**EXECUTIVE BOARD MEETING**

SM/18/218
Correction 1

September 5, 2018

To: Members of the Executive Board

From: The Secretary

Subject: **Portugal—Selected Issues**

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|---|---|
| Board Action: | The attached corrections to SM/18/218 (8/24/18) have been provided by the staff: |
| **Evident Ambiguity** | **Pages 6, 67, 86 (Box 2)** |
| **Factual Errors Not Affecting the Presentation of Staff's Analysis or Views** | **Pages 1, 2, 20, 26, 30, 31, 78, 86 (para. 20), 89** |
| **Typographical Errors** | **Pages 19 and 71** |
| Questions: | Mr. Cuevas, EUR (ext. 34802)<br>Mr. Santos, EUR (ext. 36389)<br>Ms. Kirabaeva, EUR (ext. 35997) |

INTERNATIONAL MONETARY FUND

# PORTUGAL

## SELECTED ISSUES

August 21, 2018

Approved by
**The European Department**

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## CONTENTS

lenders to take excessive risks, aggravating the still-elevated leverage and posing risks to financial stability in case of a negative shock. This paper attempts to provide an estimate of the downside risks to future GDP growth, based on the current level of GDP growth and current financial conditions.

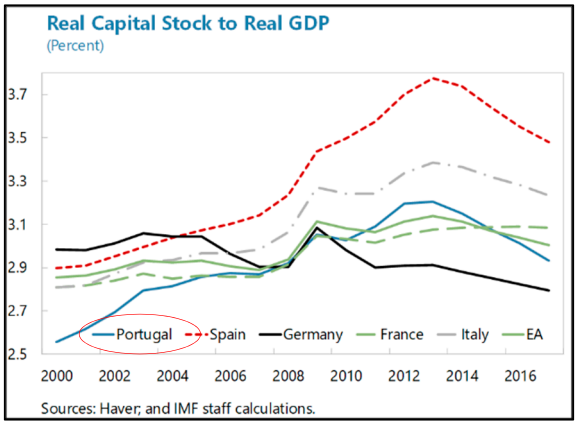
**4. The GaR methodology involves three key steps.** First, financial conditions indicators are partitioned into a predetermined number of subgroups using a data reduction technique. Second, a model of future output growth is estimated as function of current economic conditions and the partitioned financial conditions indicators using quantile regressions. Finally, the conditional quantile function (or inverse cumulative distribution function) is transformed into a probability density function by fitting a skewed *t* distribution. This probability density function is then exploited to quantify downside tail risks to future GDP growth.

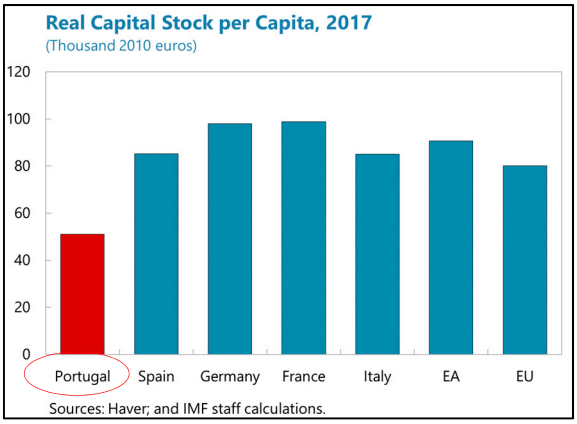
**5. The paper is organized as follows.** The next section summarizes the prevailing macro-financial environment in Portugal. The subsequent section describes the methodology for building Portugal's financial conditions measures and discusses the results. The section after provides estimates for downside risk to GDP growth. The last section concludes with policy implications.

## B. Macro-Financial Environment in Portugal

**6. Portugal's economic activity picked up in 2017, and the gap between the economic and financial cycle is narrowing.** After three years of moderate growth, real GDP accelerated to 2.7 percent in 2017, the highest since 2000, and the output gap is closing. Although the credit cycle continues to trail the cyclical recovery, the gap is narrowing driven by a strong increase in new lending to households for consumption and house purchases, as well as to nonfinancial corporates with good risk profiles. The robust growth in new lending has supported aggregate demand and thus the economic recovery, but may have also slowed the deleveraging process.

**7. Despite recent progress, financial imbalances remain elevated.** While the nonfinancial private sector's debt-to-GDP ratio fell 47 percentage points since 2012, it is still among the highest in the euro area, with total household and corporate debts standing at 74 and 138 percent of GDP at end-2017 (unconsolidated basis), respectively. For its part, public debt remains elevated at 126 percent of GDP. In the banking sector, the still high stock of non-performing loans (13.3 percent of total loans at end-2017) and modest profitability prospects remain concerns. In the housing markets, prices continue to increase (about 20 percent in real terms since 2013 compared to seven percent in the euro area), and there are concerns that the current easy financial conditions could boost mortgages and further drive up prices. In this environment, a sudden repricing of risks could affect financial stability and thus economic growth.



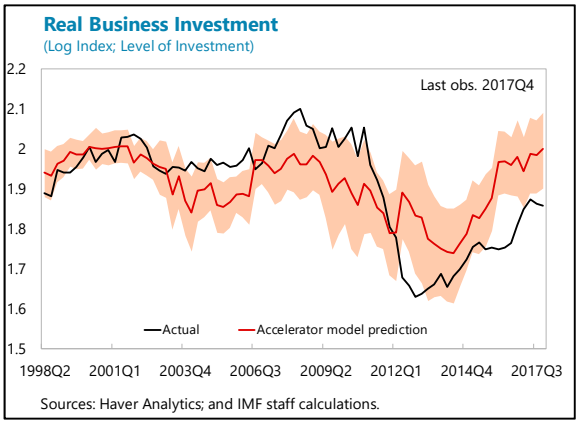



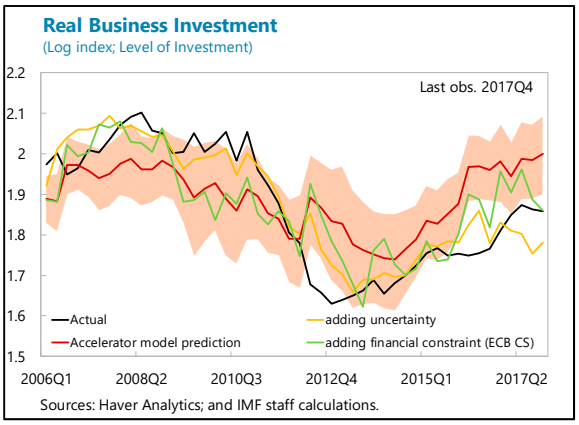

## C. Business Investment: Drivers Supporting the Recovery

**9. The business investment recovery appears to be weaker than what could be expected based on economic activity.** The literature suggests that a slump in business investment after a crisis is usually a symptom of weak economic activity. The conventional accelerator model of investment assumes that firms adjust their capital stock gradually toward a level that is proportional to output, investing to replace capital that depreciates over time. Therefore, investment is supposed to respond positively to current and lagged changes in output and to the lagged capital stock:

$$I_t = \alpha + \sum_{i=0}^{N} \beta i \Delta K^*_{t-i} + \delta K_{t-1},$$

where $I_t$ denotes real business investment and $\Delta K^*_t$ denotes the change in the desired capital stock, which is assumed to be proportional to the change in output: $\Delta K^*_{t-i} = \gamma Y_t$. [6] Estimating this model with Portuguese data, suggests that investment in Portugal remains below the level that would be predicted given the pace of economic activity.



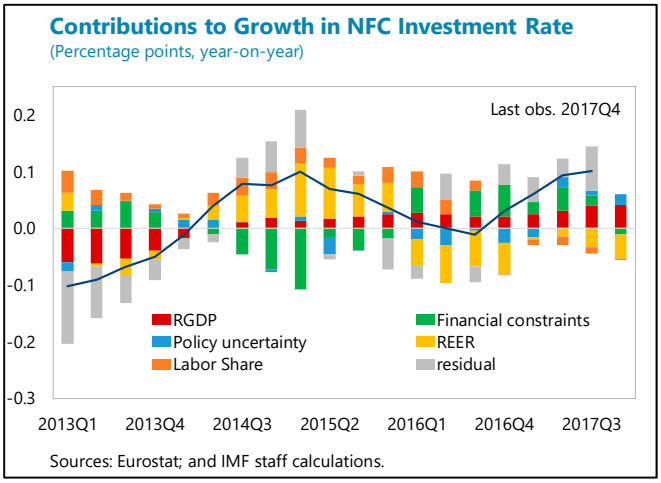




[6] This is the version applied to selected Euro Area economies in International Monetary Fund, 2015, "Private Investment: What's the holdup?", World Economic Outlook, April 2015, Chapter 4.

**10. Financial constraints and policy uncertainty appear to be the most relevant factors holding investment back, especially in economies affected by the crisis.** Adding those two factors[7] into the accelerator model helps to explain investment dynamics better (IMF, 2015). Financial constraints are measured as the percentage of respondents in the European Commission's Business and Consumer Surveys that identify such constraints as a factor limiting their business production. Uncertainty is measured by the Baker, Bloom, and Davis's (2013) index of policy uncertainty, which is based on newspaper coverage of policy-related economic uncertainty. These factors, added to economic activity in the accelerator model, bring model-predicted investment closer to observed investment. Using alternative measures such as the Composite Indicator of Financial Stress (Braga, Pereira, and Reis, 2014) and ~~news~~survey-based uncertainty measures (Manteu and Serra, 2017), the model tracks investment dynamics better during the crisis and produces similar fit for the post-crisis years (see Figure 1 in Annex I).

**11. Investment in Portugal is also hampered by still-high leverage.** At end-2017, the nonfinancial corporate sector's debt stood at 137.7 percent of GDP.[8] Already high-debt contributes to the presence of financing constraints experienced by firms. In addition, the still large stock of bad loans on their books constrains banks' ability to grow their balance sheets and provide substantial new credit for investment. The smaller firms, which are more reliant on bank financing, were found to have a lower investment response to aggregate demand (IMF, 2016a).

**12. The reduction in labor costs and the improved competitiveness mitigated the impact of financial constraints by boosting firms' internal financing.** The profit margins of NFCs were on a declining path prior to the crisis, with this trend reversing in 2009. The chapter on "Deleveraging and Profit Margins in Portugal" analyzes the determinants of NFC profit margins and finds ULCs to be negatively related to profit margins. Declining labor costs and a weaker REER contributed to the recovery of investment by NFC from 2013.[9] The impact of lower real ULC and weaker REER is interconnected and is in line with research findings that depreciations support internal financing opportunities, spurring investment (Berg, Dao, Minoiu, and Ostry, 2015).




[7] The most recent EIB Investment Survey identifies these two factors among the main barriers to investment in Portugal (EIBIS, 2017).

[8] Non-consolidated data.

[9] The regression estimation results are available in Annex I.

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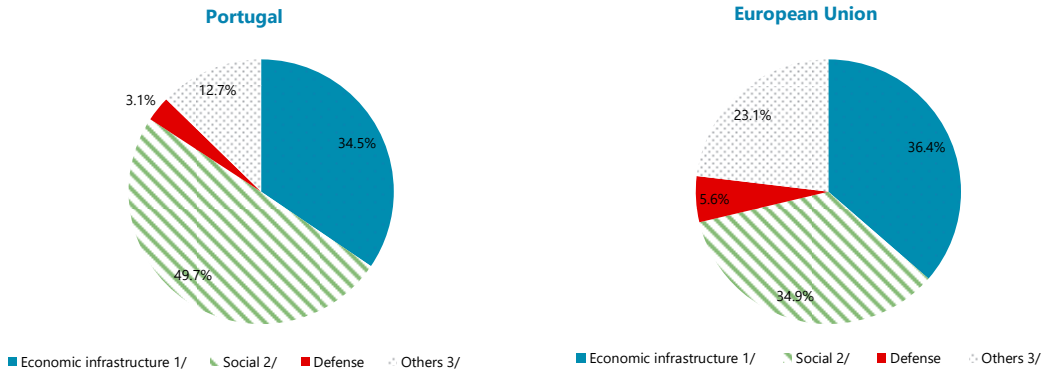
**Figure 5. Public Investment by Function in 2015**



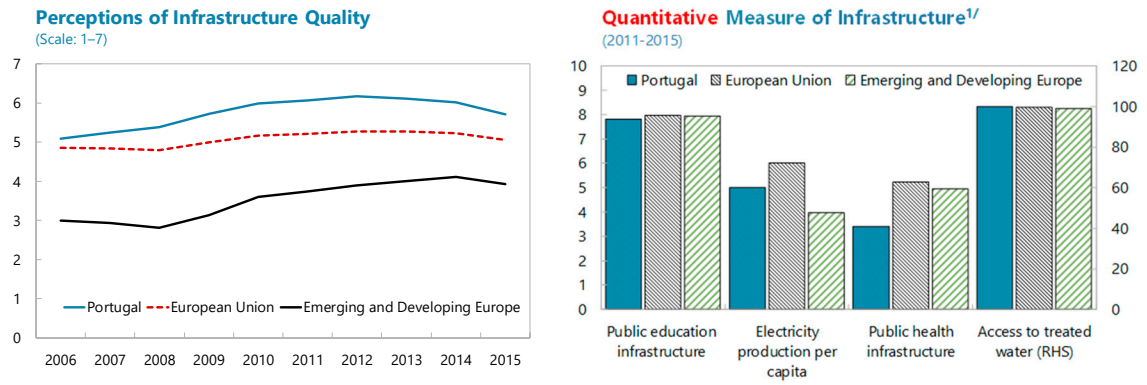

Source: IMF and staff estimates based on official data.

1/ Economic infrastructure is proxied by capital spending classified under "economic affairs' and includes public investment for transportation infrastructure, among other components.
2/ Social comprises of public investment in education, health, housing, social protection, and recreation and culture.
3/ Other includes public investment in general public services, safety and public order, and the environment.

**7. Portugal's indicators of infrastructure quality compare favorably to those for EU peers, but access appears limited in certain areas (Figure 6).**[5] The perceived quality of public infrastructure had been significantly above the average of European peers since 2006, even though the advantage narrowed somewhat after the 2010 financial crisis. At the same time, physical measures of access to infrastructure and service delivery show large variations, with some sectors lagging relative to EU countries. In recent years, Portugal had similar access to education, and treated water and sanitation services compared to other EU members; whereas, its infrastructure ~~service delivery~~ indicators in the health, and electricity ~~and roads~~ sectors was below average.

[5] It should be noted that survey-based indicators of quality of infrastructure do not cover social infrastructure, such as infrastructure services in health, education, or water sectors, which are part of the physical indicators. Thus, quality and physical indicators complement each other, allowing to get a better sense of the overall efficiency of public investment.

**Figure 6. Indicators of Infrastructure Quality and Quantity**




Sources: ~~IMF~~ World Development Indicators, World Economic Forum, and staff estimates ~~based on official data~~.
1/Units vary to fit scale. Left hand axis: Public education infrastructure is measured as secondary teachers per 1,000 persons; Electricity production per capita as thousands of kWh per person; ~~Roads per capita as kilometer per 1,000 persons~~; and Public health infrastructure as hospital beds per 1,000 persons. Right hand axis: Access to treated water is measured as percent of population.

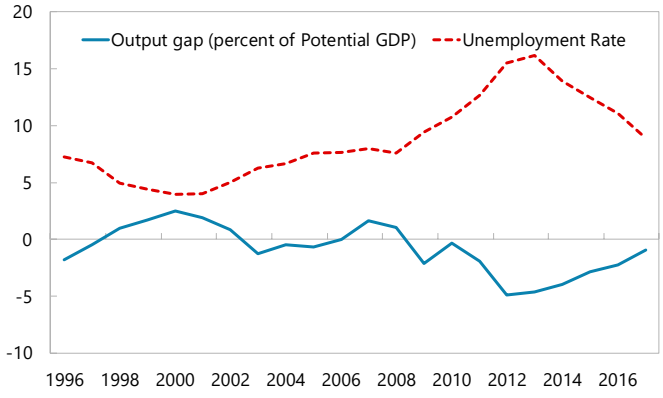
**8. On average, Portugal's public investment efficiency appears good, although there is room for improvement (Figure 7).** A combined indicator of the perception of infrastructure quality, physical access and service delivery (i.e., a hybrid indicator) suggests that public investment was below its potential efficiency level in 2015.[6] The resulting efficiency gap between Portugal and the most efficient European countries with comparable levels of public capital stock per capita averaged at about 15 percent—which is also approximately the average gap in the European Union. This suggest that less than one-fifth of Portugal's public capital stock either was not of the highest quality or failed to provide sufficient access or service delivery standards. Consequently, there is some scope for improving public sector investment efficiency.

[6] For more information on how the hybrid indicator is constructed consult IMF (2015)

**starting position.** Since 2011, a significant relative price adjustment has been achieved largely through a decline in ~~tradable sector~~ ULCs (Figure 2), contributing to the achievement of trade surpluses after many years of large deficits. However, the ULC improvements reflect, to some extent, wage declines and labor shedding (IMF, 2015). Other price-based measures of competitiveness indicate only modest gains since the global financial crisis. As of 2017, the NIIP remains very high and exposes the economy to abrupt changes in financial market sentiment, an increase in the risk premium and the reversal of capital flows. Notably, the European Commission has identified Portugal's NIIP as one of the drivers of its macroeconomic imbalances.[2] At negative 106 percent of GDP, the NIIP remains significantly beyond the Commission's country-specific prudential threshold of -48 percent.[3] To bring the NIIP to a safer level in a reasonable time, larger and persistent current account surpluses will most likely be needed.

**4. In the context of a currency union, adjustment to the external balance will require progress on a broad mix of reforms.** While a large current account adjustment has taken place since 2010—helping to move the economy towards external balance—it has coincided with a considerable deviation from internal balance. The latter has been epitomized by the rise in unemployment and the widening of the output gap, which have more recently been unwinding (Figure 3). In this context, two inter-related relative price adjustments that draw on a broad range of reforms will be central to the continuing external adjustment:

**Figure 3. Output Gap and Unemployment Rates**
(Percent)




Sources: WEO and Authors' Calculations.

(a) Lower domestic versus foreign tradable prices to boost the trade balance: this price adjustment can be achieved *inter alia* by lowering relative production costs (including wage moderation), and continuing to improve non-price competitiveness, e.g., by upgrading labor skills and adopting more efficient technologies (European Commission, 2017).

(b) Lower non-tradable relative to tradable prices to facilitate a reallocation of resources from the non-tradable to the tradable sector. This adjustment can come from a further reduction of ULCs in tradables to raise their relative profitability (e.g. labor market reforms that remove downward wage rigidity, and product market reforms that support innovation), or

[2] See European Commission (2017) and the country-specific report for Portugal (including an in-depth review on the prevention and correction of macroeconomic imbalances) in European Commission (2018).

[3] The country-specific prudential threshold for the NIIP is derived from a univariate signaling approach that identifies the NIIP level at which an external crisis is likely to begin. The threshold widens with increasing income per capita. See also European Commission (2017) and Zoppe and Copland (2017).

NIIP target of -75 percent would entail a 12 percent REER depreciation; while stabilizing the NIIP at -60 percent of GDP will require a nearly 16 percent decline of the REER (Figure ~~6~~7).

- As the target level becomes more ambitious, the present value of forecasted net exports becomes progressively less adequate to stabilize the NIIP, requiring larger real effective depreciation to generate the trade surpluses (and offset a small drag from the net investment income flows) to satisfy the external budget constraint.

## E. Probabilistic External Sustainability Analysis

**13. The probabilistic assessment of sustainability takes account of the uncertainty of future real and financial shocks.** The sustainability of the NIIP is fundamentally a probabilistic question, as forecasts of growth, net exports, gross positions and the rates of returns used in assessing sustainability are random variables. Following the approach in Blanchard and Das, we use the historical outturns of these variables in Portugal to construct their joint distribution, draw shocks from this distribution, and compute the required REER adjustment to stabilize the NIIP at the varying targets shown above under a variety of realizations of those shocks. This way we can derive an estimate of the probability that a REER depreciation may be required to reach a given target NIIP in the chosen 15-year horizon.

**14. Shocks to relative prices may arise from asymmetric price adjustments in the tradable versus the nontradable sector.** As there are two deflators—the CPI and ULC—conventionally used in constructing the REER, we consider joint distributions of shocks corresponding to each of these (Annex I, Table A2), and assess sustainability using results from both. Two observations are relevant:

- The correlations of the real and financial variable shocks with CPI-REER shocks differ from their correlation with ULC-REER shocks, indicating that it is important to explore whether these differences affect the assessment.[7]

- For example, trade shocks are negatively correlated with ULC-REER shocks but positively with CPI-REER shocks. To the extent that prices are more flexible in the tradable sector, this is what one would expect. Take, for example, a labor productivity shock that lowers ULCs. This shock will trigger expenditure switching via a price adjustment in tradables; as nontradable prices are less flexible, however, there will be a delayed adjustment in the CPI deflator, with a correspondingly low shock in the external balance.

[7] While the correlations of the ULC-REER and CPI-REER VAR shocks with the real and financial shocks are different in sign (last row in the correlation matrices of Annex I, Table A2), the remaining correlations correspond closely in sign and to some extent, even in magnitude. Thus, the overall difference in the probability calculations due to using the entire correlation matrix of VAR shocks from the ULC-REER versus CPI-REER are not large.

Bank, 2013 and 2018a).[6] The latest issue of the report positions the country in the top 15 countries surveyed (World Bank, 2018a).[7] The 2018 regional Doing Business Report on enforcing contracts finds that Portuguese courts are homogenous in performance, and "all outperform the EU average on cost and quality" (World Bank, 2018b).[8]

**4. Despite these improvements in institutional performance and efficiency gains, as well as these positive assessments, some challenges persist.** As further stated in the 2018 Article IV Consultation report, debt levels and NPLs continue to be elevated, even if these are now declining (See Figures 1, 2, and 3). Also, some authoritative reports from a few years ago pointed to persistent inefficiencies, which are difficult to reconcile with the positive institutional performance data (ECB, 2016; Jaeger and Martins, 2016).[9] A number of comparative indicators also remain negative. The 2018 European Commission Justice Scoreboard finds that Portugal is a comparatively poor performer in enforcement of civil and commercial claims in the first instance (19th out of 25 countries surveyed; EC, 2018a). Also, Portugal continues to show up in the lower third of countries when compared to European peers in terms of processing time and towards the bottom in terms of pending civil and commercial cases (OECD, 2017; EC, 2018a), although these rankings should be used with caution, as they do not always reflect recent improvements.[10] Indicators on the performance of claims enforcement in Portugal also do not give a uniform message on the efficiency of claims enforcement. The 2017 Intrum Justitia Late Payments Report finds that for business-to-business credit, Portugal is the worst performer on late payments (worst credit risk) of the 29 countries reviewed (Intrum Justitia, 2017). Since late payments are directly linked to effectiveness and efficiency of enforcement systems, presumably therefore the score must be the result of weaknesses in enforcement. Similarly, the Global Competitiveness Report—which is based on a survey by experts—ranks Portugal as 42nd. The assessment ranks the efficiency of the legal framework in Portugal in settling disputes at 121 out of 137 countries, close towards the bottom of the list. Once again, these indices must be used with caution; nonetheless, they raise issues that deserve study.

**5. It seems appropriate to explore more deeply the apparent gap between institutional official performance data, authoritative reports, and indicators in assessing the legal and institutional framework for debt enforcement and insolvency.** The authorities recognize certain

[6] It is recognized that due to methodological changes, 2014 and 2015 data from the World Bank's Doing Business cannot be compared.

[7] Nevertheless, it's worth keeping in mind that the World Bank Doing Business indicators are not based on actual case data but on standardized test cases.

[8] The granular studies of individual courts in the World Bank report concludes that all Portuguese courts covered are faster than the European average, with the exception of Lisbon and Porto. According to the World Bank report, except for those two courts, Portugal would be in the top 15 performers worldwide (World Bank, 2018b).

[9] In a 2015 Fund staff survey of businesses, the effectiveness of the judicial system was identified as a key area in need of further reforms (Jaeger and Martins, 2016). In a 2016 ECB report, the judicial system was considered as one of the main obstacles to NPL resolution in Portugal~~by the national central bank, the Banco de Portugal~~. For instance, a 2016 Reuters article also describes negative perceptions about the inefficiency and slowness of the judiciary (See: https://www.reuters.com/article/us-portugal-judiciary-insight-idUSKBN13H0GI).

[10] While the EC Justice Scoreboard generally uses 2016 data, the most relevant charts show only 2010 data for Portugal. The OECD report uses 2014 data.

given that 64 percent of the NPLs relate to non-financial corporations, and part of them are ~~"legacy NPLs" which overwhelmingly appear to be~~ non-viable ~~businesses (EC, 2018b)~~.

**21. Recently, the authorities have also undertaken other supporting reforms to increase equity in companies.** The government created a mechanism for increasing share capital by converting shareholder loans into shares. In addition, since March 2018, a legal regime for debt-equity swap is in place by which—in cases of negative equity or default—courts may override shareholder opposition to swap debt into equity if requested by two thirds of creditors.[24]

### Out-of-Court Regime

**22. It appears that the purely out-of-court principles adopted in 2011 have been used[25] and in February 2018, the out-of-court regime— namely, the *Sistema de Recuperação de Empresas por Via Extrajudicial (SIREVE)*[26] was replaced by a new out-of-court process—*Regime Extrajudicial de Recuperação de Empresas (*RERE).[27]** Since purely out-of-court restructurings are typically confidential and do not involve courts there is no official data on them. Up until December 2017, 625 cases (83 percent of which were micro or small businesses) entered the SIREVE process, of which 87 percent were accepted. Of those, about 94 percent have concluded in the meantime, with 57 percent of those cases ending with a debt restructuring agreement.[28] The median duration of the concluded processes was about eight months.

#### Box 2. Key Differences Between RERE and SIREVE

**There are a number of key differences between RERE and SIREVE:**

- Instead of the *Agência para a Competitividade e Inovação* (IAPMEI, a government agency), there are newly certified mediators that may support the debt restructuring process.
- In contrast to SIREVE, RERE no longer stays creditors' enforcement actions. RERE is purely out-of-court and does not have any enhanced (in-court) features like SIREVE. However, PER can be used to approve a restructuring plan agreed under the RERE.
- In RERE, the early warning attestation from an accountant is no longer mandatory. There is now a general early warning system for all businesses administered by IAPMEI.
- Tax incentives treating debt restructuring events as tax neutral are available for the RERE.

**23. Regarding private sector initiatives, the three major banks set up a platform to coordinate debt claims concerning their common debtors.** This platform became operational in May 2018. The governance structure of the platform enables coordination and triaging of the NPLs among the participating banks.

[24] Law 7/2018, of March 2, 2018.

[25] Out-of-court principles of October 25, 2011.

[26] Decree-Law 178/2012, August 3, 2012, as amended by Decree-Law 26/2015, February 6, 2015.

[27] Law 8/2018, March 2, 2018.

[28] See SIREVE *Sintese Informativa* December 2017.

such as the 2018 EC Justice Scoreboard, which generally uses 2016, but on some charts, use data as old as 2010 or the OECD report that uses 2014 data (EC, 2018; OECD, 2018).

- ***Survey versus analysis***. Indicators which are based on perception and surveys rather than on data and empirical studies, tend to be more critical.[30] This seems to suggest that market perceptions lag indicators based on data and empirical studies.

**32. Finally, it is recognized that an efficient legal and institutional framework for debt enforcement and insolvency is only one of the elements needed to resolve NPLs (Aiyar and others, 2016).** For a number of reasons, the authorities have not employed all tools available to resolve NPLs such as asset management companies. NPL sales only recently have increased. There have also been major bank recapitalizations in recent years further stabilizing the financial system (IMF, 2018). Some stakeholders also report that during the height of the crisis, creditors may have used delays in the court system to buy time to await economic recovery and asset price appreciation. There ~~are no~~is limited ~~data~~ publicly available data to better understand the stock of NPLs in terms of vintage and types of loans (for instance, secured versus unsecured).

## D. Conclusions

**33. Empirical evidence and official data confirm that the reforms to the debt enforcement and insolvency regime have been sustained.** The reforms have been structural and continued in the post Fund-supported program period. This is commendable. It appears that market perceptions may lag actual system performance to some extent.

**34. The authorities continue monitoring and reforming the insolvency and debt enforcement system.** The authorities on many levels actively monitor and adjust, to the extent necessary, prioritization and resources. The level of coordination among ministries and agencies continues to be exemplary. For example, the Ministry of Justice closely monitors insolvency and debt enforcement cases and immediately adjust as necessary. The High Council of the Judiciary recently introduced a trial system to monitor debt enforcement cases' recovery rates and disposition times, which is unique in Europe. The authorities' recent plan on the *justiça mais próxima*—which is a plan to make the judiciary a one-stop shop and access electronically to the extent possible—is positive and demonstrates their continued commitment to reform. Finally, Portugal will need to transpose or comply with any instruments—such as the proposed EU preventive restructuring directive—eventually adopted by the EU including in the context of the 2017 Council Conclusions on an Action Plan to Tackle Non-Performing Loans in Europe.[31]

**35. Despite the comprehensive approach to tackling NPLs in Portugal, the focus on NPL resolution for corporates—in particular SMEs which are the highest segment (BdP, 2018; Bergthaler and others 2015)—must continue at the top of the authorities' agenda.** In recent

[30] More generally, the Fund has attached priority to data-based third-party indicators over perception-based ones. See International Monetary Fund (2017).

[31] Proposal for a Directive of the European Parliament and the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures**.** https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2016:0723:FIN.