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FOR AGENDA

SM/08/298

September 9, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Portugal—Staff Report for the 2008 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2008 Article IV consultation with Portugal, which is tentatively scheduled for discussion on **Wednesday, October 1, 2008**. At the time of circulation of this paper to the Board, the Secretary's Department has received a communication from the authorities of Portugal indicating that they consent to the Fund's publication of this paper.

Questions may be referred to Mr. Daniel (ext. 39698), Ms. Honjo (ext. 34163), and Mr. Xiao (ext. 38725) in EUR.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the European Central Bank forthwith; to the WTO Secretariat on Wednesday, September 17, 2008; and the European Commission and the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

This document, together with a supplement providing an informational annex, will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities. The supplement, which is not being distributed in hard copy, will also be available in the Institutional Repository; a link can be found in the daily list (http://www-int.imf.org/depts/sec/services/eb/dailydocumentsfull.htm) for the issuance date shown above.

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INTERNATIONAL MONETARY FUND

PORTUGAL

Staff Report for the 2008 Article IV Consultation

Prepared by Staff Representatives for the 2008 Consultation with Portugal

Approved by Poul M. Thomsen and Martin Fetherston

September 5, 2008

Contents Page

I. Staff Appraisal and Executive Summary

1. **Weaker global economic conditions underscore the importance of addressing Portugal's long-standing challenges, building on recent achievements.** Portugal has accumulated substantial macroeconomic imbalances, and the policy challenge is to smooth the adjustment, containing domestic demand while increasing productivity and flexibility, rebalancing growth to the external sector. The weaker global conditions should thus be taken as a reason to strengthen efforts to reignite the stalled convergence process: continuing fiscal consolidation and reform; keeping the financial sector sound; and raising the economy's supply capacity; and improving its competitiveness.

2. **Growth will likely slow to about 1 percent in 2008 and to about ¾ percent in 2009.** The current account deficit is projected to widen somewhat over this period and inflation to pick up in 2008 before declining in 2009. The risks to growth seem tilted to the downside, in particular, the slowdown in credit growth, prompted by the international financial turbulence, could be more pronounced. Inflation risks, however, seem tilted to the upside.

3. **Decisive action has reduced fiscal imbalances and enhanced credibility.** Following substantial overperformance in 2007, the government appropriately tightened the 2008 deficit target. However, the cut in the VAT rate and some measures to support those most affected by higher commodity prices and interest rates will reduce the structural consolidation in 2008.

4. **Fiscal consolidation needs to continue in 2009, and there is no scope for any further discretionary loosening.** To ensure the credibility of achieving the Medium-Term Objective (MTO), even by 2011, and to avoid jeopardizing the gains achieved so far, structural consolidation should be at least ½ percent of GDP in 2009, which should be achievable on current policies. Any further measures to mitigate recent commodity price and interest rate increases should continue to be well targeted, temporary, offset by other measures, designed to maximize the supply response, and avoid distorting price signals. Efforts to enhance the quality, transparency, and durability of fiscal consolidation need to continue.

5. **The financial system remains sound and well supervised.** While global financial tensions and the macroeconomic outlook have heightened some existing vulnerabilities, the Bank of Portugal has been pro-active in addressing them, and they should remain manageable and the system resilient. Some further enhancements to the financial stability framework could be considered, including further strengthening liquidity supervision and the deposit insurance system, ensuring adequate capital buffers, and speeding the implementation of the Basle II framework.

6. **At the root of Portugal's economic problems lies anemic productivity growth and a significant external competitiveness gap.** Important steps are being taken to address these challenges. These need to be followed through and assessed, and further reform should focus on making the economy more flexible and competitive:

- **The recent agreement on reforming labor relations is a welcome step forward.** The envisaged higher rate of social security contributions on fixed-term contracts, however, should be reconsidered.

- **The ambitious and broad-ranging SIMPLEX program continues to improve the business climate, and its priority on licensing in 2008 is well placed.** Advantage should be taken of the need to implement the EU Services Directive to make a clean sweep of regulations at all levels of government. The recent public administration reforms should also be built upon to continue to enhance public sector productivity.

- **Competition in domestic markets needs to be further enhanced.** Strengthening judicial system efficiency would improve the Competition Authority's effectiveness. For electricity, it will be important that regulated tariffs are set to ensure full cost recovery that the roadmap for the end of regulated prices be developed, and that opportunities be grasped to increase competition in domestic generation.

7. **The reform momentum needs to be maintained.** Policies should avoid jeopardizing recent achievements and long-term goals for short-term gain, preserving the continuity of adjustment and reform, and avoiding policy drift that Portugal can ill-afford.

8. It is proposed to hold the next Article IV consultation on the regular 12-month cycle.

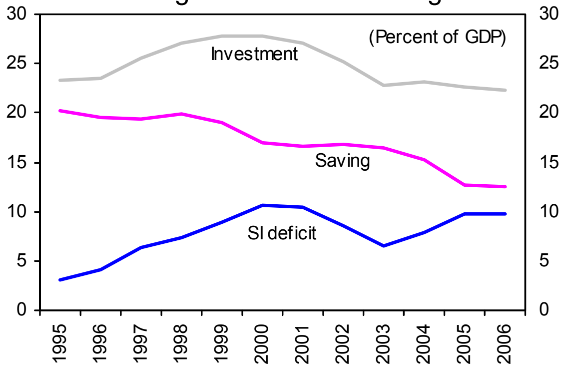
II. Context: Global Headwinds Buffet the Recovery

9. **Portugal's euro-adoption boom turned into a post-adoption bust.** The economy boomed in the run-up to euro entry as real interest rates plummeted; investment, consumption, and wages surged; and fiscal policy loosened, narrowing the income gap with the EU-15. But expectations of higher productivity and growth proved optimistic, and the economy was saddled with macro imbalances: a competitiveness gap; wide current account and fiscal deficits; and, high household, corporate, and government debt.

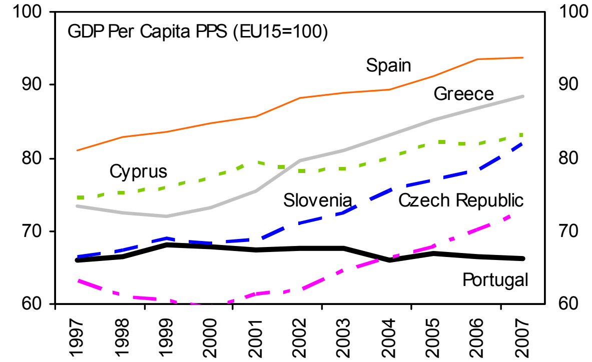
10. **A modest recovery had been underway.** Growth picked up over the previous two years, driven by strong external demand (reflecting a cyclical pick-up in the euro area) and a recovery in business investment. The current account deficit remained around 10 percent of GDP, swollen by continued strong import growth and the widening income account deficit (reflecting the large and growing external indebtedness). Consumer price inflation had been moderating before picking up in recent months, but since late 2007 has been below that of the euro area (in part due to lower regulated prices). Modest employment growth failed to keep

up with continuing labor force growth, leading to unemployment rising to above the euro area average. Limited real wage growth and some improvement in productivity implied little change in unit labor costs.

Portugal has been dissaving...

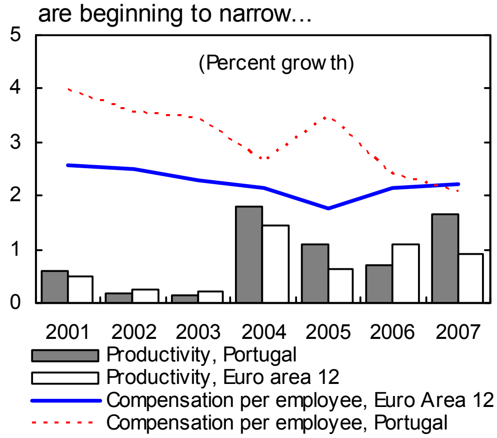


...while falling behind

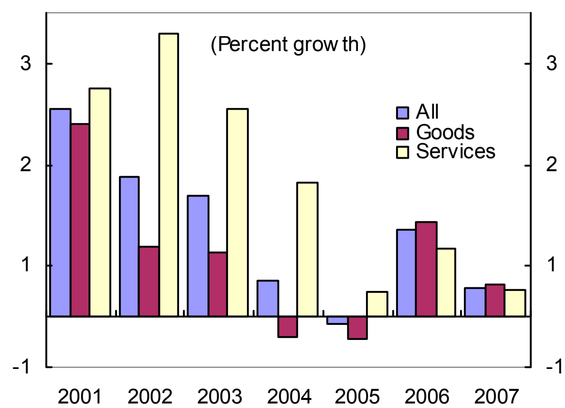


Source: Eurostat.

Labor cost and productivity differentials are beginning to narrow...



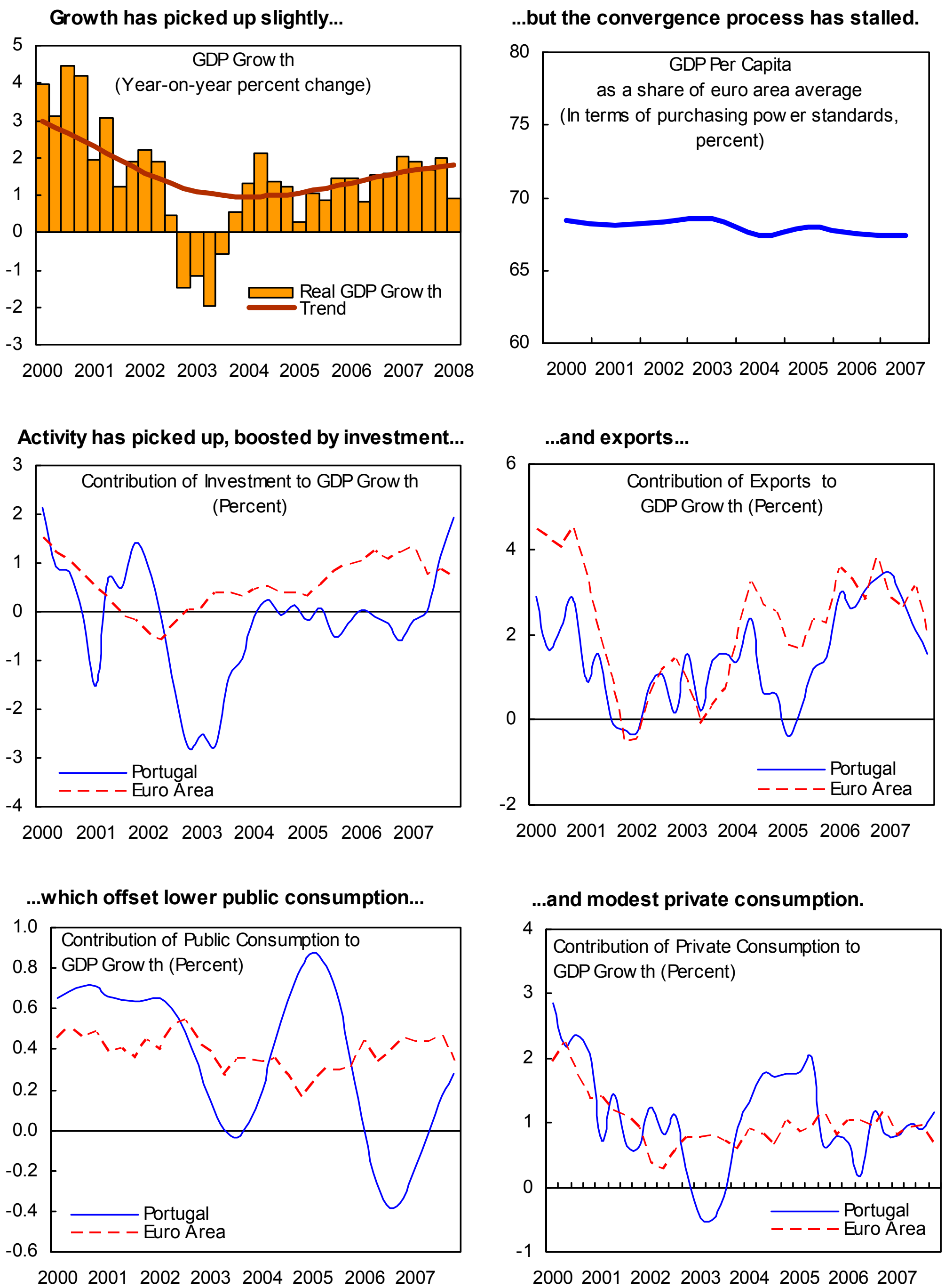
...as are nontradable price differentials



11. **Recent high frequency indicators suggest the economy is being buffeted by headwinds from the global financial turmoil.** Growth slowed sharply in 2008:Q1, largely reflecting weaker exports and investment. More recent data for industrial production, retail trade, and confidence also look weak. Banks have so far been able to sustain credit growth by increasing retail deposit funding, though mortgage growth is slowing. Forward-looking indicators point to significantly slower credit growth as the scope for further retail deposit funding narrows, and banks tighten credit standards.

Figure 1

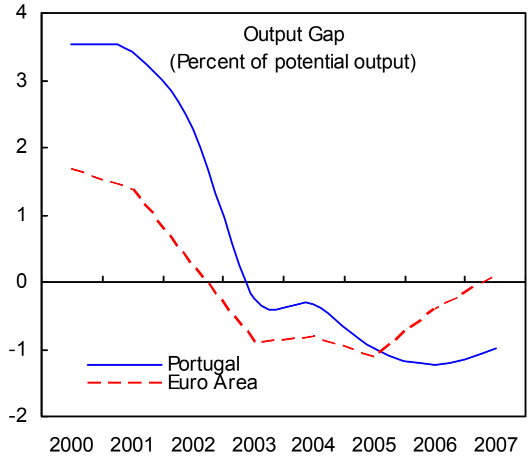
A Modest Recovery Has Been Underway Since 2004…



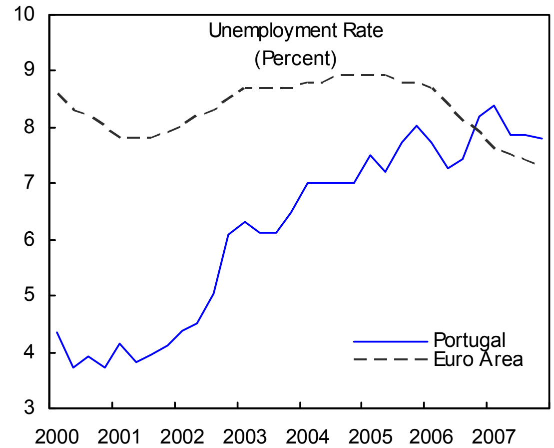
Sources: Bank of Portugal; National Institute of Statistics (INE); and IMF staff calculations.

…But High Frequency Indicators Are Not Encouraging

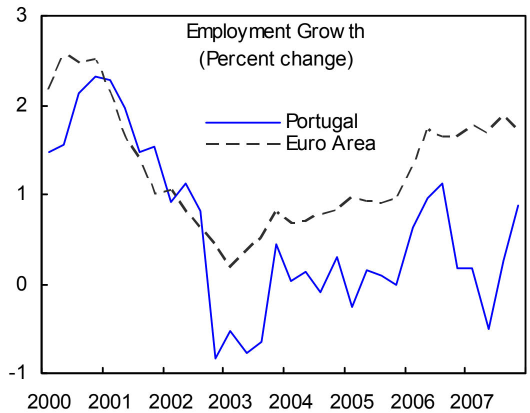
The output gap has remained negative.



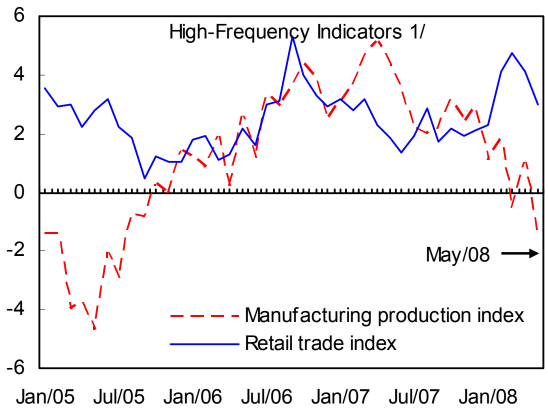
Unemployment has doubled since 2000.



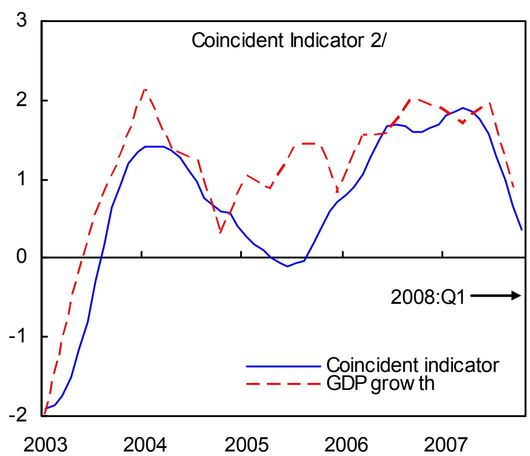
Employment growth is weak, as are…



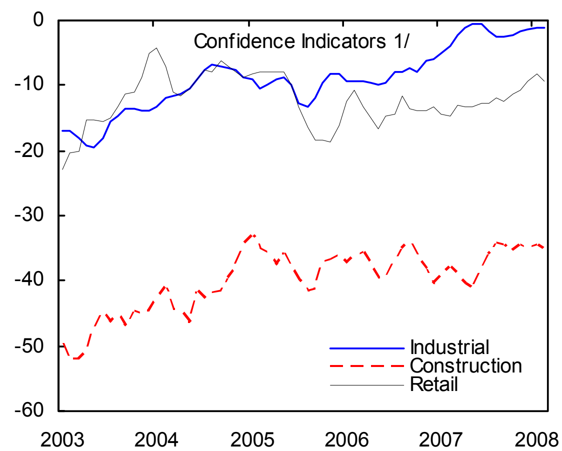
…high frequency indicators…



…the coincident indicator…



…and business confidence.

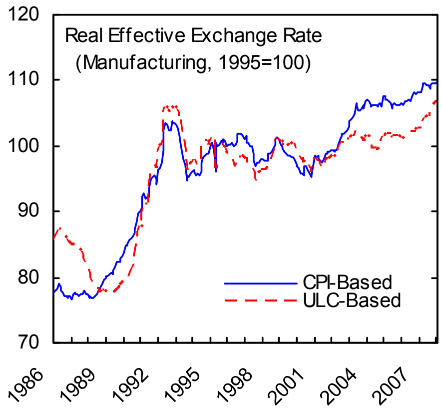


Sources: INE; Bank of Portugal; and IMF staff calculations, end of period.

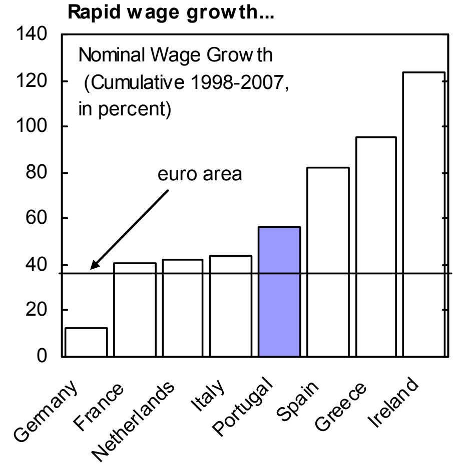
1/ Three-month moving average of year-on-year growth rate.
2/ Year-on-year growth rate (three-month moving average, seasonally adjusted). The coincident indicator is a composite indicator for economic activity published by the Bank of Portugal. It combines indicators of retail sales, heavy commercial vehicle sales, cement sales, manufacturing production, household's financial situation, new job vacancies, and a consumer survey of Portugal's main trade partners.

Portugal Has Lost Competitiveness...

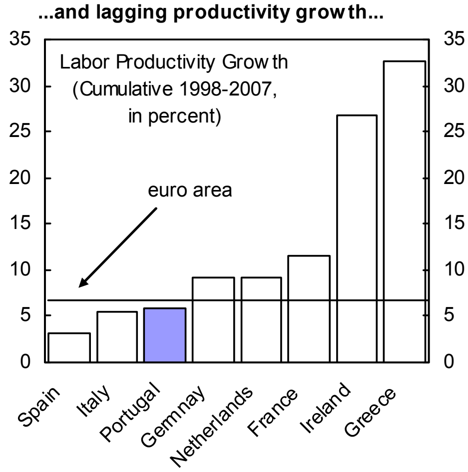
The REER has appreciated.



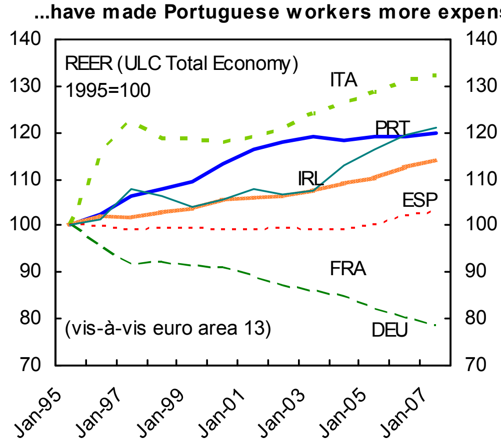
Rapid wage growth...



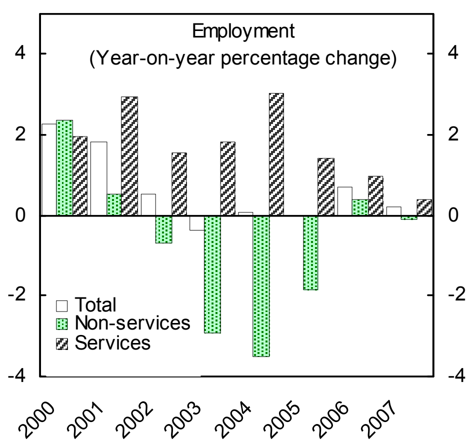
...and lagging productivity growth...



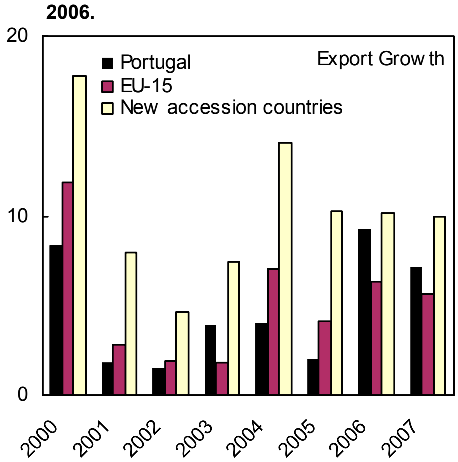
...have made Portuguese workers more expensive.



Employment in sectors more open to competition has declined.



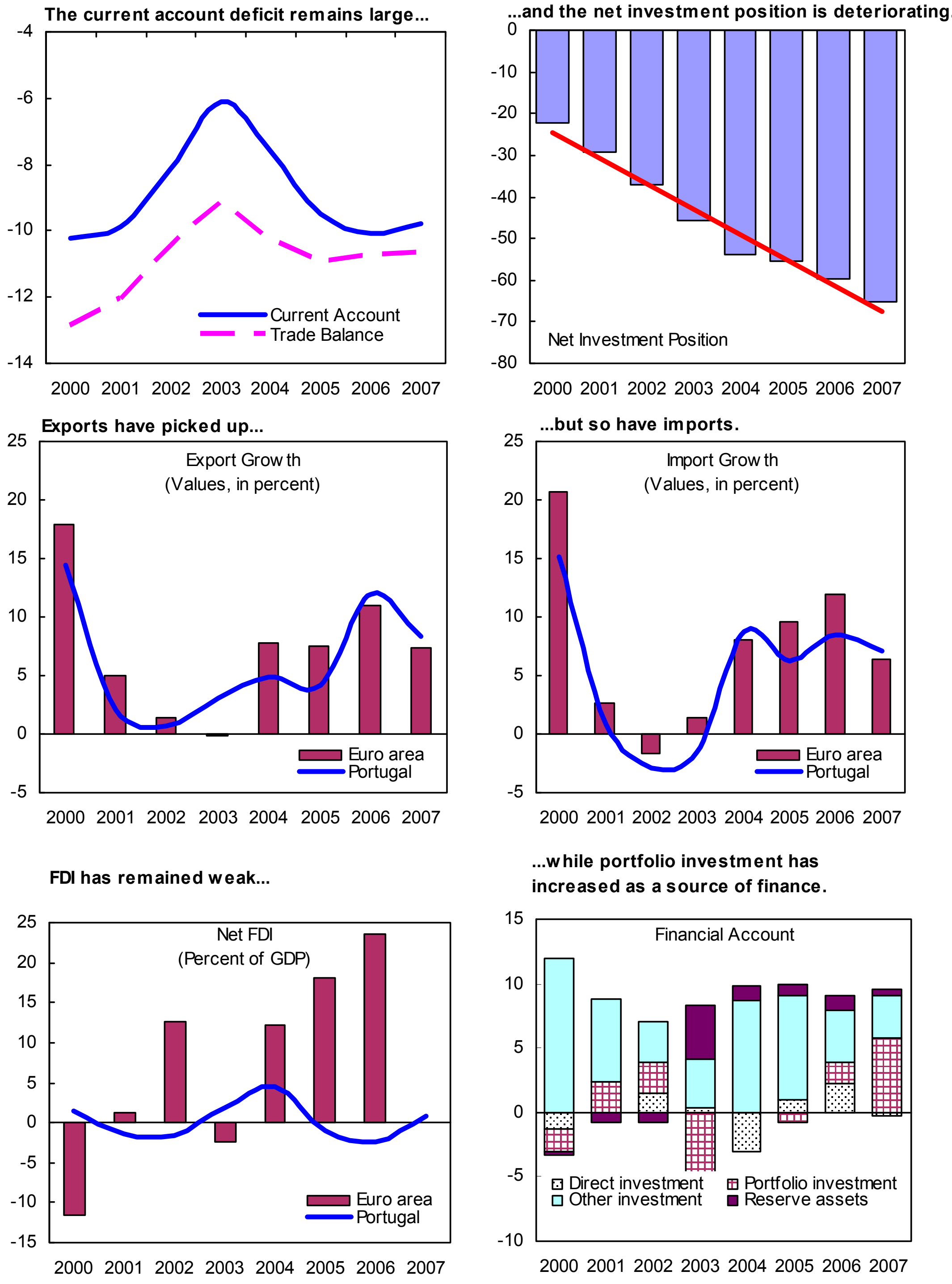
Export performance had been weak until 2006.



Sources: OECD Economic Outlook; AMECO; National Institute of Statistics (INE); Eurostat; European Commission; and IMF staff calculations.

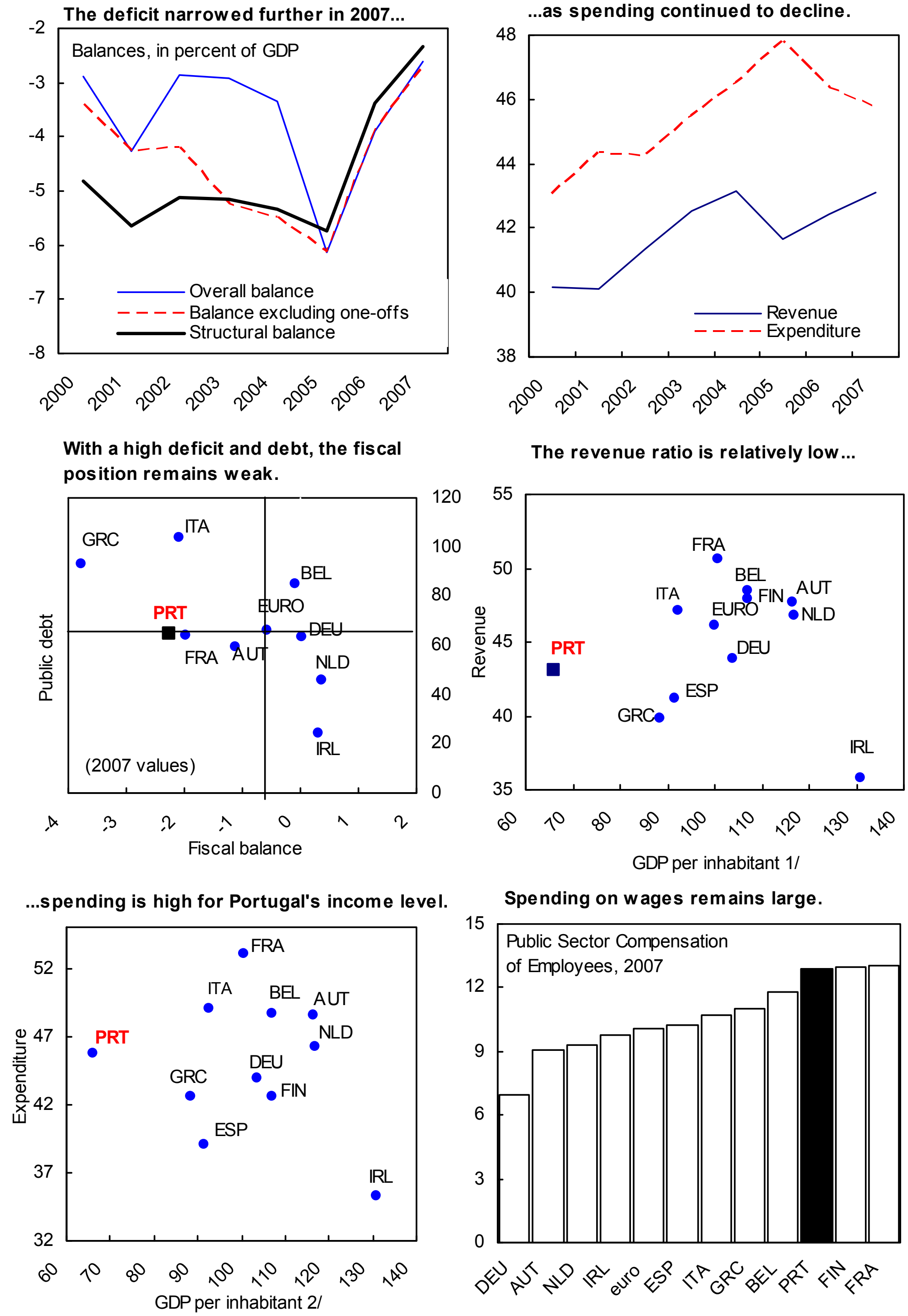
...And the External Accounts Remain Weak

(Percent of GDP, unless otherwise indicated)



Source: Bank of Portugal.

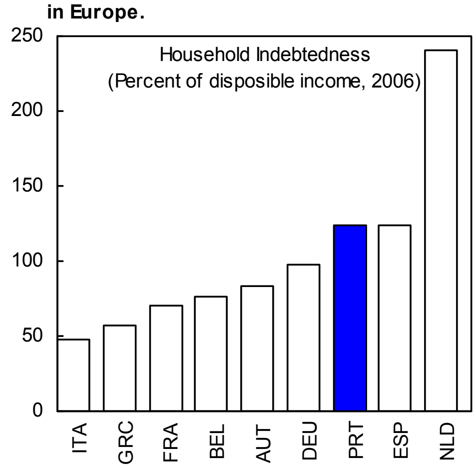
Weak Fiscal Accounts Are Improving
(Percent of GDP, unless otherwise indicated)



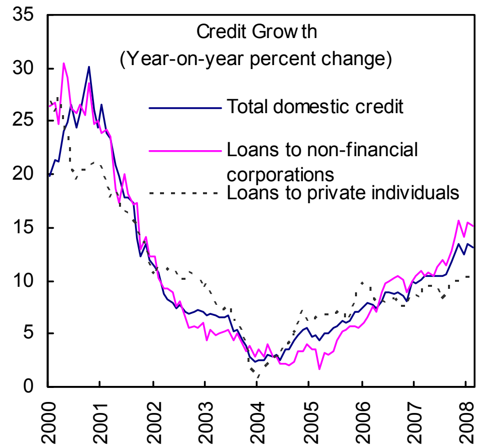
Sources: Bank of Portugal; Eurostat; and IMF staff calculations.
1/ euro area=100; data are as of 2007.

Private Debt Is High and Growing (But No Housing Boom)

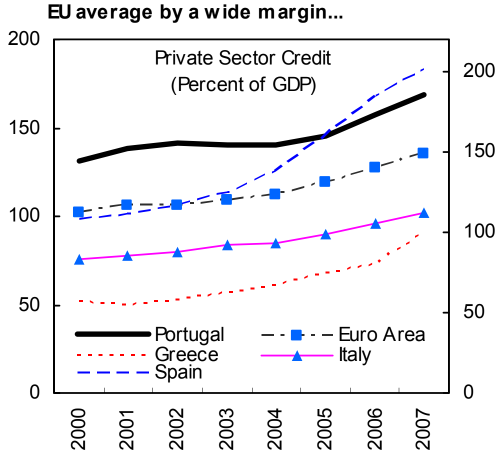
Household debt remains one of the highest in Europe.



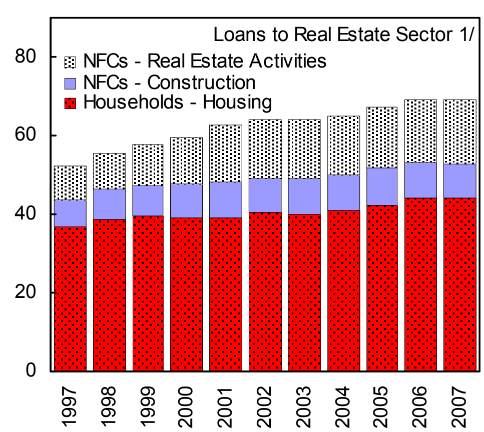
Credit growth is accelerating again.



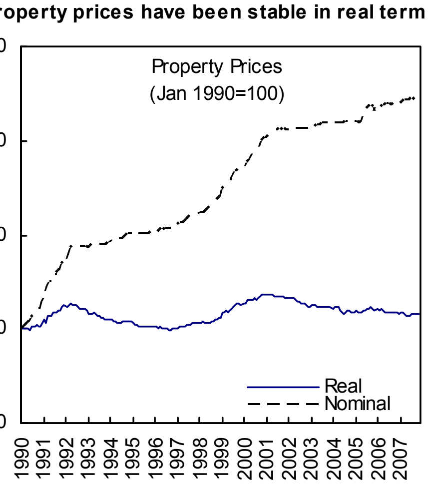
Credit to the private sector exceeds the EU average by a wide margin...



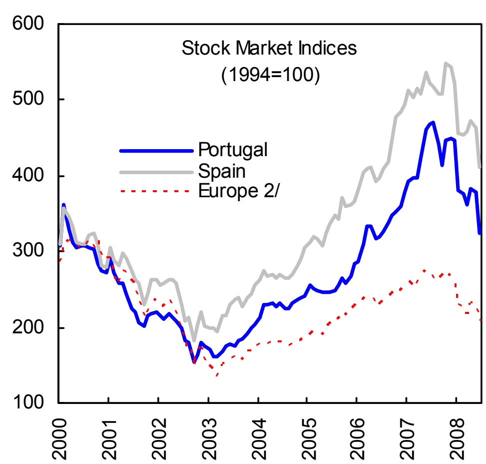
...with large exposures in real estate loans.



Property prices have been stable in real terms...



...while share prices have risen faster than the EU average.

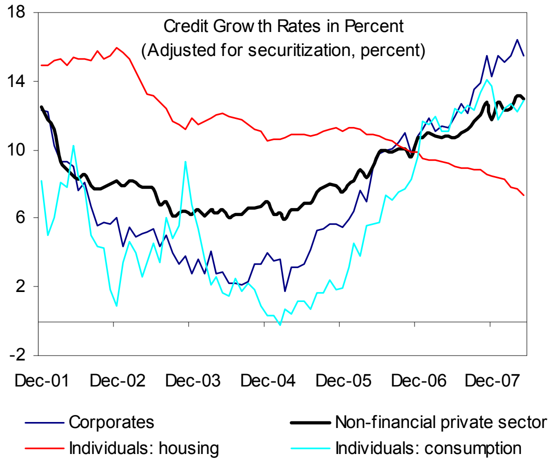


Sources: Bank of Portugal; Ministry of Finance, Monthly Economic Indicators; Datastream; and IMF staff calculations.

1/ Loans to nonfinancial corporations of the construction and real estate sectors and to households for housing as a percentage of total loans extended to the nonfinancial private sector.

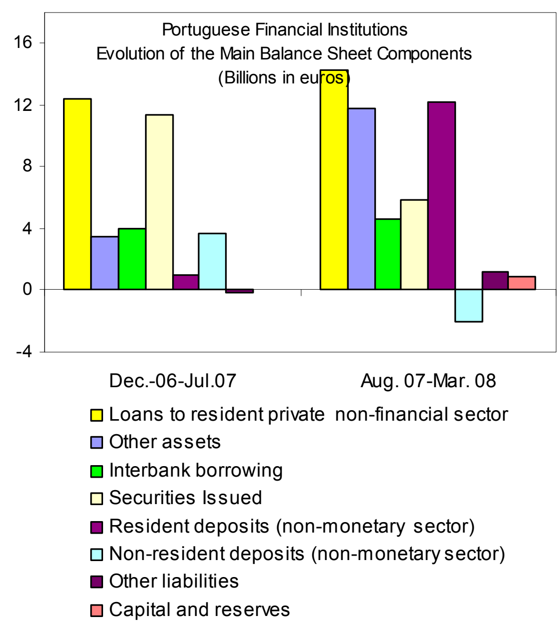
2/ FTSE Eurotop 100 (in euros).

Credit growth remains strong...



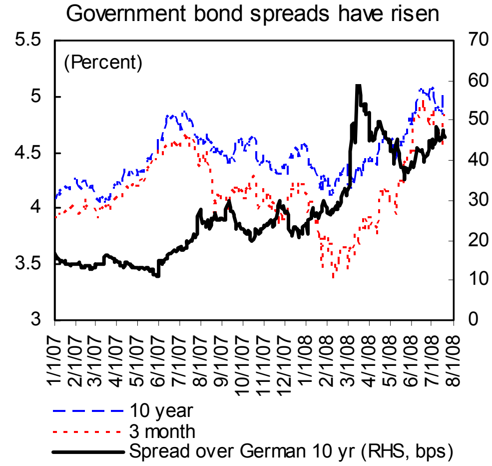
Source: Bank of Portugal.

...funded by retail deposits



12. **The financial system has come under pressure but has so far weathered the storm.** While write-offs arising from U.S. subprime exposure were minimal, CDS spreads for the main banks increased substantially, equity prices declined, and banks' funding through securities dried up. Debt issuance shows signs of recovery in 2008:Q2, although funding costs have increased and maturities shortened. Declining equity valuations of banks' portfolios and employee pension funds and increasing borrowing costs have dented profitability. The stock market has fallen by more than other EU countries (though this reflects larger prior gains), government bonds spreads have risen to close to Italian levels, and corporate borrowing spreads have widened. Housing price growth remains flat in real terms, with real house prices at their long-term average.

Government bond spreads have risen



III. Outlook and Risks: Domestic Imbalances Aggravated by Global Tensions

13. **Staff project growth to slow to about 1 percent in 2008, and to about ¾ percent in 2009.** Key factors behind the slowdown are spillovers from the weaker global outlook (Box 1), higher commodity prices, the stronger euro, and the fallout from the financial turbulence. Thereafter, staff project a modest recovery towards potential and gradual adjustment in the stretched balance sheets, with household consumption growth below that of GDP and business investment growing modestly, constrained by Portugal's still-large

competitiveness gap and weak economic prospects, but with some further structural reform and rebalancing of growth towards the external sector as wages and prices are contained.

14. **Risks to growth seem tilted to the downside.** In particular, the balance sheet adjustment—prompted by the global financial turbulence—could be more rapid, dampening growth over the next few years, which could be exacerbated by failure to implement structural reforms. On the upside, exports could strengthen, driven by somewhat stronger partner country growth and the ongoing restructuring process, especially in the short term.

Box 1. Portugal: Growth Spillovers

Portugal is becoming increasingly integrated in the global economy, and growth appears to have become more synchronized with its partners.

Correlation of GDP Growth Between Portugal and Other Economies

	Correlation (1981–95)	Correlation (1996–2007)
Spain	0.8	0.5
Germany	0.2	0.6
France	0.7	0.7
United Kingdom	0.0	0.6
United States	-0.2	0.6
Netherlands	0.4	0.9
Belgium	0.5	0.4
Italy	0.5	0.6

How much might a slowdown in the EU or the U.S. affect growth in Portugal? Staff analysis, based on VAR methodology, suggests that a one percentage point decrease in the quarterly growth rate of the EU would lead cumulatively to one-third of a percentage point decrease in Portugal's quarterly growth rate, while a one percentage point decrease in the quarterly growth rate of the U.S. would lead cumulatively to an decrease in Portugal's quarterly growth rate by 0.2 percentage points.

Correlation of Stock Market Returns with Portugal

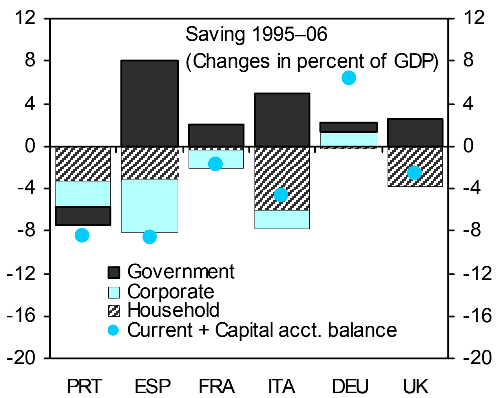
	1993–99	2000–07
United States	0.17	0.91
United Kingdom	0.53	0.93
Spain	0.81	0.92
Germany	0.78	0.90
France	0.44	0.88

Portugal's economy is particularly sensitive to developments in Spain. Staff estimates suggest that, based just on trade links, a one percentage point decline in Spain's real growth would lead to a decline of about half a percentage point in Portugal's real exports and 0.14 percent in GDP. Given the latest WEO exercise projects growth to slow by some 3 percentage points in Spain between 2007–09, this would lower Portuguese growth by about half a percentage point over this period.

Figure 2

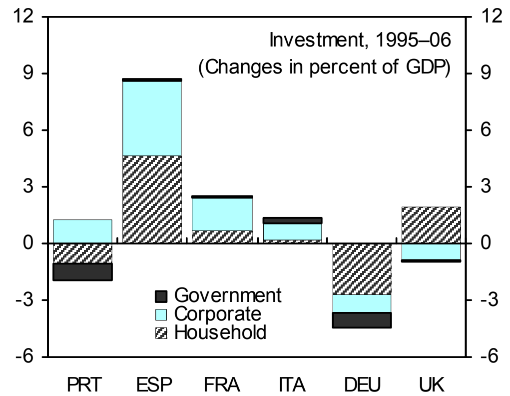
The Current Account and Developments in Private Sector Balance Sheets

A rapid decline in savings by all sectors was behind the widening current account deficit.



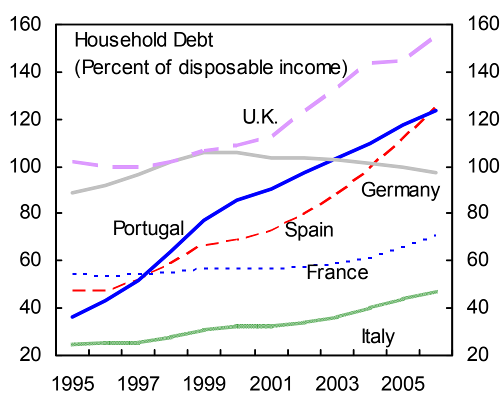
Note: 1995–2005 for Portugal.

Unlike most other euro area countires, there was no sustained increase in investment.

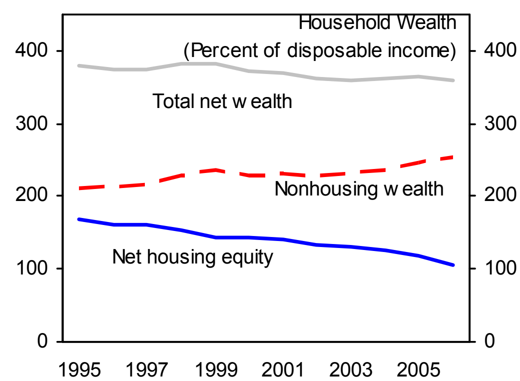


Note: 1995–2005 for Portugal.

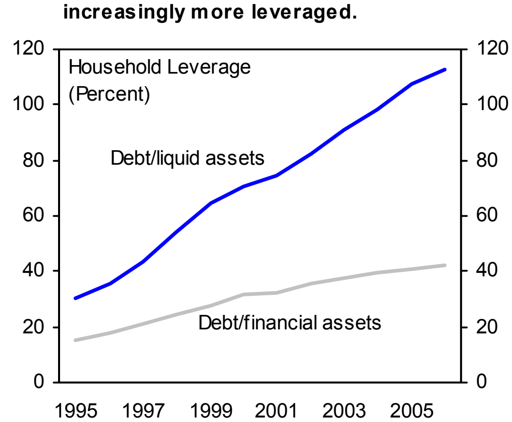
Reflecting financial liberalization and lower interest rates, household debt tripled since 1995.



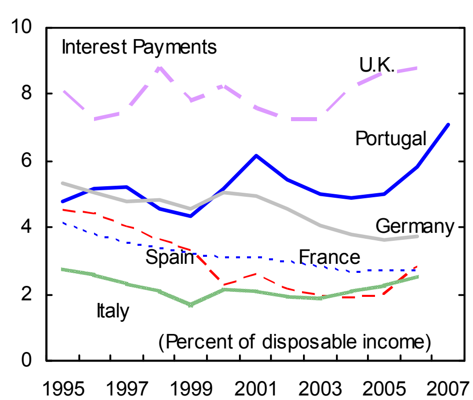
Household wealth and housing equity fell on the back of stagnant house prices and only a modest increase in financial assets.



As a result, households have become increasingly more leveraged.



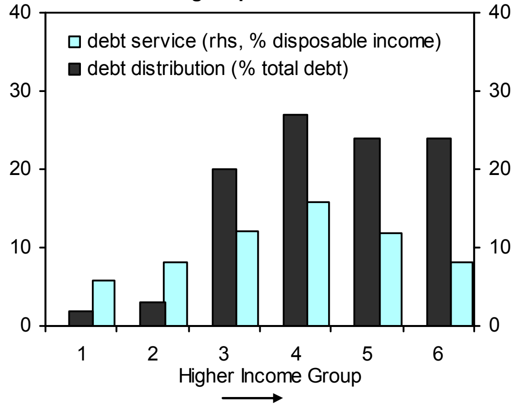
Interest payments continued to rise.



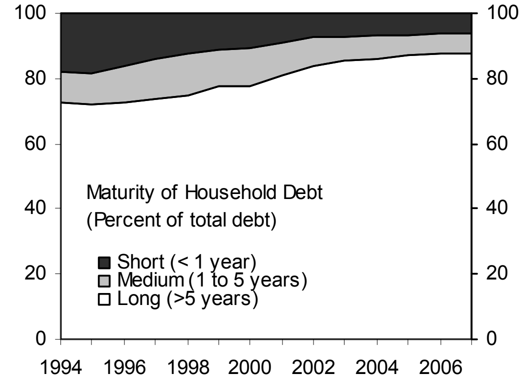
Sources: Eurostat; and IMF staff calculations.

The Current Account and Developments in Private Sector Balance Sheets (Concluded)

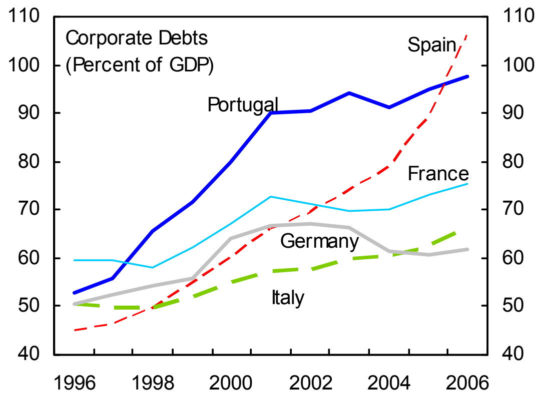
Debt service remained contained, and only a small fraction of total debt was held by lowest income group.



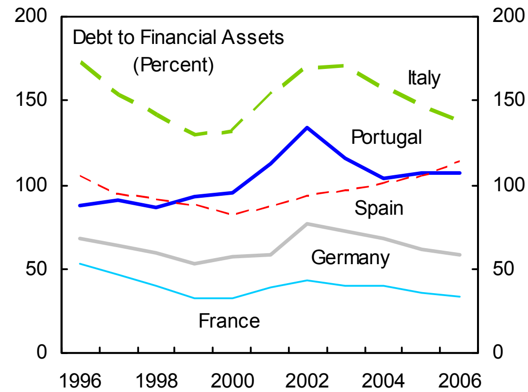
Lengthening of maturities helped limit the increase in debt service.



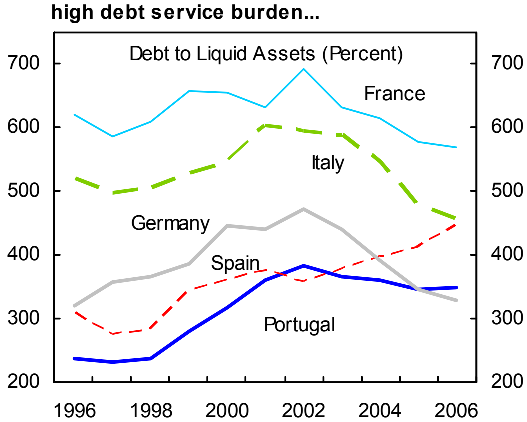
The corporate sector is also highly indebted.



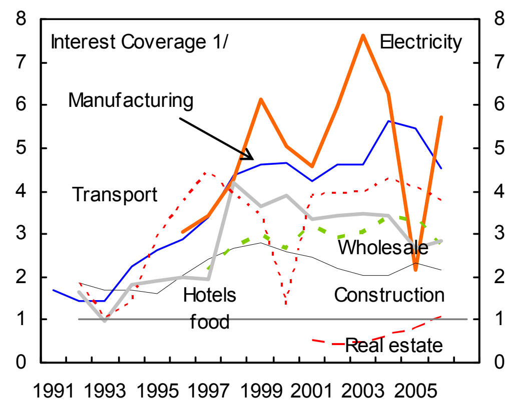
The sharp increase in debt was accompanied by an increase in financial assets, in part reflecting merger and acquisitions.



The share of liquid assets is high in Portuguese companies, in part reflecting the high debt service burden...

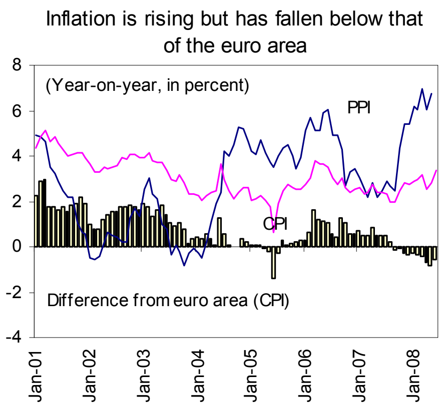


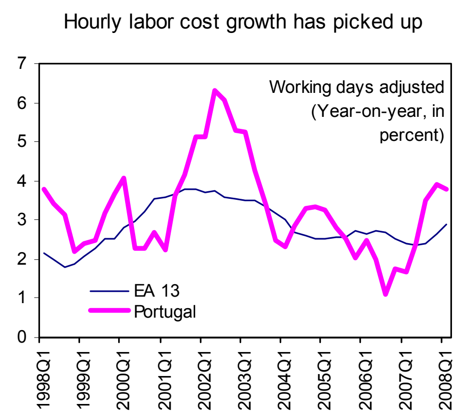
...though considerable dispersion exists among different sectors.



Sources: Eurostat; European Commission; Bank of Portugal; and IMF staff calculations.
1/ Ratio of earning before interest and depreciation to interest payments.

15. **Inflation should stay below the euro area average, though wage growth and high producer prices pose a threat.** The continued weak economy, combined with the VAT rate reduction in July, should allow inflation to moderate in the second half of the year and remain below the euro area average. The risks though are for higher inflation in the near term, as recent stronger wage growth and higher producer price rises may yet be passed on.





16. **The current account deficit is projected to widen, through 2009 but narrow gradually thereafter.** Higher oil prices alone are likely to increase imports by some 3 percent of GDP between 2004–08. In the medium term, import growth is projected to moderate in line with weakening domestic demand and export shares to be maintained, resulting in the current account moderating slightly to about 10 percent of GDP by 2013 (with the income account deficit rising to 7 percent of GDP). The main downside risks are that domestic demand does not moderate and competitiveness deteriorates.

17. **The authorities recognized that the macroeconomic outlook, driven by external shocks, had deteriorated significantly.** The Bank of Portugal's recently revised projections are broadly in line with staff's for 2008, and the somewhat higher growth in 2009 is largely due to their more positive external assumptions. The Ministry of Finance is also likely to revise down significantly their projections in the forthcoming budget. The authorities underscored, however, that achievements over the past two years have placed Portugal in a stronger position to face the current adverse shocks from the financial market turmoil and higher commodity prices.

Comparison of Growth Outlook
(Percent)

	2007	2008					2009					2010		2011		2012	2013
		BoP	MoF	OECD	EC	Staff	BoP	MoF	OECD	EC	Staff	MoF	Staff	MoF	Staff	Staff	Staff
Real GDP	1.7	1.2	1.5	1.6	1.7	1.0	1.3	2.0	1.8	1.6	0.8	2.2	1.5	2.2	1.7	1.8	1.8
Private consumption	0.7	1.3	1.4	1.4	1.2	1.0	0.7	1.7	1.6	1.4	0.9	1.8	1.1	1.9	1.1	1.1	1.1
Public consumption	0.1	-0.2	-1.1	0.5	0.3	-0.6	0.0	-0.6	0.5	0.5	-0.6	-0.3	-0.3	1.1	0.4	0.4	0.4
Gross fixed investment	3.0	1.0	3.5	3.0	2.9	1.6	1.2	5.5	3.1	1.4	1.5	5.7	1.9	5.5	1.8	1.6	1.6
Exports	8.1	4.4	5.3	4.0	4.6	4.2	4.0	4.7	5.3	4.2	3.5	5.1	5.0	5.2	4.9	4.9	4.8
Imports	5.2	3.3	4.3	3.7	3.3	3.2	2.1	4.5	4.3	2.8	2.9	5.0	3.3	5.3	3.1	2.9	2.9
CPI inflation	2.4	3.0	2.6	3.0	…	3.2	2.5	2.2	2.2	…	2.1	2.0	2.1	2.0	2.1	2.1	2.1
Partner countries real imports	5.8	…	4.9	…	…	4.8	…	4.2	…	…	3.5	6.7	5.0	6.7	4.9	4.9	4.8
Current account	-9.9	…	…	-11.6	-10.1	-11.7	…	…	-11.6	-9.4	-12.0	…	-11.6	…	-11.1	-10.5	-9.9
Current account (including capital transfers)	-8.6	-10.6	-8.5	…	…	-10.4	-11.1	-8.7	…	…	-10.7	-8.7	-10.3	-8.6	-9.8	-9.2	-8.6

Sources: Bank of Portugal Economic Bulletin (Summer 2008); Ministry of Finance (May 2008); OECD Economic Outlook (June 2008); EC Spring Economic Forecasts 2008; and IMF staff projections.

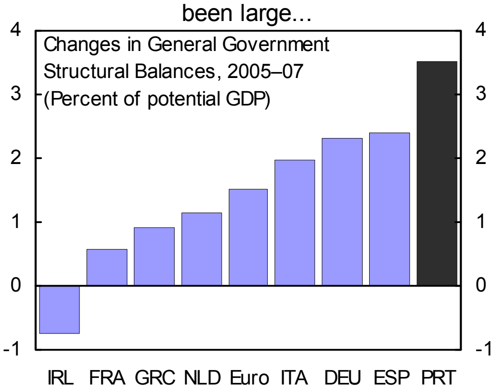
IV. The Policy Agenda: Promoting Adjustment and Growth

18. **Policies should focus on fostering the smooth unwinding of macro imbalances to address the main challenges to domestic[1] stability:** i) achieving fiscal soundness; ii) ensuring financial stability; and iii) enhancing growth and competitiveness. Given the rigidity of the economy and the accumulated macro imbalances, meeting these challenges will likely prove long and demanding—marginal changes are not enough, and a critical mass of supply-oriented reforms is necessary to rebalance growth to the external sector and reignite the convergence process.

A. Challenge 1: Achieving Fiscal Soundness

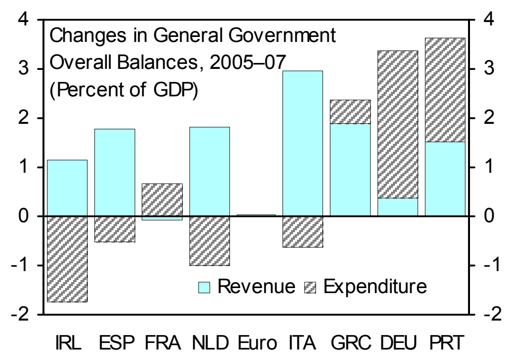
19. **Decisive action has reduced fiscal imbalances and enhanced credibility, putting the fiscal accounts on a stronger footing to face the current more difficult economic circumstances.** Since 2005, the deficit has fallen by 3½ percentage points of GDP to 2.6 percent of GDP in 2007—the lowest level for some 30 years, allowing Portugal to exit the Excessive Deficit Procedure a year earlier than envisaged and the debt-to-GDP ratio to fall. The consolidation has, appropriately, been driven by containing primary current spending. Revenue overperformance has also contributed, due in significant part to enhanced revenue administration. While euro area countries in general have also improved their fiscal position over the past two years on the back of favorable cyclical conditions, the improvement was largest in Portugal.

Portugal's recent consolidation has been large...



Source: WEO.

...and expenditure based



Note: Expenditure in oppositve sign. (+) means reduction.

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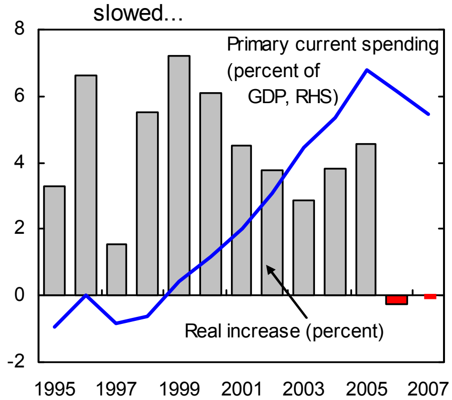
[1] Accounting for less than 2 percent of euro area GDP and financial assets, and 4 percent of euro area country current account imbalances, Portugal has only a minimal impact on the union's balance of payments and hence external stability.

20. **The deficit fell by more than a percentage point of GDP in 2007, exceeding targets.** This considerable overshooting stems mainly from higher revenue, which was largely saved. Current revenue increased by nearly a percentage point of GDP in the year, about half of which seems due to improved administration. Two facts stand out:

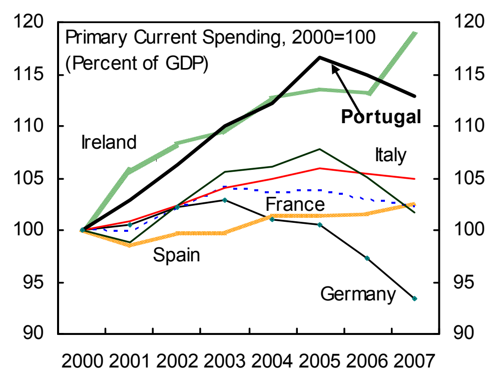
- The lion's share of the revenue overperformance came from buoyancy in income tax, especially corporate. This reflected more taxpaying firms and better financial results by large taxpayers. In contrast, indirect tax revenue declined slightly due to moderate household consumption growth.

- Primary spending continued to fall—both as a share of GDP and in real terms—driven by the wage bill, reflecting the elimination of automatic career progression, base wage growth below inflation and a two-for-one hiring policy. Unemployment benefits also declined reflecting tighter criteria introduced in 2006.

Primary current spending has slowed...



...but had increased rapidly.



Source: Eurostat.

21. **Fiscal consolidation is set to continue in 2008, though at a slower pace.** Following substantial overperformance in 2007, the government appropriately tightened the deficit target to 2.2 percent of GDP. However, the cut in the VAT rate by a percentage point[2] and some specific measures to support those most affected by higher commodity prices and interest rates[3] will reduce the structural consolidation to somewhat below ½ a percent of GDP.

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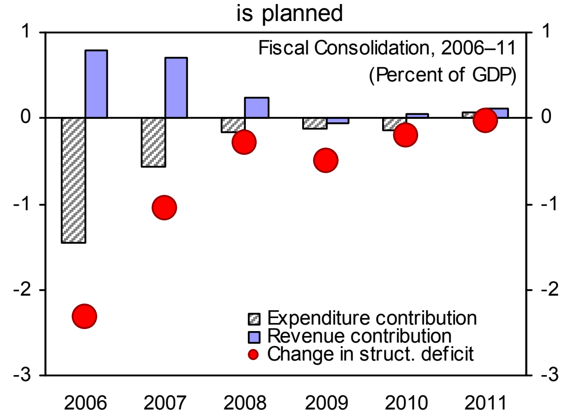
[2] The tax cut is estimated to reduce revenue by 0.4 percent of GDP on an annual basis.

[3] These included suspending the inflation adjustment of the petroleum excise, a 25 percent increase in child support, lower toll charges, and higher interest rate deductibility for low-income households. While in general staff does not support tackling interest deductibility, the measure introduced was well targeted, with limited implication for distorting price signals.

22. **The fiscal authorities emphasized the adjustment in 2008 needs to be assessed in the context of the consolidation process that started in 2005.** Two years of significant overperformance had to be balanced against the growing pressures to respond to short-term output-stabilization and social assistance concerns. They argued that the cut in the VAT rate announced in March aimed at providing some stimulus to the economy given stronger than expected overperformance in 2007 and the early signs of weakening economic activity. As the economy was further buffeted by the external shocks, additional measures were required to support those most affected by high commodity prices and rising interest rates.

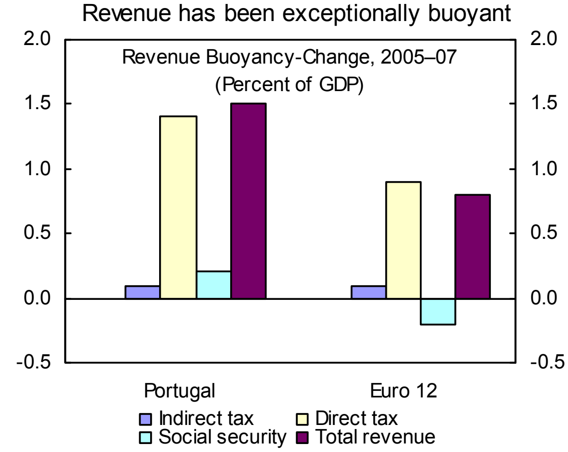
23. **Despite impressive recent consolidation, Portugal's fiscal situation remains weak, and consolidation needs to continue in 2009.** Public debt remains above 60 percent of GDP, the MTO of a structural deficit of ½ a percent of GDP remains a long way off, and Portugal's external imbalances continue. To ensure the credibility of achieving the MTO, even by 2011, and to avoid jeopardizing the gains achieved so far, structural consolidation should be at least a ½ percent of GDP. Such an adjustment in 2009 should (just) be achievable on the basis of current policies—there is no scope for further discretionary loosening. Beyond 2009, additional measures of about 1 percent of GDP will likely be needed to reach the MTO.

Further expenditure based consolidation is planned



24. **There are, however, considerable risks to the envisaged consolidation.** The recent revenue buoyancy, especially of corporate income tax, may not be sustained. On the spending side, particular care should be taken to maintain current wage restraint, not only to foster competitiveness and consolidation, but also to prevent "second-round" effects feeding into inflation. The benefits of the public administration reform also still need to be realized[4] to make the wage bill consolidation more durable and the administration more productive. Any further measures to mitigate

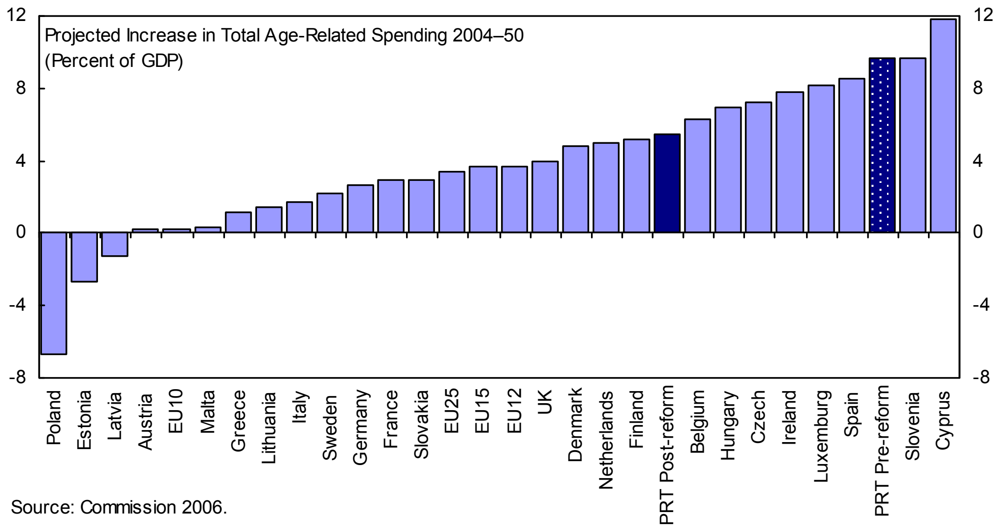
Revenue has been exceptionally buoyant



[4] Recent reforms included reducing the number of types of public sector contracts, introducing a merit-based system for promotion and pay increases, and an internal mobility scheme.

recent commodity price and interest rate increases should continue to be targeted, temporary, offset by other measures, designed to maximize the supply response, and to avoid distorting price signals. Indeed, as the heightened spreads on Portugal's government debt indicate, there is little room for maneuver, and the costs of slippage are high. The MTO may also need eventually to be improved upon to address longer-term pressures such as population aging.

Age-related spending is still likely to rise sharply



Source: Commission 2006.

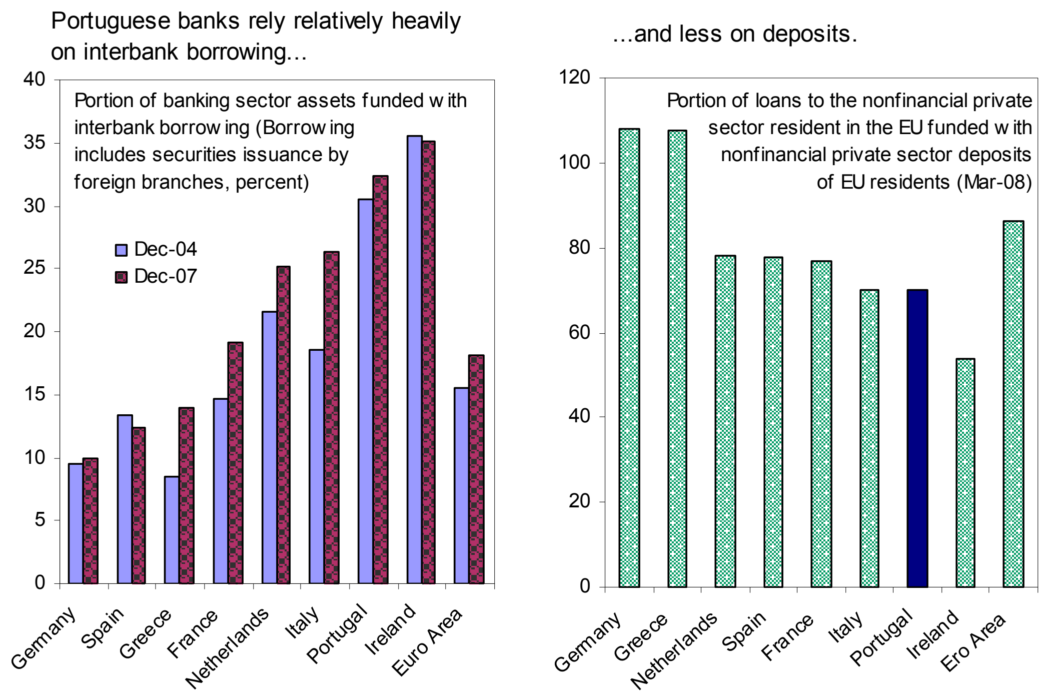
25. **The fiscal authorities agreed with staff on the extent of the needed consolidation.** They acknowledged that the previously envisaged consolidation of 0.8 percent of GDP in 2009 had become less realistic given economic developments, and to ensure the credibility of achieving the MTO and to not undermine gains achieved so far, structural consolidation of at least a ½ percent of GDP should be targeted. The new fiscal targets would be spelled out in the context of the 2009 Budget to be published in October.

26. **Efforts to enhance the quality, transparency, and durability of fiscal consolidation need to continue.** In particular, progress should continue to be made on performance-based budgeting and a binding medium-term framework. Continued progress needs also to be made on divesting and reforming public enterprises, including greater use of performance evaluation, centralizing the ownership function in the Ministry of Finance, and enhancing transparency in public accounts. Especially in the current economic context, the program to make public agencies pay on time needs to be strictly enforced and possibly made more ambitious.

B. Challenge 2: Ensuring Financial Stability

27. **While Portugal's financial system remains sound and well supervised, vulnerabilities have risen.** Portuguese banks' reliance on wholesale funding raises liquidity risks, and banks are exposed to market risk through employees' pension funds and banks'

own investment portfolios. High household and corporate debt increases credit risk given rising interest rates and the weak macroeconomic outlook, and loan concentration in some banks to certain sectors and large exposures appears significant.



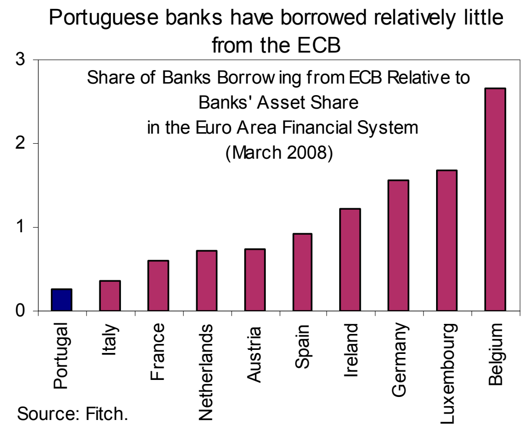
Sources: BIS, Locational Banking Statistics; and ECB, aggregated balance sheet of euro area monetary financial institutions.

28. **Staff's stress tests indicate that the current environment poses risks, although these seem manageable, and the system should be resilient.**

- Simulation of the evolution of the main balance sheet components indicate that while credit growth will likely decelerate, it would not grow more slowly than nominal GDP. A credit crunch seems unlikely except in a rather extreme scenario where banks cannot rollover maturing securities and a large proportion of interbank loans, for example, due to a worsening of the global liquidity situation.

- Analysis of corporate balance sheets suggests that declining profits and increasing interest rates could almost triple existing corporate nonperforming loans. Nevertheless, bank profitability, provisioning and capital levels should provide adequate buffers to absorb this shock, although some banks would likely need to reinforce their capital positions.[5]

- Liquidity shocks are more of a concern but again seem largely manageable. Compared to peers, Portuguese banks' liquidity appears a little low in general on some measures, but at the consolidated level, banks are required to cover 90 percent of one-month liabilities plus financing gaps over a one-year horizon with liquid assets.



Source: Fitch.

29. **The authorities are well aware of the vulnerabilities and have been pro-active in addressing them.** Banks with weaker capital ratios have been strongly encouraged to raise capital, and two large private banks and one small one have increased capital through rights issuance and profit allocation, while others have announced plans to increase capital by year-end. Banks were recently encouraged to issue securities to retain in their portfolio to use as collateral for central bank lending as a precautionary liquidity measure, although Portuguese banks have made relatively little use of ECB funding due to the increase in retail deposit funding. The Bank of Portugal has enhanced monitoring of banks' liquidity positions and banks' plans to address potential liquidity shortfalls.

30. **These measures are welcome, and some further enhancements to the financial stability framework could be considered.** Many of these are already under consideration, including in the context of ongoing changes in the international financial architecture. To further strengthen liquidity supervision, a zero maturity gap could be required at the 15-day or one-month horizon and, in line with recommendations from the Basel Committee, haircuts for structured products might warrant reconsideration. The Bank of Portugal should ensure that banks have appropriate internal limits on sectoral credit concentrations and large exposures, in compliance with the internal controls instructions. Stress tests could be more proactively used to assess the adequacy of capital buffers. If Tier I capital ratios were to fall significantly below 7 percent, banks should be encouraged to raise capital. In the context of Basel II implementation, banks' own risk-management models should be validated. The transition to full economic provisioning might also usefully be completed.

[5] Stress tests of corporate balance sheets assumed a 30 percent decline in profitability and 100 b.p. increase in financing costs. Bank stress tests assumed that NPLs would reach 3 percent of total loans, in line with the corporate stress test and historical data, and a 50 b.p. decline in net interest margins. Banks were required to maintain current provisioning levels.

31. **In the context of EU-wide revision of deposit insurance schemes, the opportunity should be taken to further enhance the deposit guarantee fund (FGD).** In particular, the maximum period for the payment of guaranteed deposits could be substantially shortened. Consideration could also be given to updating the guaranteed amount, setting a target coverage ratio for FGD resources, including the minimum cost principle for the FGD, and to altering the provider of emergency FGD lending from the Bank of Portugal to the Ministry of Finance.

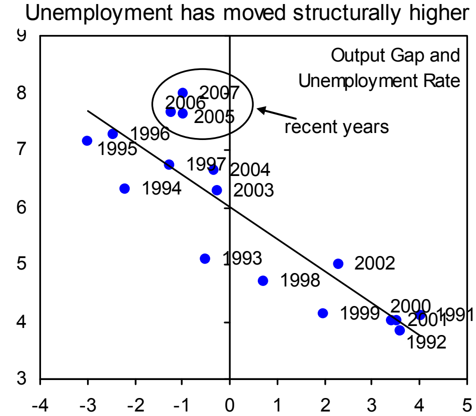
32. **Given Portugal's external imbalances, household savings need to rise over time.** Recent reforms of the social security system and the benefits of enhancing banks' domestic retail funding also call for more proactive promotion of household savings. A key channel for such savings are occupational pension schemes, but these are relatively undeveloped—consideration should be given to conducting a public financial literacy campaign and to introducing "soft compulsion" schemes that require opting out of, rather than into, occupational pension schemes (e.g., the U.K.'s "National Pensions Savings Scheme" or the New Zealand "Kiwisaver" plan).

33. **The authorities welcomed staff recommendations to further enhance the financial stability framework, indicating that many of the measures were already under consideration.** On further strengthening liquidity supervision, requiring banks to implement a zero maturity gap at the 15-day or one-month horizon would be considered, but this was not a priority as most banks tend to maintain net positive liquidity positions for those time horizons. The authorities agreed that transition to economic provisioning on an individual basis, similar to what is already implemented at the consolidated level, would be desirable. While acknowledging the difficulties in setting the appropriate parameters to conduct stress tests in the current environment, the authorities considered that they could take more advantage of banks' internal stress tests for supervisory purposes. The areas for enhancing the FGD would also be considered in the context of EU-wide revision.

C. Challenge 3: Enhancing Growth and Competitiveness

34. **At the root of Portugal's problems lies a severe lack of productivity.** This in turn reflects a rigid economy, as well as other structural factors relating to human capital and the justice system. Unlike other EU countries, including those with weak growth (such as Italy), unemployment has risen, apparently structurally as the historical relationship with the output gap seems to have broken down. Employment protection legislation remains among the most restrictive in the OECD, and total factor productivity growth has been

Unemployment has moved structurally higher

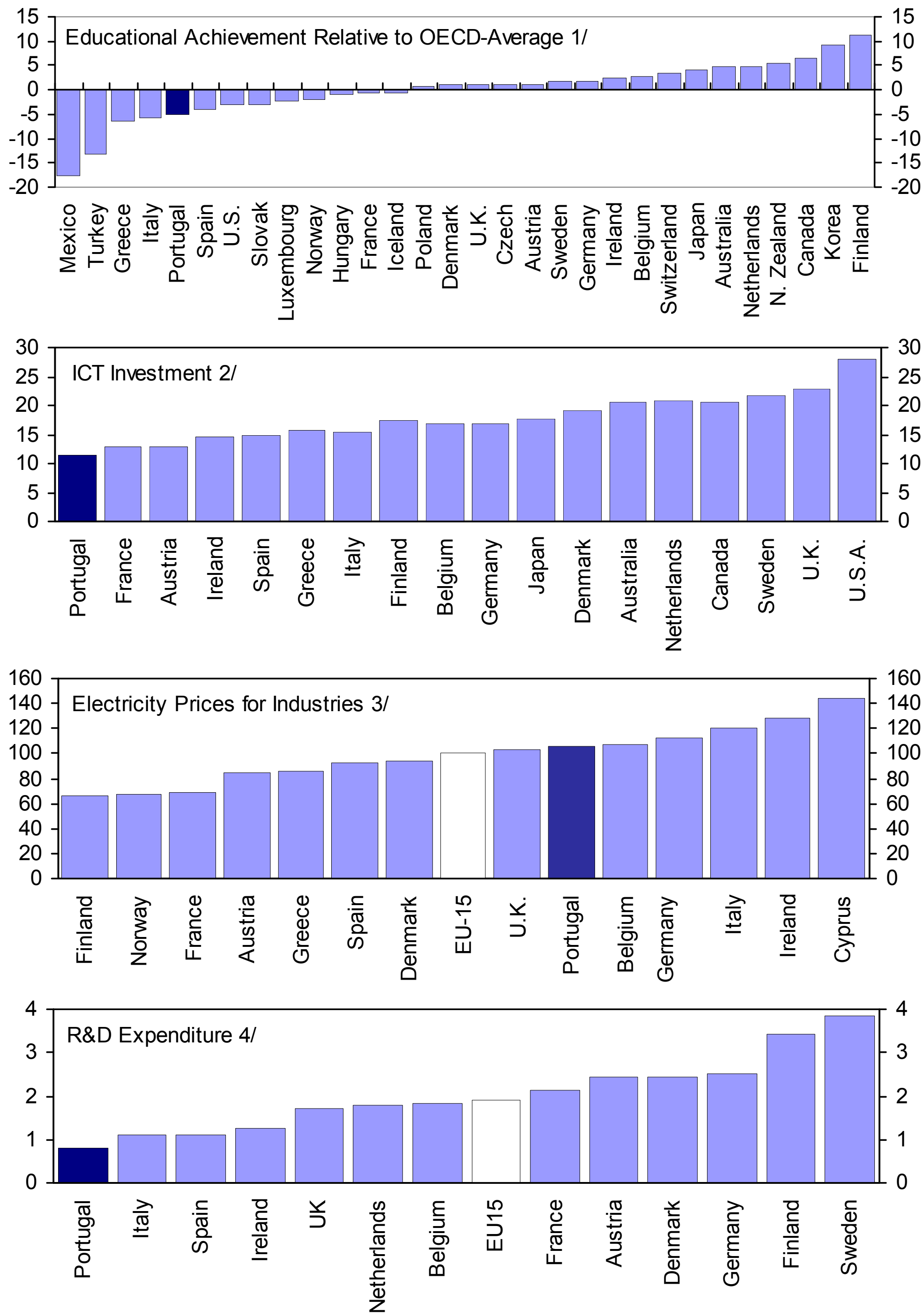


Sources: BOP; and Eurostat.

stagnant in recent years. Surveys of the business environment point to some progress but with substantial scope for improvement.

Figure 3

Structural Indicators Are Weak



Sources: OECD; EUROSTAT; and IMF staff calculations.

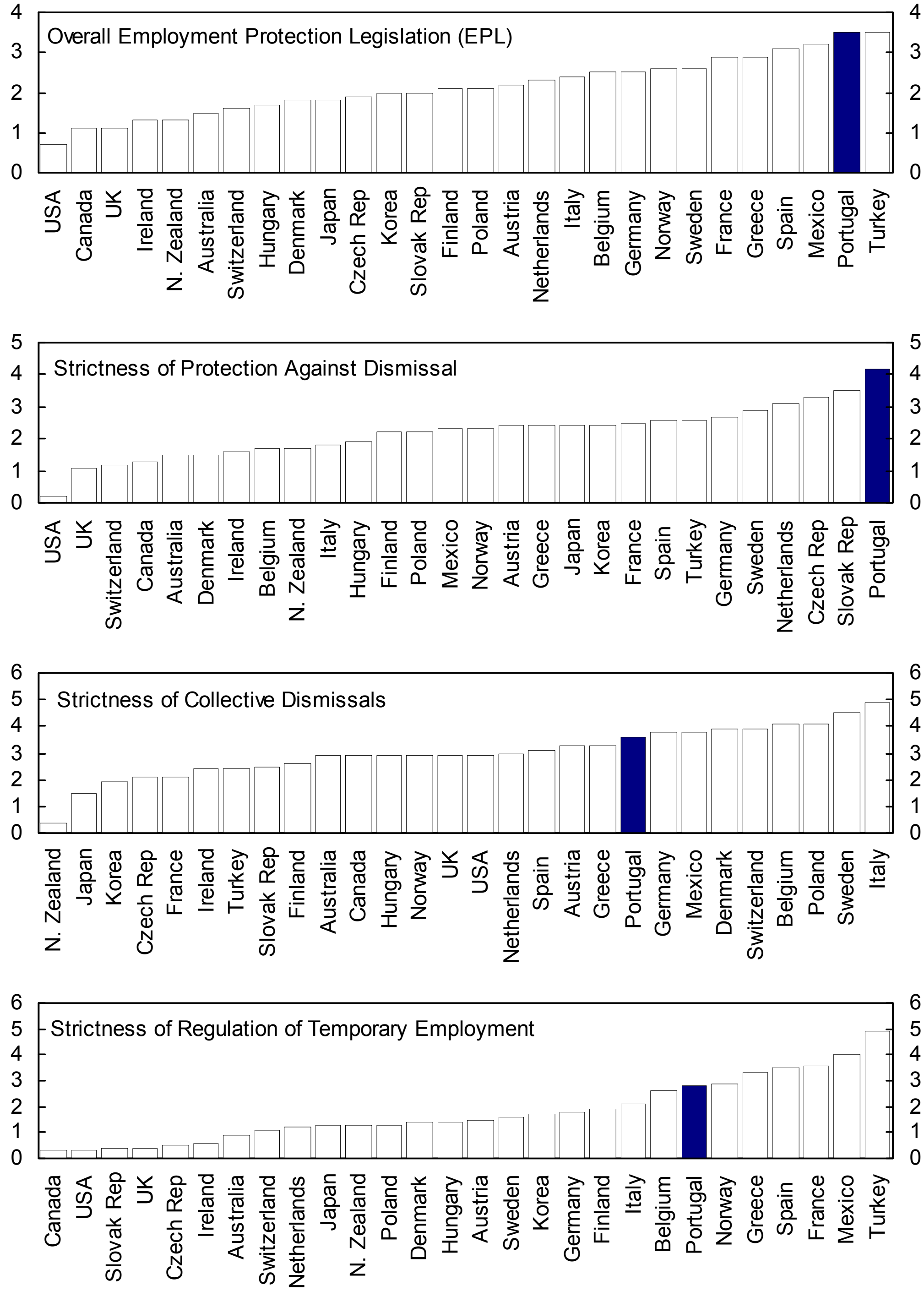
1/ Average of PISA scores in reading, mathematics, and science, 2000–06.

2/ Percent of nonresidential gross fixed capital formation, total economy, 2001.

3/ Index EU15=100, 2006 (first half).

4/ In percentage of GDP; data are as of 2005, except Italy, Netherlands, U.K. and EU-15 as of 2004; and Austria and Finland as of 2006.

Employment Is Highly Protected
(Data refers to 2003)



Source: OECD Employment Outlook 2006.

35. **Weak productivity, combined with strong wage growth and external shocks, led to Portugal losing competitiveness since the mid-1990s, which has not been regained.** Portugal's CPI-based and ULC-based real effective exchange rates have appreciated by around 10 percent since EMU accession in 1999 though have recently stabilized. Estimates of the equilibrium real exchange rates based on CGER methodologies also suggest a competitiveness gap in the range of 10–20 percent in April 2008 (which would likely require at least five–eight years to eliminate). Portugal had been losing export market shares until 2005 but has regained some ground since. Nonprice indicators for recent years suggest some improvement, but not as fast as peers, and not sufficient to significantly reduce the competitiveness gap (Box 2).

CGER Results

	Fall 2006	Apr-07	Apr-08
MB Approach	-1.8	1.1	-0.5
ERER Approach	12.8	15.3	18.1
ES Approach	15.3	15.4	14.0

Note: MB stands for macro balance; ERER for equilibrium real exchange rate; ES for external sustainability.

Box 2. Is Portugal Gaining Competitiveness by Restructuring? 1/

Standard measures indicate that Portugal has a sizeable competitiveness gap. But it is often countered with anecdotal evidence of restructuring by export industries. Could such restructuring imply that Portugal is substantially more competitive than standard indicators suggest?

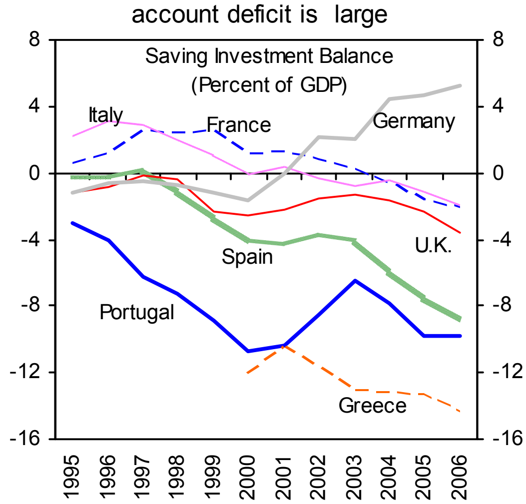
Evidence in the last decade suggests that some restructuring has taken place, but the scope has been limited and the pace slower than competitors'. On the positive side, Portuguese firms were able to diversify their export products and upgrade their technological content, albeit from low bases, and also entered markets with less competition. Less encouragingly, the sectoral allocation of FDI was not the most conducive to future growth, and Portugal had less FDI in manufacturing than its peers. Portugal also tended to export relatively less to the world's dynamic countries, and although it managed to increase market share in those markets, they were from extremely low levels. Portugal also tended to specialize in products with slow growth in global demand, and improvements in export quality were limited and slower than its main EU competitors. There was also little sign of restructuring in terms of service exports.

On balance, restructuring has likely alleviated some of the competitiveness gap but not enough to substantially offset the broader structural shortcomings weighing on external performance. Looking forward, further restructuring may be required in the export sector, as the dynamics of competition from emerging markets plays out, especially as these countries may intensify their upgrading.

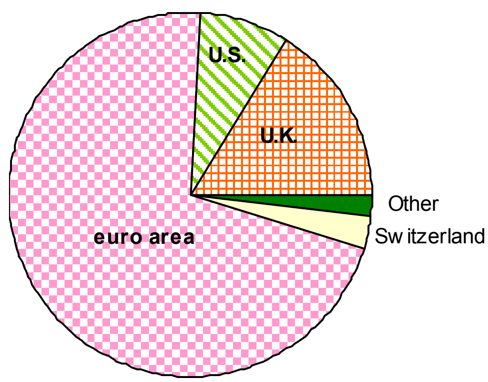
1/ See "France, Greece, Italy, Portugal and Spain – Competitiveness in the Southern Euro Area," (Country Report No. 08/145).

36. **Reflecting the loss of competitiveness, the current account deteriorated to around 10 percent of GDP.** Unlike other euro area countries with large current account deficits (e.g., Spain, Greece), Portugal has not been growing fast, and Portugal's current account deficit exceeds other euro area countries' with low growth and competitiveness problems (e.g., Italy), partly due to the deteriorating income account. Reflecting the difficult international capital market conditions, foreign financial investment in Portugal and bank issuance of long-term debt abroad have fallen sharply, as has the accumulation of foreign assets by residents. There has also been a shift from portfolio investment toward other investment (interbank borrowing and deposits).

Portugal's current account deficit is large



Portugal's creditors, stock at end-2007



Source: Bank of Portugal.

37. **The authorities agreed that Portugal continues to face a competitiveness gap, but Bank of Portugal officials expressed concern about the staff's quantitative assessments based on standard indicators.** They felt the presence of such a gap was not fully consistent with a robust recovery in export market share over the past few years despite the substantial euro strengthening. In addition, such indicators suffered from methodological shortcomings and masked the fundamental restructuring underway in some sectors of the economy. The fiscal authorities also considered that these indicators do not capture the positive spillover effects from the efficiency gains resulting from the implementation of public sector administration reform.

38. **The authorities' strategy to boost competitiveness focuses on enhancing productivity and the business environment.**

- The recent agreement on labor relations signed by the social partners can be expected to facilitate internal flexibility for companies, rationalize collective bargaining, encourage firm-level agreements, and streamline procedures for dismissal. It also envisages an increase in the rate of social security contributions on fixed-term contracts by three percentage points (financing a cut of one percentage point for permanent contracts).

- Public sector employment is being cut, and wages contained, while being restructured, helping to moderate economy-wide wage growth and enhance public sector efficiency.

- The ambitious and broad-ranging SIMPLEX program continues, as recognized by all interlocutors, to significantly improve the business climate. The focus for 2008 is on streamlining licensing.

39. **These are important achievements and need to be followed through and assessed.** Further reform should focus on making the economy more flexible and competitive.

- **The recent agreement on reforming labor relations is a welcome step forward.** The envisaged increase in the rate of social security contributions on fixed-term contracts by three percentage points, however, should be reconsidered: experience from Portugal, and other EU countries, show that such contracts are an important path to traditional, open-ended employment for many and have proven critical to boosting employment. The test of the new agreement will be in its implementation and whether it improves the working of the labor market. This will need to be carefully monitored and further actions, such as eliminating the automatic extension of collectively agreed contracts and broadening the scope for individual dismissal, could be considered.

- **The SIMPLEX program continues to improve the business climate, and its priority on licensing in 2008 is well placed.** It will be important to broaden the participation of local governments, building on recent efforts; ensure that small and medium-sized businesses are included in the benefits; and, to follow through with plans to assess effectiveness. In this context, advantage should be taken of the need to implement the EU Services Directive to make a clean sweep of regulations at all levels of government. The recent public administration reforms should also be built upon to continue to enhance public sector productivity.

- **Competition in domestic markets needs to be further enhanced.** The Competition Authority should build on its encouraging first five years to continue to advocate and enforce competition. Enhancing judicial system efficiency would also support the Authority’s effectiveness.

- For **electricity,** integration with the Spanish market is continuing, but it will be important that regulated tariffs are set to ensure full cost recovery that the roadmap for the end of regulated prices be developed, and that opportunities be grasped to increase competition in domestic generation.

40. **The authorities welcomed staff's endorsement of the labor agreement but underscored the rationale for the envisaged higher social security contributions on fixed-term contracts.** They emphasized the measure aimed at reducing abuse of the system and that the lower rate on permanent contracts, coupled with new steps to streamline procedures for dismissal, would encourage creation of permanent employment.

41. **The reform momentum needs to be maintained.** Policies should avoid jeopardizing recent achievements and long-term goals for short-term gain, preserving the continuity of adjustment and reforms and avoiding policy drift that Portugal can ill-afford. In this context, consideration could be given to developing mechanisms to formulate a "catch-up" growth agenda, which could broaden social support and could be rapidly acted upon by the next legislature (elections are due in October 2009). Mechanisms that have worked well for other countries include expert committees (e.g., Australia's Productivity Commission, a range of commissions in France, and the U.K.) or stakeholder committees to generate a consensus based on a shared diagnosis (e.g., Spain's Toledo Pact or the *Conseil d'Orientation des Retraites* in France).

Table 1. Portugal: Selected Economic Indicators, 2003–09
(Changes in percent, except as otherwise indicated)

	2003	2004	2005	2006	2007	Proj. 2008	Proj. 2009	Latest	
Domestic economy									
Real GDP	-0.8	1.5	0.9	1.4	1.7	1.0	0.8	0.9	Q1 08
Real domestic demand	-2.1	2.7	1.6	0.7	1.1	0.8	0.8	2.2	Q1 08
Private consumption	-0.1	2.5	2.0	1.7	0.7	1.0	0.9	1.9	Q1 08
Public consumption	0.2	2.6	3.2	-1.4	0.1	-0.6	-0.6	0.4	Q1 08
Gross fixed investment	-7.4	0.2	-0.9	-0.7	2.8	1.6	1.6	3.0	Q1 08
Foreign sector contribution	1.5	-1.4	-0.8	0.6	0.5	0.1	0.0	-1.4	Q1 08
Savings-investment balance (percent of GDP)									
Gross national savings	16.8	15.5	13.1	12.1	12.4	10.7	10.6	...	...
Private	18.1	17.9	16.3	13.7	12.4	10.9	10.7	...	...
Government	-1.4	-2.4	-3.2	-1.6	-0.1	-0.2	-0.1	...	...
Gross domestic investment	22.9	23.1	22.6	22.2	22.2	22.4	22.5	...	...
Private	19.8	20.0	19.5	19.9	19.8	20.1	20.1	...	...
Government	3.1	3.1	3.0	2.3	2.4	2.3	2.5	...	...
Resource utilization									
Employment	-0.4	0.1	0.0	0.7	0.2	0.4	0.4	1.1	Q1 08
Unemployment rate	6.3	6.7	7.6	7.7	8.0	8.0	8.0	7.6	Q1 08
Real potential GDP	1.7	1.5	1.5	1.4	1.5	1.2	1.3	...	...
Output gap	-0.3	-0.3	-0.9	-0.9	-0.7	-0.9	-1.4	...	...
Labor productivity	-0.4	1.4	0.9	0.6	1.5	0.6	0.4	...	...
Compensation per worker (whole economy)	3.5	2.6	3.5	2.4	2.4	2.3	2.3	...	...
Unit labor costs (whole economy)	3.9	1.2	2.5	1.7	0.9	1.7	1.9	...	...
Prices									
Consumer prices (harmonized index)	3.3	2.5	2.1	3.0	2.4	3.2	2.1	3.4	Jun08
GDP deflator	3.2	2.4	2.5	2.8	3.0	2.2	2.2	2.2	Q1 08
External accounts									
Export volume (goods)	5.8	4.4	1.1	8.2	6.8	4.2	3.5	2.1	Q1 08
Import volume (goods)	-0.2	6.9	4.7	4.3	5.1	3.2	2.9	6.1	Q1 08
Export unit value (goods and services)	-1.4	1.5	1.9	4.2	2.9	3.0	1.8	3.2	Q1 08
Import unit value (goods and services)	-1.8	2.2	3.2	3.9	1.8	5.0	1.5	5.4	Q1 08
Current account (percent of GDP)	-6.1	-7.6	-9.5	-10.1	-9.9	-11.7	-12.0	...	...
Nominal effective exchange rate	3.2	0.8	0.1	0.2	1.3	...	...	2.9	May08
Real effective exchange rate (CPI based)	4.4	1.0	0.1	0.6	1.8	...	...	1.9	May08
General government finances (percent of GDP)									
Revenues	42.5	43.1	41.6	42.4	43.1	43.6	43.6	...	...
Expenditures	45.5	46.5	47.8	46.3	45.8	45.9	45.7	...	...
Overall balance	-2.9	-3.4	-6.1	-3.9	-2.6	-2.2	-2.2	...	...
Excluding one-off measures	-5.3	-5.5	-6.1	-3.9	-2.7	-2.4	-2.2		
Government debt, Maastricht definition	56.8	58.3	63.6	64.7	63.6	63.4	63.5	...	...
Financial variables 1/									
National contribution to euro area M3 2/	4.3	5.7	5.8	3.4	9.0	...	...	13.7	May08
Credit to the private sector 3/	6.4	6.1	7.7	8.7	9.9	...	...	10.5	April08
Interest rates (percent)									
Overnight rate	2.3	2.2	2.4	3.5	3.8	...	...	4.0	Jun08
Deposit rate, up to two years	2.0	2.0	2.1	2.7	3.6	...	...	3.6	April08
Loans granted to nonfinancial corporations	4.4	4.3	4.4	5.4	6.2	...	...	6.1	April08
Government benchmark bond	4.4	3.6	3.5	4.0	4.5	...	...	5.0	Jun08

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

1/ End-of-period data.
2/ Excludes currency in circulation held by nonbank private sector.
3/ Includes securitized loans. Also corrected for loan write-offs and reclassifications.

Table 2. Portugal: Balance of Payments, 2002–13

	2002	2003	2004	2005	2006	2007	Proj. 2008	2009	2010	2011	2012	2013
						(Billions of euros)						
Current account	**-11.0**	**-8.5**	**-10.9**	**-14.1**	**-15.7**	**-16.0**	**-19.7**	**-20.7**	**-20.8**	**-20.7**	**-20.4**	**-20.0**
Trade balance	-14.1	-12.6	-14.8	-16.4	-16.7	-17.5	-19.4	-19.8	-19.7	-19.5	-19.0	-18.5
Exports fob	27.5	28.4	29.8	31.0	34.7	37.8	40.5	42.7	45.5	48.4	51.5	54.7
Imports fob	41.6	41.0	44.5	47.4	51.4	55.3	59.9	62.5	65.3	67.9	70.5	73.2
Services, net	3.3	3.6	4.0	3.8	4.8	6.2	6.7	7.1	7.8	8.5	9.3	10.1
Exports	10.9	10.9	11.9	12.3	14.2	16.3	17.5	18.4	19.5	20.7	22.0	23.2
Imports	7.6	7.3	7.8	8.4	9.4	10.1	10.8	11.3	11.8	12.2	12.7	13.2
Of which												
Tourism	3.8	3.7	4.0	3.7	4.0	4.5	5.1	5.5	6.0	6.6	7.2	7.8
Exports	6.1	5.8	6.2	6.2	6.7	7.4	8.1	8.6	9.2	9.9	10.6	11.4
Imports	2.2	2.1	2.2	2.5	2.7	2.9	3.0	3.1	3.2	3.3	3.4	3.6
Income	-3.2	-2.3	-3.0	-3.9	-6.3	-7.4	-9.7	-10.8	-11.6	-12.5	-13.4	-14.3
Current transfers, net	3.0	2.9	2.8	2.3	2.5	2.6	2.7	2.8	2.8	2.8	2.8	2.8
Private remittances, net	2.6	2.2	2.2	1.9	2.2	2.6	2.7	2.7	2.7	2.7	2.7	2.7
Official transfers, net	0.4	0.7	0.6	0.4	0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Capital account	**2.0**	**2.6**	**2.2**	**1.7**	**1.2**	**2.1**	**2.2**	**2.2**	**2.3**	**2.4**	**2.5**	**2.6**
Current account (including capital transfers)	-9.0	-5.8	-8.7	-12.4	-14.5	-14.0	-17.5	-18.5	-18.5	-18.3	-17.9	-17.4
Financial account	**8.3**	**5.1**	**9.3**	**13.1**	**13.3**	**15.0**	**17.5**	**18.5**	**18.5**	**18.3**	**17.9**	**17.4**
Direct investment	2.1	0.5	-4.4	1.5	3.5	-0.4	2.7	2.9	2.7	2.7	2.8	2.9
Portuguese investment abroad	0.2	-5.8	-6.0	-1.7	-5.6	-4.5	-1.5	-1.5	-1.9	-2.0	-2.1	-2.2
Foreign investment in Portugal	1.9	6.3	1.6	3.2	9.0	4.1	4.2	4.4	4.5	4.7	4.9	5.1
Portfolio investment, net	3.1	-6.5	0.0	-1.2	2.6	9.4	8.2	8.7	8.7	8.6	8.4	8.2
Equity securities	2.5	8.0	4.3	3.1	-0.3	-2.3	1.5	2.4	2.7	2.7	2.7	2.6
Long-term debt securities	-0.2	-11.4	-11.2	-5.8	4.1	7.8	5.2	4.6	4.3	4.2	4.1	4.0
Money market instruments	0.8	-3.1	7.0	1.5	-1.3	3.9	1.6	1.7	1.7	1.7	1.6	1.6
Financial derivatives	0.0	0.1	-0.1	-0.2	-0.2	0.7	0.1	0.1	0.1	0.1	0.1	0.1
Other investment, net	4.3	5.2	12.3	11.5	5.6	4.7	6.4	6.7	7.0	6.9	6.6	6.2
Of which												
Monetary financial institutions	8.8	9.4	1.7	6.7	14.9	8.2	...	...	...	...	...	...
Of which												
Short-term	-1.2	-2.8	-1.8	-5.0	5.7	7.9	...	...	...	...	...	...
Long-term	10.0	12.2	3.6	11.7	9.2	0.3	...	...	...	...	...	...
Reserve assets	-1.1	5.8	1.5	1.4	1.9	0.7	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	0.6	0.8	-0.6	-0.6	1.1	-1.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:												
Net international investment position 1/	-77.6	-82.5	-92.9	-105.9	-125.5	-148.8	-166.3	-184.7	-203.2	-221.5	-239.4	-256.8
Direct investment, net	-22.2	-20.7	-16.9	-18.1	-25.9	-30.5	-33.3	-36.2	-38.8	-41.6	-44.3	-47.2
Portfolio investment, net	-24.9	-21.0	-20.5	-20.9	-25.8	-37.9	-46.1	-54.8	-63.5	-72.1	-80.5	-88.7
Financial derivatives	0.5	0.0	-0.6	-0.1	0.0	-0.1	-0.2	-0.3	-0.4	-0.5	-0.7	-0.8
Other investment, net	-47.9	-50.9	-63.5	-75.6	-81.4	-88.1	-94.6	-101.3	-108.3	-115.1	-121.7	-127.9
Reserve assets	16.9	10.1	8.6	8.8	7.5	7.8	7.8	7.8	7.8	7.8	7.8	7.8
Nominal GDP	135.4	138.6	144.1	149.1	155.4	162.8	168.0	173.1	179.5	186.5	193.9	201.6
						(Percent of GDP)						
Current account	**-8.1**	**-6.1**	**-7.6**	**-9.5**	**-10.1**	**-9.9**	**-11.7**	**-12.0**	**-11.6**	**-11.1**	**-10.5**	**-9.9**
Current account (including capital transfers)	-6.6	-4.2	-6.1	-8.3	-9.3	-8.6	-10.4	-10.7	-10.3	-9.8	-9.2	-8.6
Of which: balance of goods and services	-7.9	-6.5	-7.5	-8.4	-7.6	-6.9	-7.6	-7.4	-6.7	-5.9	-5.0	-4.2
Net international investment position 1/	-57.3	-59.5	-64.5	-71.0	-80.7	-91.4	-99.0	-106.7	-113.2	-118.8	-123.5	-127.4
Direct investment, net	-16.4	-14.9	-11.7	-12.1	-16.7	-18.8	-19.8	-20.9	-21.6	-22.3	-22.9	-23.4
Portfolio investment, net	-18.4	-15.2	-14.2	-14.0	-16.6	-23.3	-27.5	-31.7	-35.4	-38.7	-41.5	-44.0
Financial derivatives	0.4	0.0	-0.4	0.0	0.0	-0.1	-0.1	-0.2	-0.2	-0.3	-0.3	-0.4
Other investment, net	-35.4	-36.7	-44.1	-50.7	-52.3	-54.1	-56.3	-58.5	-60.3	-61.7	-62.8	-63.4
Reserve assets	12.5	7.3	6.0	5.9	4.8	4.8	4.7	4.5	4.4	4.2	4.0	3.9

Sources: Bank of Portugal; and IMF staff calculations.

1/ End-of-period data.

Table 3. Portugal: General Government Accounts, 2004–13 1/

	2004	2005	(0) SGP 06 2006	(1) Apr 07 2006	(2) Actual 2006	(3) SGP 06 2007	(4) Apr 07' 2007	(5) SGP 07 2007	(6) Prel. 2007	Staff Projections 2008	2009	2010	2011	2012	2013
								(Millions of euros)							
Total revenues	62,164	62,094	63,641	65,601	65,912	66,628	67,879	68,831	70,213	73,287	75,386	78,242	81,406	84,614	87,974
Current receipts	57,040	59,946	61,523	64,033	64,162	65,034	66,513	66,675	68,753	71,036	72,924	75,380	78,217	81,327	84,556
Tax revenue	32,716	34,958	37,258	37,592	37,656	39,417	39,638	40,021	40,433	41,588	42,359	43,868	45,482	47,291	49,168
On goods and services	20,400	22,384	23,649	...	23,995	24,726	24,969	24,699	24,541	24,901	25,089	26,054	26,966	28,038	29,151
Direct taxes	12,316	12,574	13,609	...	13,662	14,691	14,669	15,323	15,892	16,686	17,270	17,814	18,516	19,253	20,017
Social security contributions	17,573	18,697	18,684	19,347	19,360	19,526	20,026	20,254	20,702	21,746	22,398	23,044	23,876	24,826	25,812
Other current revenues	6,750	6,291	5,580	7,094	7,145	6,091	6,849	6,400	7,618	7,702	8,166	8,468	8,858	9,211	9,576
Capital revenues	5,124	2,148	2,119	1,568	1,750	1,595	1,367	2,155	1,460	2,251	2,463	2,862	3,189	3,287	3,417
Total expenditures	67,007	71,240	70,669	71,656	71,941	72,538	73,166	73,701	74,470	77,038	79,166	81,886	85,175	88,524	92,000
Primary current expenditures	56,687	60,786	60,819	61,968	62,365	62,322	63,313	63,507	64,235	66,451	67,747	69,619	72,355	75,232	78,219
Compensation of employees	20,342	21,541	21,207	20,958	21,165	21,010	21,189	20,744	21,006	20,857	20,797	21,215	22,032	22,908	23,818
Intermediate consumption	5,728	6,316	6,194	6,174	6,428	6,393	6,424	6,587	6,670	7,217	7,250	7,243	7,500	7,798	8,107
Subsidies	2,170	2,339	1,787	2,144	2,155	1,803	1,556	1,911	1,901	2,053	2,241	2,309	2,394	2,489	2,588
Social transfers	25,438	27,516	28,235	29,067	29,221	29,394	30,465	30,878	31,308	32,778	33,815	35,143	36,576	38,031	39,541
Other	3,008	3,075	3,395	3,625	3,397	3,722	3,679	3,387	3,350	3,547	3,644	3,709	3,853	4,006	4,165
Interest payments	3,820	3,900	4,364	4,354	4,313	4,770	4,628	4,737	4,608	4,957	5,318	5,647	5,834	6,028	6,229
Capital expenditures	6,501	6,554	5,487	5,333	5,264	5,446	5,225	5,458	5,627	5,630	6,102	6,620	6,986	7,264	7,552
Fixed capital formation	4,525	4,532	3,747	3,558	3,612	3,678	3,678	3,646	3,920	3,987	4,188	4,596	4,851	5,044	5,244
Net lending	1,976	2,022	1,740	1,775	1,651	1,767	1,547	1,811	1,707	1,644	1,914	2,024	2,135	2,220	2,309
Overall balance 2/ 3/	-4,844	-9,146	-7,027	-6,055	-6,029	-5,910	-5,287	-4,871	-4,257	-3,751	-3,780	-3,644	-3,769	-3,910	-4,026
Excluding one-off measures	-7,895	-9,146	-7,027	-6,055	-6,029	-5,910	-5,287	-4,871	-4,420	-4,087	-3,780	-3,644	-3,769	-3,910	-4,026
								(Percent of GDP)							
Total revenues	43.1	41.6	41.7	42.2	42.4	41.7	41.8	42.4	43.1	43.6	43.6	43.6	43.7	43.6	43.6
Current receipts	39.6	40.2	40.3	41.2	41.3	40.7	41.0	40.9	42.2	42.3	42.1	42.0	41.9	41.9	41.9
Tax revenue	22.7	23.4	24.4	24.2	24.2	24.7	24.4	24.6	24.8	24.8	24.5	24.4	24.4	24.4	24.4
On goods and services	14.2	15.0	15.5	...	15.4	15.5	15.4	15.2	15.1	14.8	14.5	14.5	14.5	14.5	14.5
Direct taxes	8.5	8.4	8.9	...	8.8	9.2	9.0	9.4	9.8	9.9	10.0	9.9	9.9	9.9	9.9
Social security contributions	12.2	12.5	12.2	12.4	12.5	12.2	12.3	12.4	12.7	12.9	12.9	12.8	12.8	12.8	12.8
Other current revenues	4.7	4.2	3.7	4.6	4.6	3.8	4.2	3.9	4.7	4.6	4.7	4.7	4.8	4.8	4.8
Capital revenues	3.6	1.4	1.4	1.0	1.1	1.0	0.8	1.3	0.9	1.3	1.4	1.6	1.7	1.7	1.7
Total expenditures	46.5	47.8	46.3	46.1	46.3	45.4	45.1	45.3	45.8	45.9	45.7	45.6	45.7	45.7	45.6
Primary current expenditures	39.3	40.8	39.8	39.9	40.1	39.0	39.0	39.0	39.5	39.6	39.1	38.8	38.8	38.8	38.8
Compensation of employees	14.1	14.4	13.9	13.5	13.6	13.2	13.1	12.7	12.9	12.4	12.0	11.8	11.8	11.8	11.8
Intermediate consumption	4.0	4.2	4.1	4.0	4.1	4.0	4.0	4.0	4.1	4.3	4.2	4.0	4.0	4.0	4.0
Subsidies	1.5	1.6	1.2	1.4	1.4	1.1	1.0	1.2	1.2	1.2	1.3	1.3	1.3	1.3	1.3
Social transfers	17.6	18.5	18.5	18.7	18.8	18.4	18.8	19.0	19.2	19.5	19.5	19.6	19.6	19.6	19.6
Other	2.1	2.1	2.2	2.3	2.2	2.3	2.3	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Interest payments	2.7	2.6	2.9	2.8	2.8	3.0	2.9	2.9	2.8	3.0	3.1	3.1	3.1	3.1	3.1
Capital expenditures	4.5	4.4	3.6	3.4	3.4	3.4	3.2	3.4	3.5	3.4	3.5	3.7	3.7	3.7	3.7
Overall balance	**-3.4**	**-6.1**	**-4.6**	**-3.9**	**-3.9**	**-3.7**	**-3.3**	**-3.0**	**-2.6**	**-2.2**	**-2.2**	**-2.0**	**-2.0**	**-2.0**	**-2.0**
Excluding one-off measures 3/	**-5.5**	**-6.1**	**-4.6**	**-3.9**	**-3.9**	**-3.7**	**-3.3**	**-3.0**	**-2.7**	**-2.4**	**-2.2**	**-2.0**	**-2.0**	**-2.0**	**-2.0**
Memorandum items:															
One-off measures	2.1	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.2	0.0	0.0	0.0	0.0	0.0
Structural balance (excluding one-off measures) 4/	-5.4	-5.8	-3.4	-2.7	-3.5	-2.6	-2.2	-2.1	-2.4	-2.1	-1.6	-1.4	-1.4	-1.5	-1.5
Primary balance (excluding one-off measures) 4/	-2.8	-3.5	-1.7	-1.1	-1.1	-0.7	-0.4	-0.1	0.1	0.5	0.9	1.1	1.1	1.1	1.1
Primary structural balance	-2.7	-3.2	-0.5	0.1	-0.7	0.4	0.7	0.8	0.4	0.9	1.4	1.7	1.7	1.6	1.6
Public debt (Maastricht definition)	**58.3**	**63.6**	**67.4**	**64.7**	**64.7**	**68.0**	**65.1**	**64.4**	**63.6**	**63.4**	**63.5**	**63.2**	**62.9**	**62.5**	**62.1**
Real increase in primary current spending	3.8	4.6	...	...	-0.2	...	...	...	0.0	1.2	-0.3	0.5	1.8	1.8	1.8
Nominal GDP (millions of euros)	144,128	149,124	152,787	155,446	155,446	159,601	162,205	162,833	162,756	167,983	173,074	179,544	186,457	193,872	201,569
Output gap (percent of potential output)	-0.3	-0.9	-2.7	...	-0.9	-2.4	...	-2.2	-0.7	-0.9	-1.4	-1.5	-1.4	-1.4	-1.3
Real GDP growth (percent)	1.5	0.9	1.4	1.3	1.4	1.8	1.8	1.8	1.7	1.0	0.8	1.5	1.7	1.8	1.8

Sources: Ministry of Finance; and IMF staff estimates.

1/ For 2008–10, staff projections are based on unchanged policies, and the envisaged savings from the reforms that have already been introduced (for example, of the social security system), and thereafter unchanged structural primary balance.

2/ Structural balance calculated using staff's estimate of the output gap.

3/ One-off measures consist of the transfer of the postal pension fund in 2003, the state enterprises pension funds in 2004, securitization and asset sales.

4/ Calculated using the staff's estimates of potential output. Asset sales, including UMTS receipts, the transfer of pension funds and securitization are netted.

Table 4. Portugal: Medium-Term Scenario
(Changes in percent, unless otherwise indicated)

	1996–2003	2004	2005	2006	2007	Proj. 2008	2009	2010	2011	2012	2013
Real GDP	2.8	1.5	0.9	1.4	1.7	1.0	0.8	1.5	1.7	1.8	1.8
Real domestic demand	3.1	2.7	1.6	0.7	1.1	0.8	0.8	1.0	1.1	1.1	1.1
Private consumption	2.9	2.5	2.0	1.7	0.7	1.0	0.9	1.1	1.1	1.1	1.1
Public consumption	3.2	2.6	3.2	-1.4	0.1	-0.6	-0.6	-0.3	0.4	0.4	0.4
Gross fixed investment	3.5	3.2	-1.0	-0.3	3.0	1.6	1.5	1.9	1.8	1.6	1.6
Public	4.2	2.7	-2.3	-22.4	6.7	-1.4	6.8	6.4	3.2	1.4	1.4
Private	3.9	-0.1	-0.7	2.7	2.3	2.0	1.0	1.5	1.5	1.5	1.5
Structure	3.0	-1.8	-3.2	-5.4	-0.2	1.2	1.2	2.1	1.3	0.9	0.9
Equipment and machinery	5.0	2.3	1.3	3.7	5.4	2.0	2.0	2.0	2.0	2.0	2.0
Change in stocks (contribution to growth)	-0.1	0.7	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign balance (contribution to growth)	-0.5	-1.4	-0.8	0.6	0.5	0.1	0.0	0.4	0.5	0.6	0.6
Exports of goods and services (real)	4.9	4.0	2.0	8.7	8.1	4.2	3.5	5.0	4.9	4.9	4.8
Exports of goods and services (nominal)	6.1	5.6	3.9	13.2	11.2	7.3	5.4	6.6	6.4	6.4	6.3
Imports of goods and services (real)	5.3	6.7	3.5	5.2	5.2	3.2	2.9	3.3	3.1	2.9	2.9
Real imports of partner countries (WEO)	7.0	8.9	7.6	8.4	5.8	4.8	3.5	5.0	4.9	4.9	4.8
Export market share (2000=100)	103.9	93.7	88.7	89.0	90.9	90.9	90.9	90.9	90.9	90.9	90.9
Terms of trade	0.3	-0.7	-1.3	0.2	1.1	-1.9	0.3	0.5	0.4	0.5	0.5
Savings-investment balance (percent of GDP)	-7.4	-7.6	-9.5	-10.1	-9.9	-11.7	-12.0	-11.6	-11.1	-10.5	-9.9
Gross national savings	18.5	15.5	13.1	12.1	12.4	10.7	10.6	11.0	11.3	11.8	12.2
Private	18.3	17.9	16.3	13.7	12.4	10.9	10.7	10.9	11.3	11.7	12.2
Government	0.2	-2.4	-3.2	-1.6	-0.1	-0.2	-0.1	0.1	0.0	0.0	0.1
Gross domestic investment	25.9	23.1	22.6	22.2	22.2	22.4	22.5	22.5	22.4	22.3	22.1
Private	22.1	20.0	19.5	19.9	19.8	20.1	20.1	20.0	19.8	19.7	19.5
Government	3.7	3.1	3.0	2.3	2.4	2.3	2.5	2.6	2.6	2.6	2.6
Resource utilization											
Population (15–64)	0.2	0.6	0.4	0.0	0.3	0.1	0.0	-0.1	-0.2	-0.1	-0.1
Labor force	2.3	0.5	1.0	0.8	0.6	0.4	0.4	0.3	0.2	0.2	0.2
Employment	2.5	0.1	0.0	0.7	0.2	0.4	0.4	0.5	0.5	0.5	0.5
Labor force participation rate	73.8	77.5	77.9	78.5	78.7	79.0	79.3	79.7	80.0	80.2	80.5
Unemployment rate	5.3	6.7	7.6	7.7	8.0	8.0	8.0	7.8	7.5	7.2	7.0
Potential output	2.4	1.5	1.5	1.4	1.5	1.2	1.3	1.6	1.7	1.7	1.7
Output gap	0.9	-0.3	-0.9	-0.9	-0.7	-0.9	-1.4	-1.5	-1.4	-1.4	-1.3
Labor productivity	1.4	1.4	0.9	0.6	1.5	0.6	0.4	1.0	1.2	1.3	1.3
Nominal wage (whole economy)	4.7	2.6	3.5	2.4	2.4	2.3	2.3	2.3	2.3	2.3	2.3
Real wage (whole economy)	1.8	0.1	1.3	-0.7	0.0	-0.9	0.2	0.2	0.2	0.2	0.2
Unit labor costs (whole economy)	4.4	1.2	2.5	1.7	0.9	1.7	1.9	1.3	1.1	1.0	1.0
Consumer prices (harmonized index)	2.9	2.5	2.1	3.0	2.4	3.2	2.1	2.1	2.1	2.1	2.1

Table 5. Portugal: Selected Financial Indicators of the Banking System, 2000–07
(Percent)

	2000	2001	2002	2003	2004	2004 1/	2005 1/	2006 1/	2006 2/	2007 2/
Capital adequacy										
Regulatory capital to risk-weighted assets*	9.2	9.5	9.8	10.0	10.4	10.2	11.3	10.9	11.0	10.2
Regulatory tier I capital to risk-weighted assets*	7.6	7.3	7.1	7.1	7.3	7.0	7.1	7.7	7.8	6.7
Capital (net worth) to assets 3/	5.8	5.5	5.6	5.8	6.2	5.1	5.8	6.4	6.2	6.2
Asset composition and quality										
Sectoral distribution of loans to total loans*										
Households	48.2	47.7	48.4	48.3	49.3	49.3	50.7	52.8	52.8	52.5
Of which: housing	36.3	36.8	38.4	38.6	39.4	39.4	41.2	42.9	42.9	42.2
Construction	8.1	8.6	8.4	8.8	8.7	8.7	8.9	8.4	8.4	8.3
Manufacturing	8.0	7.8	7.6	7.6	6.8	6.8	6.2	5.5	5.5	5.3
Agriculture	0.6	0.6	0.6	0.7	0.7	0.7	0.7	0.6	0.6	0.7
Services	24.8	26.7	27.5	28.7	27.9	27.9	27.0	26.6	26.6	26.6
NPLs to gross loans* 4/	2.2	2.2	2.3	2.4	2.0	1.5	1.5	1.3	1.2	1.3
Specific provision to NPLs 4/	67.7	66.8	62.8	73.0	83.4	72.2	79.0	80.5	83.9	75.7
NPLs net of provisions to capital* 4/	7.3	7.5	9.1	6.7	3.3	4.8	3.3	2.7	2.2	3.5
Large exposure to capital* 4/	...	...	119.9	94.1	91.4	97.5	75.5	88.7	86.9	91.8
Earnings and profitability										
ROA (post-tax)*	0.9	0.8	0.7	0.8	0.8	0.6	0.9	1.1	1.0	1.0
ROE (post-tax)*	15.1	14.9	11.7	13.9	12.8	10.8	14.5	15.6	16.9	15.2
Interest margin to gross income*	62.9	65.8	65.0	60.0	58.1	60.0	54.8	54.7	55.7	57.7
Noninterest expenses to gross income*	58.2	57.6	59.1	57.4	57.2	71.7	58.3	53.3	53.5	53.2
Personnel expenses to noninterest expenses	61.8	59.5	59.3	59.3	58.6	59.9	57.7	57.5	56.8	55.0
Trading and fee income to total income	29.5	25.5	26.1	27.7	29.1	33.0	40.9	39.5	38.8	37.4
Spread between reference loan and deposit rates 5/	4.1	4.3	3.6	3.4	3.1	3.1	3.1	3.5	3.5	3.7
Stock price index of bank shares 6/	107.9	92.9	69.3	72.1	80.7	80.7	100.5	135.4	135.4	142.0
Liquidity										
Liquid assets to total assets* 7/	...	15.3	12.5	17.1	15.4	15.2	14.8	13.5	13.1	12.6
Liquid assets to total short-term liabilities* 7/	...	89.0	85.6	108.6	115.2	108.6	95.1	91.7	96.0	88.2
Loans as percent of deposits*	116.0	122.7	129.5	129.1	128.3	130.9	137.5	145.6	146.7	154.9
FX liabilities to total liabilities 8/	10.7	9.9	9.0	9.0	7.9	7.9	8.3	8.9	8.9	10.1
Sensitivity to market risk										
Net open position in FX to capital*	...	...	7.1	4.7	3.9	4.0	4.5	6.1	5.9	4.7
Net open position in equities to capital	...	...	1.8	0.2	1.8	1.8	1.3	2.6	2.6	2.3

Sources: Bank of Portugal; and IMF staff estimates.

Note: * denotes Core Financial Sector Indicators.

1/ For 2005 and 2006 the figures are for the sample of institutions that are already complying with IAS, accounting as of December 2004 for about 87 percent of the usual aggregate considered. To ensure comparability, the figures for 2004 for this subsample are also presented.

2/ The sample of banking institutions under analysis was expanded in order to include the institutions that adopted IAS only in 2006.

3/ On accounting basis; consolidated.

4/ On a consolidated basis. NPLs are defined as credit to customer overdue. For comparable 2004 and 2005 figures. The concept of NPL is only applicable at an individual level and for prudential purposes. The following definition of NPL's will be used: principal and interest past due for more than 90 days (amount overdue only) + future installments of loans fallen due and classified as doubtful, according to criteria that include initial maturity, the time elapsed since the first installment fallen due, and the relative importance of fallen due installments in each loan.

5/ Based on weighted averages of lending rates to households and to nonfinancial corporations and of deposit interest rates for the two sectors.

6/ PSI Financial Services (Euronext Lisbon); 01/01/2000 =100.

7/ Three-month residual maturity horizon.

8/ FX liabilities include foreign currency deposits and deposit-like instruments of resident nonmonetary sector and claims of nonresident vis-à-vis resident monetary financial institutions (excluding Bank of Portugal).

Table 6. Portugal: Indicators of External and Financial Vulnerability, 2001–07
(Percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	2007
External indicators							
Exports (goods, annual percent change in euro)	3.5	14.5	2.1	0.8	3.1	4.9	4.1
Imports (goods, annual percent change in euro)	8.3	15.1	0.9	-2.9	-1.6	8.8	6.3
Terms of trade (goods and services, annual percent change)	0.5	1.6	0.4	-0.7	-1.3	-0.1	1.5
Current account balance	-9.9	-8.1	-6.1	-7.6	-9.5	-10.1	-9.9
Current account balance (including capital transfers)	-9.0	-6.6	-4.2	-6.1	-8.3	-9.3	-8.6
Capital and financial account balance	9.3	7.6	5.6	7.6	9.5	10.1	9.9
Of which : inward portfolio investment (debt securities, etc.)	9.2	7.9	9.0	7.6	9.9	6.7	11.2
inward foreign direct investment	5.4	1.4	4.6	1.1	2.1	5.8	2.5
other investment liabilities (net)	6.4	3.1	3.8	8.1	7.3	4.3	2.2
Central Bank foreign liabilities (billions of euro) 1/	8.3	8.7	2.7	8.6	12.8	6.8	6.3
Foreign assets of the financial sector (billions of euro) 2/	60.3	59.0	69.6	73.9	80.4	85.0	93.6
Foreign liabilities of the financial sector (billions of euro) 2/	95.7	102.0	116.2	118.1	128.2	150.6	162.7
Exchange rate (per U.S. dollars, period average)	1.12	1.06	0.88	0.80	0.80	0.80	0.73
Financial market indicators							
Public sector debt (Maastricht definition)	52.9	55.6	56.8	58.3	63.6	64.7	63.6
Money market rate—three month Euribor (period average in percent)	4.3	3.3	2.3	2.1	2.2	3.1	3.8
Money market rate (real, in percent)	-0.1	-0.3	-0.9	-0.3	0.1	0.1	1.4
Stock market index (PSI 20, 1992=3000)	7,831	5,825	6,747	7,600	8,619	11,198	13,019
Share prices of financial institutions (2005=1000)	977	735	764	856	1065	1435	1506
Spread of 10-year benchmark bond with euro bond yield (percentage points)	0.11	0.08	0.04	0.00	0.00	0.06	0.09
Financial sector risk indicators							
Foreign exchange assets (billions of euro) 3/	7.0	5.9	4.9	4.6	4.8	5.2	…
Deposits in foreign exchange (billions of euro) 4/	5.5	3.7	4.9	5.4	5.1	6.2	…
Share of foreign deposits in total deposits (percent) 4/	4.1	2.8	3.5	3.7	3.1	3.6	…
Share of real estate sector in private credit 5/	53.7	55.7	57.9	60.1	63.0	63.7	…
Share of nonperforming loans in total loans 2/ 6/	2.1	2.1	2.1	1.8	1.7	1.5	1.5
Risk-based capital asset ratio 7/	9.5	9.8	10.0	10.2	11.3	11.0	10.2
Return on equity for the banking system	17.8	14.1	16.2	13.1	19.4	20.6	18.0
Household debt							
Percent of disposable income	90	97	103	110	116	123	129
Percent of GDP	64	68	73	78	83	88	91
Nonfinancial corporate debt (percent of GDP)	95	95	100	99	104	107	114

Sources: Bank of Portugal; Ministry of Finance; IMF, Balance of Payments Yearbook database; and IMF staff estimates.

1/ Reserves and foreign liabilities refer to the Bank of Portugal.
2/ Banks only.
3/ Non-euro area currencies assets vis-à-vis the resident and nonresident nonmonetary sector.
4/ Deposits in non-euro area currencies by the resident nonmonetary sector and liabilities in non-euro area currencies by the nonresident nonmonetary sector.
5/ Real estate defined as the sum of total credit by monetary financial institutions to individuals for housing and to nonfinancial corporations for construction and real-estate activities; private credit defined as total domestic credit excluding the general government. Stocks adjusted for securitization operations.
6/ NPL concern households and nonfinancial corporations.
7/ Capital over risk-weighted assets. Consolidated data for the banking system.

Table 7. Portugal: External Debt Sustainability Framework, 2003–13
(Percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing noninterest current account** 6/
1	Baseline: external debt 1/	154.6	160.6	176.4	183.4	194.4	200.7	206.5	210.9	214.8	217.8	220.3	**-1.7**
2	Change in external debt	5.9	5.9	15.8	7.0	11.0	6.3	5.8	4.4	3.8	3.1	2.4	
3	Identified external debt-creating flows (4+8+9)	-6.7	-2.1	4.8	-0.4	0.1	2.7	1.8	-0.1	-0.9	-1.8	-2.4	
4	Current account deficit, including capital transfers and excluding interest payments	0.3	2.0	4.2	3.0	1.0	1.9	1.7	1.3	0.7	0.0	-0.7	
5	Deficit in balance of goods and services	6.5	7.5	8.4	7.6	6.9	7.6	7.4	6.7	5.9	5.0	4.2	
6	Exports	28.3	28.9	29.0	31.4	33.2	34.6	35.3	36.2	37.1	37.9	38.7	
7	Imports	34.9	36.3	37.4	39.1	40.2	42.1	42.7	42.9	43.0	42.9	42.9	
8	Net nondebt creating capital inflows (negative)	-7.6	-2.4	1.8	-2.6	-0.8	-2.4	-3.0	-3.0	-2.9	-2.8	-2.7	
9	Automatic debt dynamics 2/	0.6	-1.7	-1.2	-0.8	-0.2	3.3	3.1	1.6	1.3	1.0	1.0	
10	Contribution from nominal interest rate	3.9	4.1	4.1	6.3	7.6	8.6	9.0	9.0	9.1	9.2	9.3	
11	Contribution from real GDP growth	1.0	-2.0	-1.4	-2.3	-2.7	-1.7	-1.5	-3.0	-3.4	-3.7	-3.8	
12	Contribution from price and exchange rate changes 3/	-4.2	-3.7	-4.0	-4.8	-5.1	-3.6	-4.3	-4.4	-4.4	-4.5	-4.5	
13	Residual, including change in gross foreign assets (2–3)	12.6	8.1	11.1	7.4	10.9	3.6	4.0	4.6	4.7	4.9	4.8	
	External debt-to-exports ratio (percent)	545.6	556.2	608.4	583.4	585.1	581.0	585.1	582.2	579.2	574.8	569.4	
	Gross external financing need (billions of euros) 4/	47.7	51.4	60.2	65.9	69.5	75.3	79.7	83.2	86.1	89.3	80.1	
	In percent of GDP	34.4	35.7	40.4	42.4	42.7	44.8	46.0	46.4	46.2	46.1	39.7	
	Scenario with key variables at their historical averages 5/						216.2	216.2	215.6	215.1	214.7	214.2	**-9.2**
	Key macroeconomic assumptions												
	Real GDP growth (percent)	-0.8	1.5	0.9	1.4	1.7	1.0	0.8	1.5	1.7	1.8	1.8	
	GDP deflator (change in domestic currency)	3.2	2.4	2.5	2.8	3.0	2.2	2.2	2.2	2.1	2.1	2.1	
	Nominal external interest rate (percent)	3.2	3.0	2.7	3.7	4.7	5.1	4.6	4.6	4.5	4.5	4.5	
	Growth of exports (euro terms, in percent)	2.2	5.9	3.9	13.0	10.6	7.3	5.2	6.5	6.3	6.3	6.1	
	Growth of imports (euro terms, in percent)	-1.8	8.5	6.5	8.9	7.6	8.2	4.4	4.3	4.1	3.8	3.8	
	Current account balance, excluding interest payments	-0.3	-2.0	-4.2	-3.0	-1.0	-1.9	-1.7	-1.3	-0.7	0.0	0.7	
	Net nondebt creating capital inflows	7.6	2.4	-1.8	2.6	0.8	2.4	3.0	3.0	2.9	2.8	2.7	

1/ Refers to gross external debt.

2/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

3/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both noninterest current account and nondebt inflows in percent of GDP. Averages are for the period 1998–2007.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and both noninterest current account and nondebt inflows in percent of GDP) remain at their levels of the last projection year.

Table 8. Portugal: Status of Implementation of FSAP Main Recommendations

Recommendation	Status
Short-term stability issues	
► Continue to carefully monitor key risk areas:	
- household debt, especially toward more vulnerable subgroups of household borrowers;	Results of the new round of the wealth survey have become available in early 2008.
- corporate debt developments;	Refinement of existing statistics for cohorts of corporate sector and development of credit risk analytical tools were introduced.
- banks' lending concentrations; and	Instruction 17/2007 on concentration risks require banks to adopt internal limits on exposure concentrations to certain sectors and regions. However, banks have yet to establish these internal limits.
- banks' external borrowing and the associated pricing and liquidity risks.	The frequency of liquidity monitoring has been increased. In early 2008 banks were required to report liquidity stress test results and contingency plans to deal with prolonged wholesale funding distress.
► Continue to ensure bank capital levels are consistent with the evolving risk outlook and if necessary impose additional capital requirements using the discretion available under Basel II.	Bank of Portugal (BdP) has been proactive encouraging banks to increase capital, particularly in recent months. Most major banks have either increased capital or announced capital increases.
► Continue to foster banks' systems to accurately measure, monitor, and adequately control risks, and further strengthen the BdP's supervisory capacity in this area.	Banks' risk management systems have been enhanced recently following the adoption of Basel II. BdP's capacity in this area is also being strengthened in the context of the adoption of a risk rating system (MAR).
► Perform further stress testing on the financial system at appropriate intervals, taking into account banks' linkages with the insurance sector and their employee pension funds.	A new run of stress-tests encompassing the whole range of materially relevant risks to the banking system is programmed to take place in the second half of 2008.
Structural and longer-term issues	
► Improve the judicial framework for debt recovery by speeding up court processes in particular.	Not yet Implemented
► Enhance the financial independence of the securities and insurance supervisors, Comissão do Mercado de Valores Mobiliários (CMVM) and the Instituto de Seguros de Portugal (ISP).	The Government has approved the inclusion of a permanent provision on the subject of the surplus and the freezing of CMVM budget lines that will be published and come into force this summer. There is also a proposal for the revision of the Ministerial Order setting CMVM supervisory fees. The ISP has already submitted to the Government a proposal to amend its charter to replicate the provision that has been included in the State Budget Law since 2006, setting out that the general budgetary and public accountancy rules regarding freezing of funds, carry-over and use of surplus, and the twelfth expenditure system are not applicable to the ISP.
► Transfer the management of the guarantee fund for Motor Third Party and workers compensation from the ISP to other organizations.	The draft law that implements the transfer of the management of the Guarantee Fund for Motor Third Party and Workers Compensation Fund from the ISP to a new public company was in public consultation until 14th of July and it now under scrutiny by the Government.
Refinements to supervisory and safety net arrangements	
► Fully implement the new system for risk profile assessment of credit institutions and other financial intermediaries, as planned; and	BdP's risk assessment system (MAR) is already in force. During 2008, and after being fully tested during 2007, throughout its application to a sample of institutions, this methodology is being used to guide on-site examinations to all the major banks. Additionally, BdP is developing a software tool to support MAR.
► In insurance supervision, set appropriate fit and proper criteria for members of governing bodies of insurance undertakings and intermediaries, strengthen corporate governance requirements, and establish rules or guidelines on market conduct regarding the problem of fraud.	A draft law, currently under Government consideration after a period of public consultation, will: a) Set fit and proper requirements for senior management; the supervisory authority could recommend the replacement of a senior manager that does not comply with the fit and proper requirements; b) Establish a duty for insurance undertakings to approve and monitor standards of business conduct and an ethical behavior code for the industry; d) Require insurance undertakings to establish a specific and autonomous complaint management function and to set out an Ombudsman; e) Introduce an obligation to insurance undertaking to have a policy regarding the prevention, detection and report of insurance fraud.

Table 9. Portugal: Fund Policy Recommendations and Implementation

Policy Area	Fund Recommendations	Implementation
Fiscal policy		
Fiscal consolidation	Front-load the adjustment in 2007 and 2008 to make the objective of meeting the MTO by 2010 more credible, by following through on central administration restructuring.	The 2007 deficit target was surpassed without one-off measures. The improvement was driven by expenditure reduction especially of the wage bill, and significant revenue overperformance. However, the cut in the VAT rate and some stimulative measures will reduce the structural consolidation in 2008. Additional measure will likely be needed to reach the MTO.
Budget planning	Strengthen budget planning and control and move toward comprehensive multiyear budget targets.	Good progress with pilot programs to implement performance-based budgeting. The plan is to move to performance-based, medium-term budgeting with expenditure ceilings.
Structural reforms		
Labor market	Take steps to make the labor market more flexible in the context of the labor code review. These include easing employment protection legislation, eliminating the automatic extension of collectively agreed contracts to firms not part of the agreement, and making procedures less cumbersome.	The recent agreement on reforming labor relations is expected to facilitate internal flexibility for companies, rationalize collective bargaining, encourage firm-level agreements, and streamline procedures for dismissal. However, the envisaged increase in the rate of social security contributions on fixed-term contracts may hamper employment creation and needs to be carefully monitored.
Product market	Extend the SIMPLEX program to simplify the permit system, especially at the local level, to further strengthen the business environment. Enhance competition further in domestic markets, especially in network industries and some service sectors.	Significant progress with the SIMPLEX program to streamline licensing. Progress in increasing competition in the domestic market, for example with the notaries.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
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Appendix I

Public Information Notice (PIN) No. 08/--
FOR IMMEDIATE RELEASE
October --, 2008

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

IMF Executive Board Concludes 2008 Article IV Consultation with Portugal

On October 1, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Portugal.[1]

Background

A modest recovery was underway until 2007. Growth rose to 1.8 percent in 2007, led by strong external demand, which had been driving a notable rebound in export growth in the last two years. In response, corporate investment gathered steam, which, along with robust private consumption, led to a pick up in domestic demand. Modest employment growth failed to keep up with continuing labor force growth, leading to unemployment rising to 8.0 percent in 2007. Inflation, while below that of the euro area since late 2007 (in part due to lower regulated prices), has picked up due to higher food and energy prices. The current account deficit (including capital transfers) narrowed to about 8½ percent of GDP in 2007.

Real GDP growth is projected to slow to about 1 percent in 2008 and to about ¾ percent in 2009, owing to deterioration in the global outlook, higher commodity prices, the stronger euro, and the

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

fallout from the international financial turbulence. Relatively robust external demand is forecast to lead to a positive contribution from the external sector, while domestic demand is expected to become more subdued. Private consumption is forecast to remain constrained by weak employment growth and high indebtedness. While some corporate balance sheet restructuring has occurred, still-high enterprise debt levels and tighter credit conditions may restrain the rebound in investment. Some continued fiscal consolidation and structural reforms are projected to prompt a gradual recovery in competitiveness and productivity.

Decisive government action has reduced fiscal imbalances and enhanced credibility—since 2005, the deficit has fallen by 3½ percentage points of GDP to 2.6 percent of GDP in 2007. The consolidation has been driven by containing primary current spending. Revenue overperformance has also contributed, due in significant part to enhanced revenue administration. Fiscal consolidation is set to continue in 2008, though at a slower pace. Following substantial overperformance in 2007, the government lowered the deficit target to 2.2 percent of GDP. The restructuring of the central administration will play a central role in achieving fiscal consolidation goals and improving productivity. Recent reforms to the social security system have significantly improved long-term fiscal sustainability. Important steps to move to performance-based budgeting are underway.

Portugal's financial system remains sound and well supervised. The financial system has come under pressure but has so far weathered the recent global financial turmoil, though vulnerabilities have risen. Portuguese banks' reliance on wholesale funding, the sensitivity of bank employees' pension funds and banks' own investment portfolios to stock market returns, high household and corporate debt, and significant loan concentration in some banks to certain sectors and large exposures remain sources of risk. The authorities have been pro-active in addressing these vulnerabilities; for example, banks with weaker capital ratios have been encouraged to raise capital, and the Bank of Portugal has enhanced monitoring of banks' liquidity positions and banks' plans to address potential liquidity shortfalls.

Executive Board Assessment

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Portugal: Selected Economic Indicators, 2003–09

	2003	2004	2005	2006	2007 1/	2008 1/	2009 1/
Real economy (change in percent)							
Real GDP	-0.8	1.5	0.9	1.4	1.7	1.0	0.8
Domestic demand	-2.1	2.7	1.6	0.7	1.1	0.8	0.8
CPI (year average, harmonized index)	3.3	2.5	2.1	3.0	2.4	3.2	2.1
Unemployment rate (percent)	6.3	6.7	7.6	7.7	8.0	8.0	8.0
Gross national saving (percent of GDP)	16.8	15.5	13.1	12.1	12.4	11.5	11.3
Gross domestic investment (percent of GDP)	22.9	23.1	22.6	22.2	22.2	22.1	22.1
Public Finance (percent of GDP)							
General government balance	-2.9	-3.4	-6.1	-3.9	-2.6	-2.2	-2.2
General government balance 2/	-5.3	-5.5	-6.1	-3.9	-2.7	-2.4	-2.2
Primary balance 2/	-2.5	-2.8	-3.5	-1.1	0.1	0.5	0.9
Public debt	56.8	58.3	63.6	64.7	63.6	63.3	63.3
Money and credit (end-of-period, percent change)							
Total domestic credit	1.7	4.5	6.9	12.5	13.5	...	...
National contribution to euro area M3 3/	4.3	5.7	5.8	3.4	9.0	...	...
Interest rates (end-period)							
Deposit rate, up to two years 4/	2.0	2.0	2.1	2.7	3.6	...	...
10-year government bond yield	4.4	3.6	3.5	4.0	4.5	...	...
Balance of payment (percent of GDP)							
Trade balance	-9.1	-10.3	-11.0	-10.7	-10.8	-10.4	-10.3
Current account (including capital transfers)	-6.1	-7.6	-9.5	-10.1	-9.9	-10.7	-10.8
Net official reserves (billions of U.S. dollars, end of period)	11.5	10.7	10.9	9.4	10.8	...	...
Exchange rate							
Exchange rate regime -- euro-area member							
Present rate (July 24, 2008) U.S.$1.57 per euro							
Nominal effective rate (2000=100)	104.6	105.4	105.6	105.8	107.1	...	...
Real effective rate (2000=100)	109.6	110.6	110.8	111.5	113.5	...	...

Sources: Bank of Portugal; Ministry of Finance; and IMF staff estimates and projections.

1/ Figures for 2008 and 2009 are projections.
2/ Excludes one-off measures.
3/ Excludes currency in circulation held by nonbank private sector.
4/ Data refer the stock of outstanding deposits.