthening investment and raising productivity further.

Mr. Dairi made the following statement:

Once again, we congratulate the Portuguese authorities for their excellent performance. I would like just to support what Mr. Fanizza said, supported by Mr. Montero. As the saying goes, the better is the enemy of the good, and in my view, the authorities have a plan of fiscal consolidation which looks credible.

Portugal is not like other countries. It has gone through a crisis, and managing expectations in this post-crisis period is extremely important. The public should be convinced that the authorities are on the right track, and the authorities are doing the best they can . If there is a perception that what they are doing is not credible or is not sufficient, it may send a very negative and even dangerous message.

If I look at even at the background section of the staff report, it says clearly that public debt is on a firm downward trajectory, and the authorities project it to reach 100 percent of GDP by 2024, which is very good compared to what they are now, what they have been in recent years. We should be as flexible as possible with countries that are trying to get out of debt when they are enacting good policies, sound policies, as we are with countries that have larger fiscal space and do not use it for reasons that may also be valid. I am not questioning their motivations, but we have to be symmetrical in our assessment and ensure that we do not endanger the gains in stability and confidence and credibility that Portugal has made. Calling for a stronger fiscal consolidation than they are considering now, and on top of that, saying that they will be ready to use any windfall gain from revenues to further reduce the debt, is very credible and welcome. I would call for caution on this area to continue to support the authorities in a very effective way.

The staff representative from the European Department (Mr. Cuevas), in response to questions and comments from Executive Directors, made the following statement:

Since this is the point that is being discussed, just a reflection. The Medium-Term Objective (MTO), which is the benchmark we are recommending that the authorities treat as a floor, sets the level of the structural balance that will over a 20-year period, if adhered to, take you to the benchmark of 60 percent of GDP in public debt-- 20 years, in this calculation, without a recession. We are talking about maintaining the same discipline for five consecutive governments. This is a very demanding condition. We understand that. But since we have now a situation which is relatively benign, and since we have now a government that is committed to fiscal discipline, we think it is a good moment to make some additional headway.

As to whether we are saying that this should be done “no matter what,” as we clarify in the report, if risks to the downside were to materialize, our recommendation is not to go ahead with any such consolidation, but to let stabilizers operate. So, we are very cognizant of that risk, and our main recommendation is made on the assumption that we continue on the baseline scenario. At the same time, we did say that these automatic stabilizers should be limited to the point where debt continues on its declining path because that is the reason that Portugal has regained investment grade. We think it is a good moment in particular because monetary conditions remain accommodative. Portugal’s sovereign yield, the 10-year bond, last week was around 0.3 percent; so, this is a moment in which conditions are such that the headwinds from any additional consolidation could be mitigated by these offsetting factors. Again, along the baseline.

Mr. Fanizza made the following concluding statement:

I thank my colleagues for their insightful comments in the gray statements and for the interesting discussion and reassure them that I will convey them to my Portuguese authorities.

I would like to thank the staff for their excellent work, especially the mission chief, Mr. Cuevas, who has been able to build a very collaborative relationship with the authorities. They really appreciate what he and the team have done. Of course, disagreements are part of life and are useful to generate the discussion, so they are very grateful.

The Acting Chair (Mr. Furusawa) noted that Portugal is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed Portugal’s improved fundamentals, noting that the current real GDP level has now surpassed its pre-crisis levels, the unemployment rate declined to its lowest level in more than a decade, and that structural reforms have paid off. Directors, however, agreed that downside risks have increased amidst a less favorable global environment. They, therefore, stressed the need for continued efforts to strengthen the resilience of the economy and the financial system, including addressing the still elevated public debt level and non-performing bank loans. Implementation of further structural reforms to support potential growth, raise domestic savings and improve the business climate remains a priority.

Directors commended the authorities' commitment to sound public finances and fiscal consolidation, which resulted in reductions in the fiscal deficit and debt ratio in recent years, the repayment of the IMF loan ahead of schedule, credit rating upgrades, and substantially lower borrowing costs. Notwithstanding these achievements, Directors generally stressed the need for accelerated debt reduction to rebuild fiscal buffers to protect against unanticipated shocks as well as to address the fiscal impact of Portugal's aging population. In that context, Directors particularly welcomed the authorities' commitment to use revenue windfalls to accelerate public debt reduction. While acknowledging numerous efforts already taken to improve the efficiency of public spending, Directors called for further examination of the quality and composition of spending, with a view to shift spending toward greater public investment. Expenditures on pensions, wages, and health also deserve closer examination.

Directors agreed that banks' balance sheets had improved significantly in recent years, and especially commended the marked decline in non-performing loans. They noted, however, that modest profitability remains a concern, and encouraged further efforts to improve asset quality, efficiency, and governance. Directors also called for continued vigilance of mortgage market developments and for the authorities to stand ready to adjust macroprudential policies if needed. With respect to the financial supervision reform bill, Directors encouraged the careful consideration in Parliament of the concerns raised by the ECB, Banco de Portugal, and other domestic supervisors, and a continuing search for consensus, to ensure that the bill guaranteed the independence of supervisors, it was consistent with the European institutional framework, it would ensure timely and well-informed decision making, and it was cost-effective.

Directors emphasized the need to boost potential growth and productivity, to both reduce balance sheet risks and accelerate the pace of convergence to euro area living standards. They noted that to meet this goal, investment spending needs to increase, supported by an improved business environment, greater competitiveness and innovation, and a more efficient use of labor. To avoid the re-emergence of external imbalances, domestic savings will need to increase as well. In this regard, Directors suggested that the authorities explore ways to encourage complementary second- and third-pillar pension schemes.

It is expected that the next Article IV consultation with Portugal will be held on the standard 12-month cycle.

APPROVAL: May 26, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook/Risks

1. ***We note that the authorities' own medium-term projections are higher than those of staff, justified by structural changes in the economy, including strides made in improving education levels. The staff report identifies labor skills as a key structural constraint and acknowledges recent improvements in education and in the labor market. We would like to hear why staff considers the impact on medium-term growth to be more muted than expected by the authorities.***

- Portugal has enjoyed a continued improvement in educational attainment for over two decades, but with relatively limited impact on aggregate productivity statistics. In fact, labor productivity has been subdued in recent years, in line with the general slowdown in productivity growth in advanced economies. For that reason, continuing improvements in skills are de facto already in staff's baseline projections of trend productivity growth and potential growth. In contrast, the government's projections envisage a higher impact of skill-improvements on total factor productivity going forward. It must be said that although the government's estimates of potential growth involve some additional yield from these improvements in education, this is less than could be argued using off-the-shelf structural reform valuation models such as Quest. Staff believes that to enhance their impact on aggregate productivity, improvements in education and skills need to be accompanied by more efficient labor utilization and higher investment.
- The structural changes in the economy, including more efficient investment allocation and export orientation, justify some expectations of a higher TFP growth going forward, which staff has taken into account in arriving at their estimate of medium-term potential growth, which is higher than some years back. A rebasing of national accounts is expected later this year; the release of updated time series for real output will offer an opportunity for the mission to refresh its estimate of potential growth.

2. ***We note the non-marginal differences between the near-term GDP growth estimates of the authorities and staff for both 2019 and 2020. Could staff provide more details on discrepancy of these projections?***

- The difference mainly stems from the contribution of the foreign balance. The government's Stability Program envisages a smaller negative contribution to growth from the foreign balance, with significantly lower growth in imports. Staff's projections are similar to the projections by Banco de Portugal, the EC and the ECB, and are consistent with the trends observed in the data in recent quarters.

3. ***Staff estimates economic growth at 1.4 percent over the medium term, while the authorities have a more optimistic estimate of above 2 percent. We would appreciate further elaboration from staff on the main reasons behind this difference in the medium-term growth projections.***

- See answer to q.1.

4. ***From a broader perspective, after a 5-year expansion, real GDP returned to pre-crisis levels only in 2018, while employment and labor force participation are still below their pre-crisis peaks. Moreover, observed real GDP in 2018 is still around 12 percent below the counterfactual level resulting from the extrapolation of GDP since 2008 with average growth for 1980–2008. These facts suggest the presence of strong hysteresis effects from the crisis that may have reduced Portugal's productive capacity, but that also make it difficult to estimate the degree of slack in the economy. Could staff share its view on the implications of these hysteresis effects for the design of the appropriate policy mix, as well as for the estimation of Portugal's output gap?***

- The severity of the contraction in output suffered by Portugal at the time of the euro crisis significantly complicates the estimation of the time series for potential output. In fact, something very much like hysteresis is almost palpable when we consider that most of the able-bodied Portuguese who left the country during the crisis are still abroad, and when one looks at boarded-up buildings in prime real estate locations—representing valuable capital locked away while restructuring and liquidation processes run their slow course. The team has sought to approach the questions of the output gap and potential growth, therefore, by applying a range of methodologies, from production function approaches to the use of multivariate filters, as well as judgment informed by the consideration of other variables. Of particular importance in this regard has been the evolution of the labor market. Unemployment rates have not been this low since well before the Lehman crisis, vacancy rates are high, statistics on people moving up to better jobs have picked up, and business complains of growing difficulty filling up new posts. These factors lend support to statistical estimates pointing to a moderately positive output gap.
- The policy implications of these matters are that it is important to continue to encourage the return of Portuguese migrants, and to continue to boost the efficiency of restructuring and liquidation processes, to reverse some of the losses in productive factors experienced during the crisis. The government has been making efforts in these areas, but continuing attention is needed. More broadly, the uncertainty about

the measurement of output gaps and medium-term potential growth suggest caution when planning budgets and a need to persevere on supply side structural reforms—including to boost saving to provide healthy financing for additional investment.

Fiscal Policy

5. ***Could staff elaborate on the additional measures that are being considered by the authorities to address the issues related to recurrent arrears in the public health system?***

- (See below)

6. ***We note, with concern, the recurrent buildup of hospital arrears and would appreciate staff comments on whether the authorities' recent measures to address accumulation of arrears have been effective. We would also welcome staff views on the fiscal implications of these measures going forward.***

- To reduce recurrent arrears, the authorities have introduced a new governance framework for managing three groups of hospitals – i) the most efficient hospitals will receive additional financing and will have greater operational autonomy; ii) those with mid-range efficiency will face greater monitoring, and; iii) the least efficient hospitals will face greater direct intervention. It is too early to assess the effectiveness of the new measures put in place; however, the framework appears well targeted and should incentivize efficiency gains. If these measures are effective in reducing arrears, they should help to lower prices charged by suppliers, as they will no longer need to incorporate the expected cost of delayed payment.

7. ***Bringing public debt down to more sustainable levels should remain a policy priority. Under the current policies, debt will fall to 100 percent of GDP only by 2024. The current fiscal stance should be seen as a minimum, and we concur with staff that there would be merit in further fiscal tightening in the near term. Could staff provide an assessment of the impact of a tighter policy stance on GDP growth?***

- (See below)

8. ***We take note of staff's recommendation to increase by 1 percent of GDP the structural primary balance over 2019–20, up to 4.6 percent, to speed up the debt reduction pace and build fiscal buffers. In view of the expected reduction in the pace of growth, the increasing downside risks and the uncertainty on the degree of slack in the Portuguese economy, this may not be the right moment for this recommendation. Has staff estimated the impact of such proposal on Portugal's GDP growth?***

- We have not estimated ourselves a fiscal multiplier for Portugal, but available estimates of first-year fiscal multipliers in Portugal by the ECB are mostly in the range of 0.4 to 0.9, depending on the type of fiscal policy instrument one considers. Reductions in government consumption expenditure are associated with lower multipliers. These are average multipliers over the cycle; with output estimated to be above potential, and in view of the regularity that multipliers decline when output exceeds potential, well established in the literature, it is likely that the multiplier is lower than those average estimates at present. If additional adjustment were postponed to later years, it would likely take place in conditions where the fiscal multiplier would have risen. In addition, as explained in annex 7, monetary conditions in Portugal are presently accommodative, and have become more so in the past year, which would help offset any headwinds coming from the additional fiscal consolidation recommended by staff.

9. ***Could staff comment on the government's intention to further reduce the penalty on early retirement for very long careers?***

- (See below)

10. ***Also, we would welcome comments on the potential impact of reducing the penalty on early retirement on the already expensive pension system.***

- The penalty on early retirement is currently very high, implying a reduction in benefits that exceeds the fair actuarial value of the change in the starting date of benefit payouts. The reform is thus aimed at making the system fairer for those who, for some reason, decide to take early retirement after a very long career, without involving an actuarial loss to the social security system relative to a baseline calculation in which retirement is not advanced. Nevertheless, there will be some upfront cashflow costs, as some individuals will now decide to anticipate their retirement. But these costs are not expected to be significant, given the small number of those eligible for this provision (this group is relatively small, as it concerns persons with very long contributing histories, of 40 or more years). Nevertheless, as articulated in the Article IV, a more general review of the pension system is needed in order to enhance equity in the system and keep a tight control on the trajectory of pension spending.

11. ***Issues of expenditure composition need attention in the context of structural developments. As staff outlines, capital spending is well below pre-crisis and EU averages, compromising potential growth. Against this backdrop, we are somewhat surprised that according to staff the government's budget target for 2019 will also largely be achieved by lower-than-budgeted capital investments. Staff comments on whether this composition is appropriate would be welcome.***

- The authorities indicated that their lower-than-budgeted projection for public capital spending in 2019 reflects an adjustment in the expectations of execution, not a decision to curb investment. In fact, capital spending has been recovering since the trough in 2016. That said, capital spending remains low by historical and euro-area standards, and the authorities should seek to rebalance expenditure towards such spending without jeopardizing the nominal fiscal balance target for 2019 and future years. Indeed, the Stability Program 2019-2023 envisages a substantial increase in capital spending in the years ahead, which is welcome by staff, but remains under pressure from competing claims for current expenditure. This is one of the reasons staff recommends a thorough review of current spending, including the determinants of the evolution of the wage bill.

12. ***While we understand the rationale for staff to lower the medium-term objective of structure balance to 0.0 percent of GDP from 0.25 percent, the authorities viewed this new floor set by staff as too cautious considering recent strong fiscal outcomes and expectations that the authorities would exceed the target with 0.3 percent of potential GDP in 2020. We invite staff comments on the authorities' and staff's conflicting views on the MTO as well as the different medium-term growth assumptions.***

- The MTO is not set by the IMF, but by the European Commission as part of the Stability and Growth Pact. It is based upon a pre-defined formula which calculates a structural fiscal balance consistent with the return of public debt to the benchmark of 60 percent of GDP in the next 20 years. Staff advice is to treat the new MTO as a floor, with overperformance in coming years to accelerate the pace of debt reduction.

13. ***We invite staff comments on the authorities' and staff's conflicting views on the MTO as well as the different medium-term growth assumptions.***

- The authorities do not target a structural primary balance improvement in the 2019-2020 period. Rather, as Mr. Fanizza and Ms Lopes' buff indicates, they commit to saving windfalls in the near term, and project in their Stability Program additional improvements in overall balances in coming years under the baseline, assuming unchanged policies. Nevertheless, meeting the *headline* targets in the Stability Program will, in staff's estimate, require more effort in the *structural* balance front than simply maintaining the MTO, in view of the likelihood that economic conditions will not be as buoyant as in the authorities' projections.
- Our different assumptions have been discussed in previous answers.

Financial sector

14. ***We appreciate staff's box on real estate price developments, and would like to ask the drivers for foreign investment in the sector and if it has to do with differential tax treatment or other factors?***

- Key domestic drivers of foreign investment in the real estate sector include a favorable economic environment, a gradual increase in rents, and a booming tourism sector. Despite the decline in prime yields in most Portuguese real estate market segments in 2018, profitability is higher than in most European real estate market segments (Source: JLL 360 Portugal Real Estate Market), which is attractive for real estate investors searching for yields.
- Although Portuguese banks are not the main drivers of the real estate market, a possible price decrease in this market would have negative effects on the banking sector, constraining the sale of real estate held by credit institutions and hampering the reduction in NPLs associated with credit secured by real estate.

15. ***Could staff already comment on the possible capital shortfalls resulting from the prospective introduction of output floors under Basel IV and the IFRS 9?***

- In its March 2019 Basel III monitoring report, the European Banking Authority (EBA) included a high-level assessment of the potential impact of the finalized Basel III reforms (so called "Basel IV") on EU banks, in anticipation of a more detailed report. However, these data are not granular enough to show the impact on banks by country, including Portuguese banks. The assessment showed the impact for a sample of 123 banks split into two groups, Group 1 banks (consisting of 44 internationally active large banks with Tier 1 capital in excess of EUR 3 billion) and Group 2 banks (representing the remaining 79 banks). The high-level assessment showed that the increase in Tier 1 minimum required capital (MRC) is 19.1 percent across all 123 banks, 20.3 percent for Group 1 banks, and 11.8 percent for Group 2 banks. The output floor and operational risk frameworks are the two major drivers of MRC increases across all banks, accounting for 8.0 percent and 5.5 percent, respectively. For Group 1 banks, the same factors are the major drivers, accounting for 8.5 percent and 6.1 percent. The major driver for the impact on Group 2 banks is credit risk, with an impact of 8.1 percent, followed by the output floor, with an impact of 5.1 percent.
- While EBA's more detailed Basel III implementation assessment will be published in full by end-July, it published a short presentation made at a public hearing on July 2nd. The findings in the presentation were based on June 2018 data and covered 189 institutions (104 large, 61 medium, and 24 small institutions). The findings show that, while the increase in MRC will be 24.4 percent for the entire sample of banks, the impact varies across banks, with average results affected by very large banks. The shortfall in Total Capital is about €135 billion, almost entirely in large banks. For

these banks, the increase in total MRC is around 25 percent, out of which 9.5 percent is due to the output floor. For the medium and small banks, the increase in MRC is respectively 11.3 percent and 5.5 percent, with the standardized approach to credit risk being the main driver. Finally, these impacts are based on the full implementation of Basel III but the effective impact would be lower if the Basel III implementation date and transitional arrangements are taken into consideration, particularly the transitional arrangements for the output floor.

- As detailed in the 2018 Article IV staff report, the impact of the introduction of IFRS9 (which became effective on January 1st, 2018) appears to be manageable. This is due to the positive macroeconomic outlook, increase in impairment recognition over the 2016-17 following asset quality review exercises, and the improvement in market perception about Portuguese banks. In addition, the impact on capital was also smoothened due to the EU regulation on IFRS 9 transitional arrangements which allowed institutions to partially neutralize (over a five-year period) the impact on CET1 resulting due to the increase in provisions resulting from the first-time application of IFRS 9. It is worth noting that 13 banks in Portugal applied the transitional arrangements.

16. ***Could staff elaborate on the heightened competition faced by banks from non-bank institutions and its implications for banks' profitability?***

- The FinTech market in Portugal is evolving at a fast pace. Both the business and the research communities are developing FinTech projects in several domains, some of which are fostered by the Web Summit held annually in Portugal since 2016. One example is Raize, a crowdfunding platform focused on peer-to-peer lending, which was listed on the Euronext non-regulated market segment in July 2018. Portugal already has its first crypto-currency—Bityond—that allows its owners to participate in polls related to the development of the platform created by the company or to donate tokens to the company in order to develop new functionalities and applications. Given these developments, a new communication platform, Portugal FinLab, has been set up between financial sector innovators (start-ups or incumbent institutions) and the Portuguese regulatory authorities (Banco de Portugal (BdP), the Portuguese Securities and Exchange Commission (CNVM), and the Insurance and Pension Fund Authority (ASF)). Through Portugal FinLab, regulators provide clarification to participants regarding the regulatory environment. As a result, the objective of Portugal FinLab is to create efficient communication between regulators and participants, in order to facilitate the understanding of the regulatory reality in which they operate during the creation and development of new projects in the area of FinTech and Insurtech.
- The authorities do not see indications of the adoption on a significant scale of particularly sophisticated technologies by the European financial system, nor of the materialization of risks to financial stability deriving from FinTechs. They believe

that, from a historical perspective, the banking sector has shown the ability to adapt to technological innovation in financial services, internalizing it in order to maintain and strengthen its customer base. The banking system has been an active player in current developments, both as an investor in FinTechs and as partners or clients of those entities, and it may even benefit from this interaction in terms of the cost structure. Thus, even in the financial services' segment where FinTechs relate directly with final customers, the authorities believe that it seems unlikely that their growth would undermine the viability of the more traditional banking sector. They, however, believe that FinTechs require (or accelerate) the evolution and adjustment of the banking system business models.

17. ***We also echo staff in urging the authorities to closely monitor developments in the mortgage market since real estate prices are on the rise and take appropriate measures when needed. Box 1 (p.11) states that "a significant part of transactions driving real estate prices up in key locations are linked to the strong growth in the tourism sector and director investments by non-residents." We welcome staff's analysis on non-residents' property investment such as its cause, composition and possible future effects on the macro-critical vulnerability of the banking system.***

- Please see above answer to q. 14

18. ***Noting that Novo Banco continues to need capital transfers from the budget, we wonder to what extent the overall situation of the banking sector is marked by this single large bank and what the perspectives are of this idiosyncratic risk factor. Staff comments are welcome.***

- Novo Banco is one of the five largest banks in Portugal, and as such it influences average figures for the banking system, especially as it concerns system NPLs. The reduction of NPLs in Novo banco over the past two years, supported by the Contingent Capital Agreement, has thus been an important contributing factor in the overall decline in banking system NPLs. Something similar, if less strong, can be said about the influence of Novo Banco on measures of system profitability, as write-offs have consumed all operational profit at Novo Banco before triggering compensation payments under the Contingent Capital Agreement. Additional steps under this agreement should help reduce NPLs further, but without reducing capital significantly, since the contingent capitalization agreement puts a floor under Novo Banco's capital ratio.
- To elaborate: capital ratios in Novo Banco have been boosted since its sale to Lone Star in October 2017, with the Common Equity Tier 1 capital ratio edging up to 13.5 percent in 2019:Q1 from 12.8 percent at end-2017. Its asset quality has also improved, with the NPL ratio declining 6.3 percentage points from end-2017 to 21.8 percent in 2019:Q1 while the banking system average NPL ratio declined to

9.4 percent in 2018:Q4. At the same time, its impairment coverage ratio increased to 60.1 percent from 56.3 percent at end-2017. Even though its 2019:Q1 impairment coverage ratio was higher than banking system's 2018:Q4 average of 51.9 percent, its NPLs will continue to represent a drag on its profitability and, up to a point, on capital ratios as it sells at deep haircuts and writes off troubled assets covered by the Contingent Capital Agreement. For more details see the staff Report for the 2018 Art. Consultation, which contains a box on this subject.

19. ***While the banking system appears well capitalized and liquid, financial institutions are still addressing legacy non-performing loans (NPLs). That said, banks have been successful in reducing the stock of NPLs by almost a half in recent years. We would appreciate more details from staff on how the authorities were able to do so.***

- As detailed in the 2018 Article IV Staff Report, the European and Portuguese authorities have adopted several measures to address the high levels of NPLs in the Portuguese banking system. At the EU level, the European Authorities implemented the Action Plan to Tackle Non-Performing Loans in Europe that included, inter alia, the following initiatives: guidelines on management of nonperforming exposures and forborne exposures (building up on existing SSM guidelines); a blueprint for asset management companies; measures to strengthen NPL data infrastructure; measures to develop secondary markets for NPLs and enhance the protection of secured creditors; guidelines for the monitoring of loan tapes; measures to enhance disclosure requirements on asset quality; and measures to address potential under-provision of newly originated loans. At the national level, the measures included: (i) the continuous improvement of the legal, judicial and tax framework, including the recent establishment of a common decision body between the tax authority and the social security administration to participate in restructuring negotiations; (ii) the enhancement of in-court restructuring and insolvency frameworks (including through digitalization of processes); (iii) the introduction of several measures to speed up out-of-court settlement procedures; and (iv) ongoing actions to put in place an early warning mechanism and the development of a simplified regime to facilitate the transfer of NPL portfolios.

20. ***Could staff also provide comments on the regulatory landscape for Fintech and crypto assets in the country? Are banks exploring the use of fintech in Portugal to help address the issue of efficiency and profitability?***

- Please see reply to q. 16

Financial supervision framework bill

21. ***We welcome the bill that has recently been submitted to the Parliament, which seeks to reform the supervisory and resolution frameworks and improve coordination among sectoral supervisors. In this respect, we would appreciate staff elaboration on possible ways to address the concerns of supervisors on the viability of the bill in improving coordination among them while preserving their independence and compatibility with ECB requirements.***

22. ***While recognizing the good intentions of the bill proposing the creation of the National System of Financial Supervision, we also note that concerns over some elements of the bill have been raised by Banco de Portugal, Portuguese financial supervisory authorities, and the ECB. Could staff provide more information on the timeline and process of the bill, and updates, if any, on the discussion underway in the Parliament?***

23. ***We would appreciate an update from staff on the status of this reform and the likelihood of changes to address these concerns.***

24. ***Sustained improvements in the health of the financial system must consolidate the recovery accomplished. To this end, we support the reform of the financial supervision and resolution institutional framework and early consensus on the elements of the proposed Bill, to reach a strong, cost-efficient and independent architecture. Could staff offer perspectives on the processes involved and the related timelines?***

25. ***Given the concerns raised by the European Central Bank (ECB) on the recently proposed financial sector supervisory and resolution frameworks, we would appreciate staff's comments on the consistency of the proposed legislation with the Basel Core Principles and the prospect of the bill in the near term.***

26. ***While we understand the government's rationale for introducing the new Financial Supervision Framework Bill, we also note the concerns raised by the three agencies that the FSFB does not only undermine the autonomy of the central bank but introduces complexity, uncertainty and additional costs for the supervisory authorities. We urge the government and the supervisory agencies to continue their inter-agency dialogue to come up with an amicable bill. Mr. Fanizza and Ms. Lopes indicated in their buff that the proposal is now being discussed at the Parliament. Can staff shed some light on the legislative process in Portugal with respect to the FSFB and what are the chances that this Bill will be passed in its proposed form? We invite staff's view.***

- Because these questions are not technical, they will be addressed orally.

Structural

27. ***We note that Portugal has the highest inequality of income distribution for people who are 65 years and older in the Euro Area (See page 16 of staff report). We wonder if staff could comment on the cause(s) of this inequality, and measures to address it.***

- Higher income inequality among the elderly in Portugal reflects two main factors: higher than average income inequality for all age groups, and social security rules that have a comparatively small redistributive effect. Regarding general income inequality, a main underlying force is the significantly higher share of less-educated people (individuals with less than primary, primary and lower secondary education) in Portugal compared to the euro area, especially among the elderly. Concerning the second factor, the dominant role of a defined-benefit scheme with a high replacement rate, with a mild redistributive component, tends to preserve working-age earnings inequality after retirement. One of the measures recommended by staff is, in essence, some moderation of the replacement rate at retirement for individuals with high-salary histories under the social security program. Part of these savings could in fact be redistributed to retirees with low-salary histories.

28. ***We encourage the authorities to prioritize improving the regulatory environment with a view to fostering investment and raising productivity of both firms and labor. In this vein, we note that while Portugal ranks well in the OECD Product Market Regulation Indices relative to its European peers, the country's competitiveness has been constrained by high prices in the energy and transport sectors. We would appreciate staff comments on whether there is scope to reduce these prices to further improve competitiveness.***

- Energy prices in Portugal are above the European average, mainly due to the relatively high level of taxation. Clearly, this raises some trade-offs for policymakers concerned with the overall fiscal balance. That said, as noted in Mr. Fanizza and Ms Lopes' buff, tariffs should be expected to moderate over time as that part of the tariff earmarked for paying down the "tariff debt" declines in tandem with the decline in such debt. In addition, further cooperation with Spain and France on developing key energy infrastructure projects would help to improve competitiveness.

29. ***We take positive note that the authorities are actively enhancing the population's digital skills, and Figure 6 in the main text of the Staff Report suggests that Portugal is above the OECD average in terms of technological readiness. Could staff share more on the authorities' efforts in harnessing the benefits from rapid***

technological development while managing potential risks, including in the area of fintech?

- According to the European Commission report, technological upgrading has taken place in traditional sectors, such as footwear and textiles, which have boosted their global competitiveness and labor productivity (PORDATA and AICEP, 2018). Those sectors have benefited from EU funding and close cooperation with universities and business associations. Other traditional sectors such as agriculture, while benefiting from the support of EU funds, still require continuing investment in technological upgrades and the qualification of its human resources in particular in the rural areas.

30. ***We would like to hear why staff considers the impact on medium-term growth to be more muted than expected by the authorities.***

- See answer to Q. 1

31. ***Figure 6 provides a useful visual summary of the areas of structural reforms where Portugal is ahead of the OECD, and those where it remains behind. Are these indicators up to date (e.g. reflect 2018 status) and are they updated regularly?***

- The indicators are based on the latest available year, ranging from 2013 for some indicators to 2018 for others. Many indicators, such as the OECD employment protection index, are not available on the annual basis. However, staff believes even those indicators that are not regularly updated are useful since they change slowly over time.

32. ***Regarding staff's recommendation to better align wage expansion and productivity developments we would have appreciated more information about overall wage growth beyond public sector wage bill.***

- In 2017 and 2018, the real growth of compensation of employees outpaced real labor productivity growth per worker and per hour, respectively.

33. ***Could staff comment on the prospects of approval of the reform of the labor code, which is still in Parliament?***

- The discussion of the bill in Parliamentary Committee has stalled over differences among political parties on how to implement (and whether to fully respect) the agreement reached a year ago by social partners. The current legislature ends at the end of this month. If the bill does not receive a final approving vote in the floor of the National Assembly by that time, it will have to be resubmitted from scratch in the next legislature.

34. ***Staff comments on specific structural reform recommendations and sequencing would be welcome including what reforms have the most potential to boost productivity growth.***

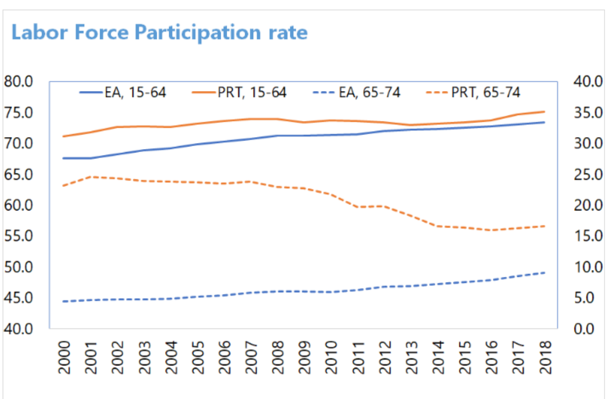
- Raising investment goes hand in hand with encouraging stronger productivity growth, as research at the IMF finds. Ensuring a stable regulatory and tax environment would contribute to limit uncertainty, an important deterrent to investment. Uncertainty, high regulatory burdens and complex licensing procedures feature prominently in various surveys of businesses, such as the EIB's, and were issues raised during meetings between staff and private sector representatives. Continuing support for initiatives such as those described in the answer to q. 29 should also be part of a deliberate approach to boosting productivity.
- Measures to strengthen saving, such as the encouragement of second and third pillar pensions, should also be part of the strategy, as they can help sustain investment. Measures to encourage FDI would also serve this dual purpose of boosting investment and productivity—this is an issue we aim to explore in more detail in the upcoming Art. IV consultation.
- The Banco de Portugal points to the need for better management in small firms, which could boost the productivity of existing resources. Points of contact between

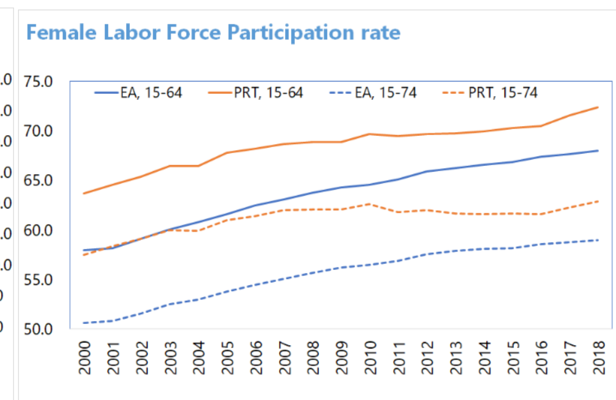
SMEs and the government, such as the tax administration, could offer a channel to disseminate and facilitate better management practices. This is an area that requires further exploration by staff to identify useful experiences.

- The regulatory gap between permanent and temporary contracts needs to be reduced further to tackle the high labor market segmentation by making permanent contracts more flexible. A reduction in the risk of litigation and reinstatement for employers could be achieved by making the receipt of (ordinary) severance pay conditional on individuals renouncing their right to litigation (similar to current practice in Germany).

35. ***Finally, we wonder about the development of labor force participation, particularly in selected age-groups and for women, as measures to raise labor supply may become more relevant given the sustained decline of unemployment and the looming aging issue. Staff comments are welcome.***

- In Portugal, the labor force participation rates (LFPR) for the 15-64 age group stands at 75.1 percent in 2018, above the respective euro area average rate of 73.4 percent. The participation rates are relatively low for young (34.2 percent in Portugal vs 40 percent in the EA) and relatively high for the elderly (16.6 percent in Portugal vs 9 percent in the EA). Female LFPR is relatively high for all age groups except the youth. While the LFPR (and the employment rate) for the 65 and older age group remains above the European averages, the gap has been narrowing. Encouraging participation of this age group is important to mitigate the impact of ageing and declining working age population on labor supply in the longer term.





36. ***We also took note that the minimum-to-median wage ratio in Portugal is one of the highest in Europe and 22.6 percent of total employment contracts are at the minimum wage. We welcome staff's view on what role such minimum policy has played so far in the context of Portuguese economy to diminish income inequality while enhancing domestic consumption.***

- The Portuguese Minimum Wage Reports assert that the recent minimum wage increases positively influenced the income distribution, since unemployment fell and income inequality was reduced during the same time period when the minimum wage increased. More rigorous analysis is needed to analyze these relationships, though, controlling for other factors. We aim to cover this topic in the next Article IV consultation. In general, the impact of the rise in the minimum wage on aggregate poverty seems small, as minimum wage earners represent a small share of the poor. The majority of the poor are unemployed or inactive and therefore do not benefit directly by the minimum wage rise. Empirical evidence suggests that, if the effect is significant at all, an increase in the minimum wage leads to a small decline in poverty (Dube, 2013; Arpaia et al, 2017).

37. ***The development of a private pension coverage could moreover contribute to an increase in household savings which in turn would help channel funding to private and public investment. In this respect, we would be interested in staff's view on the optimal design for Portugal of the complementary second and third-pillar pension schemes.***

- Assets under management in Portuguese private pension schemes are relatively low by European standards. Assets under management in Portuguese funded and private pension schemes stood at 19 percent of GDP in 2017. Meanwhile, assets under management in European funded and private pension schemes represented 41 percent of GDP on average. Portuguese pension schemes are about half occupational and half personal while European private pension schemes are more than 50 percent occupational. Finally, Portuguese pension schemes are more than half based on defined contributions while European pension schemes are more than half based on defined benefits. The literature favors a diversification of risks in pension systems, with private funded and public pay-as-you-go schemes with different risk characteristics, including with respect to political and market risks. In private funded systems, a combination of defined contribution and benefit systems would also be beneficial. Defined contribution systems offer risk sharing among different cohorts while defined benefit systems may offer risk sharing within a cohort.

38. ***We would like to inquire about the state of the authorities' reflection on the recommendations given to spur complementary second-tier and third-tier occupational pension schemes.***

- The authorities need to enact regulations for the complementary professional pension regime as mandated in the pension law. Moreover, fiscal incentives for private pension schemes have been low. They declined in 2011 when measures to raise tax revenues included the reduction of items eligible for tax deductions and the convergence of personal income tax deductions applied to pensions and labor income. As of end-March 2018, own contributions to private pension schemes in Portugal by employees are only 20-percent deductible from the employee's tax liabilities, up to a cap that declines with the employee's age. Employer's contributions to those pensions on behalf of their employee are tax exempted for the employee (i.e., are not treated as income) and are tax-deductible for the employers' tax liability. As a result, low tax incentives for contributions to private pension schemes do not encourage retirement savings.

39. ***We would like more details on the stock of foreign direct investment when compared to the euro area average and the potential in this area. We invite staff comments.***

- Portugal compares favorably with the EU and OECD countries in terms of FDI stock and FDI inflows as a percent of GDP. Foreign direct investment is helping to reduce the investment challenge that Portugal faces. Increased FDI inflows helped to improve the structure of the net international investment position at a faster rate over the past years. The increasing share of FDI in the NIIP also indicates an improved access to loans from foreign-owned parent companies.