INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/278

PORTUGAL

September 2017

2017 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR PORTUGAL

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2017 Article IV consultation with Portugal, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its September 11, 2017 consideration of the staff report that concluded the Article IV consultation with Portugal.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on September 11, 2017, following discussions that ended on June 29, 2017, with the officials of Portugal on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 16, 2017.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Portugal.

The document listed below have been or will be separately released.

Selected Issues

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

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FOR IMMEDIATE RELEASE
September 14, 2017

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Washington, D.C. 20431 USA

IMF Executive Board Concludes 2017 Article IV Consultation with Portugal

On September 13, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Portugal.

Portugal has made notable progress over the past year in reducing uncertainty over near-term risks. The exit from the Excessive Deficit Procedure this year, together with a marked improvement in stability and confidence in the banking system, have helped bolster investor confidence and contributed to a sharp narrowing in sovereign debt spreads since mid-March.

The near-term growth outlook has also improved considerably as the ongoing recovery continues to gain momentum, with a pickup in exports and investment alongside the continued growth in private consumption. Tourism remains a key driver of growth, but has also been accompanied by a broad-based pickup in exports of goods in recent quarters, while domestic confidence indicators have strengthened significantly and employment continues to rise.

Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the authorities' progress in reducing uncertainty over near term risks. Strong efforts to contain spending and meet last year's headline fiscal deficit target allowed Portugal to exit the EU Excessive Deficit Procedure in 2017, while stability and confidence in the banking system

[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.

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

have improved following successful efforts to raise capital. The recovery has also gained momentum, with a pickup in exports and investment alongside continued growth in private consumption, as well as a rise in employment. Nonetheless, the elevated public debt in the context of a modest medium term growth outlook leaves Portugal vulnerable to shocks. Directors encouraged the authorities to take advantage of the current benign macroeconomic conditions to further improve financial sector resilience, ensure durable fiscal consolidation, and raise potential growth.

Directors welcomed the improvement in financial sector stability after recent capital augmentations. However, they cautioned that the large stock of NPLs could limit banks' ability to finance productive investment. They called for comprehensive efforts to strengthen bank balance sheets by removing impediments to NPL resolution and boosting internal capital generation to maintain appropriate buffers, including in view of upcoming regulatory hurdles.

Directors commended the authorities' strong efforts to reduce the headline fiscal deficit in 2016, and noted that this year's headline target also appears well within reach. They emphasized the importance of keeping public debt on a firmly downward trajectory over the medium term, and encouraged the authorities to take advantage of the favorable cyclical conditions to make progress on more ambitious structural fiscal consolidation. They recommended focusing on durable expenditure reform to improve the efficiency of public spending while protecting public investment.

Directors emphasized that raising Portugal's productivity and growth potential remains central to reducing the vulnerabilities that weigh on the medium term outlook. Addressing impediments to higher investment is key in this regard. Directors highlighted the need to focus on issues that affect investors' perceptions of the business environment, including reducing rigidities in the labor market, improving the efficiency of judicial processes, and enhancing the predictability of the regulatory environment. In this context, they welcomed the focus of the authorities' National Reform Program on developing human capital and fostering innovation.

Portugal: Selected Economic Indicators

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

		Projections	
	2016	2017	2018
Real GDP	1.4	2.5	2.0
Private consumption	2.3	2.2	1.8
Public consumption	0.5	0.6	0.5
Gross fixed capital formation	0.1	6.9	5.7
Exports	4.4	7.6	5.2
Imports	4.5	7.3	5.1
Contribution to growth (Percentage points)			
Total domestic demand	1.5	2.6	2.2
Foreign balance	-0.1	-0.1	-0.1
Resource utilization			
Employment	1.2	1.6	0.9
Unemployment rate (Percent)	11.1	9.7	9.0
Prices			
GDP deflator	1.6	2.2	1.7
Consumer prices (Harmonized index)	0.6	1.6	2.0
Money and credit (End of period, percent change)			
Private sector credit	-3.7	-1.5	0.1
Broad money	-0.4	4.3	3.3
Fiscal indicators (Percent of GDP)			
General government balance	-2.0	-1.5	-1.4
Primary government balance	2.2	2.6	2.7
Structural primary balance (Percent of potential GDP)	3.0	2.7	2.5
General government debt	130.3	125.7	122.5
Current account balance (Percent of GDP)	0.8	0.6	0.5
Nominal GDP (Billions of euros)	184.9	193.8	201.1

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

INTERNATIONAL MONETARY FUND

PORTUGAL

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

August 16, 2017

EXECUTIVE SUMMARY

Portugal has made notable progress over the past year in reducing uncertainty over near-term risks. Strong efforts to contain spending and meet last year's headline fiscal deficit allowed Portugal to exit the Excessive Deficit Procedure, while stability and confidence in the banking system have improved following successful efforts to raise capital. Improved market sentiment regarding Portugal's near-term prospects has contributed to a sharp narrowing in sovereign debt spreads since mid-March.

The cyclical upturn has gained momentum in 2017, with a pickup in exports and investment alongside the continued growth in private consumption. Tourism remains a key driver of growth, but has also been accompanied by a broad-based pickup in exports of goods in recent quarters, supported by the euro area recovery. Meanwhile, domestic confidence indicators have strengthened significantly and employment continues to rise.

The pickup in growth puts this year's headline fiscal deficit target of 1.5 percent of GDP well within reach. In structural terms, a modest loosening of the fiscal stance is projected, as in the past two years. Durable structural fiscal consolidation is essential to ensure the sustainability of public finances, with high public debt remaining a considerable risk and the financing environment likely to be less benign as monetary accommodation is eventually reduced.

Raising Portugal's growth potential remains central to reducing the still significant vulnerabilities that weigh on the medium-term outlook. This will require further structural reforms to boost investment and productivity, as well as increased bank lending for investment. The recent growth in investment has been financed largely through retained earnings by corporates, but these are unlikely to be sufficient to finance the sustained increase necessary to raise the economy's medium-term growth potential.

The steps to increase capital in the banking system should be followed by ambitious efforts to clean banks' balance sheets. Financial stability has improved after recent capital augmentations, but the large stock of NPLs is likely to limit banks' ability to finance future growth and leave them vulnerable to downside risks. Ambitious efforts are needed by banks to strengthen their balance sheets, which would improve the effective intermediation of savings by the banking sector to productive investment.

Approved By
Mahmood Pradhan and Seán Nolan

Discussions took place in Lisbon during June 19 – 29, 2017. The staff team comprised S. Lall (head), M. Gaertner, A. Santos, Y. Cai (all EUR); E. Lundback (SPR); M. Queyranne (FAD); and T. Bayle (MCM). I. Lopes (OED) participated in key meetings. V. Bezerra de Menezes (EUR) provided assistance from headquarters.

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ANNEXES

CONTEXT: THE RECOVERY GAINS MOMENTUM

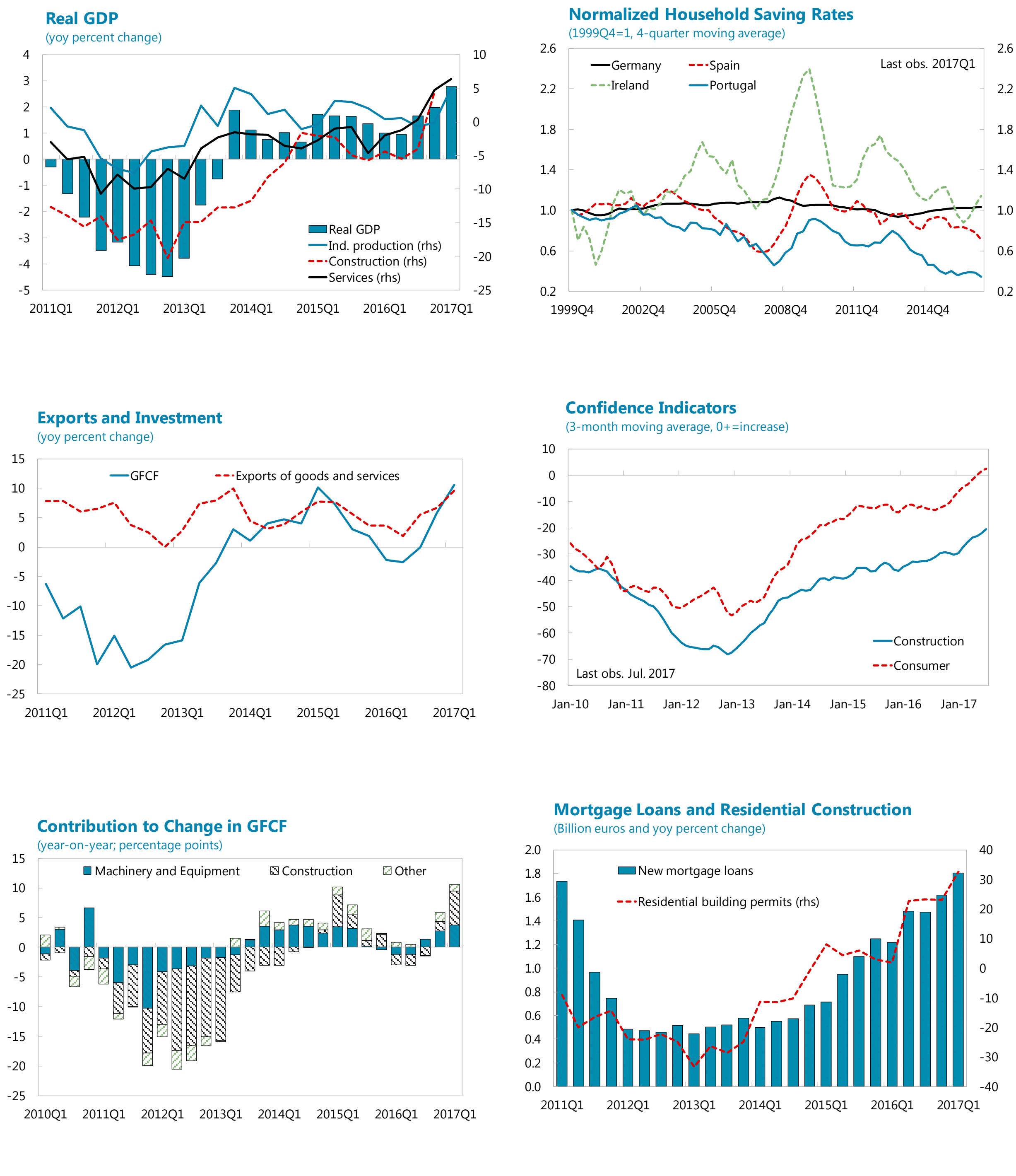
1. **Portugal has made notable progress over the past year in reducing uncertainty over the near-term outlook.** The headline fiscal deficit fell to 2 percent of GDP in 2016, reflecting strong efforts to contain spending and allowing Portugal to exit the Excessive Deficit Procedure that had been in place since 2009. Stability and confidence in the banking system have also improved over the past year, including through the public recapitalization of Caixa Geral de Depósitos (CGD) and the ongoing sale of Novo Banco. Meanwhile, Banco Comercial Português (BCP) has received a large capital injection and Banco Português de Investimento (BPI) has been taken over by Spain's CaixaBank.

2. **Economic activity has accelerated since mid-2016, with a pickup in exports and investment accompanying continued growth in private consumption.** Household consumption continues to outpace growth in disposable incomes, with the household savings rate falling below 4 percent in the first quarter. Tourism also remains a key driver of growth, and has been accompanied by a broad-based pickup in exports in recent quarters, supported by the euro area recovery. Meanwhile, domestic confidence indicators have strengthened significantly and employment continues to rise, with the unemployment rate falling to 8.8 percent in the second quarter of 2017 from 10.8 percent a year ago. Inflationary pressures remain relatively modest, meanwhile, with twelve-month core inflation at 1 percent in July. Near-term growth projections have been revised upwards by staff to reflect the underlying momentum, with real GDP growth now projected to accelerate to around 2.5 percent in 2017, easing to 2 percent in 2018.

3. **The recovery in investment has been supported by a pickup in tourism-related construction and some capital replenishment associated with depreciation.** After a prolonged slump, construction began to pick up in late 2016, boosted by the renovation of rental properties to meet tourist demand and nonresident purchases of residential real estate, including in Lisbon and Porto. House prices have increased by 15 percent in cumulative terms over the past two years through end-March, and now exceed the previous peak recorded prior to the crisis in 2010. Investment in machinery and equipment by firms has also picked up in recent quarters, financed primarily through retained earnings as companies have taken advantage of the decline in unit labor costs in recent years.

4. **Bank lending to the corporate sector remains subdued, but there has been a pickup in new consumer and mortgage lending.** The stock of outstanding credit has continued to contract reflecting in part write-offs and recognition of impairments on existing loans, with total credit granted by resident financial institutions to the private sector falling 4 percent in the twelve months through June. The decline has been particularly pronounced for corporate credit, which fell 7 percent in June (y/y) as new lending to corporates slowed in early 2017. Subdued corporate lending appears to reflect both banks' risk aversion and weak demand for credit from firms that have instead financed investment from internal savings. New lending has instead been concentrated primarily in mortgages and consumer loans, helping to sustain the strong growth in private consumption and rise in housing prices.

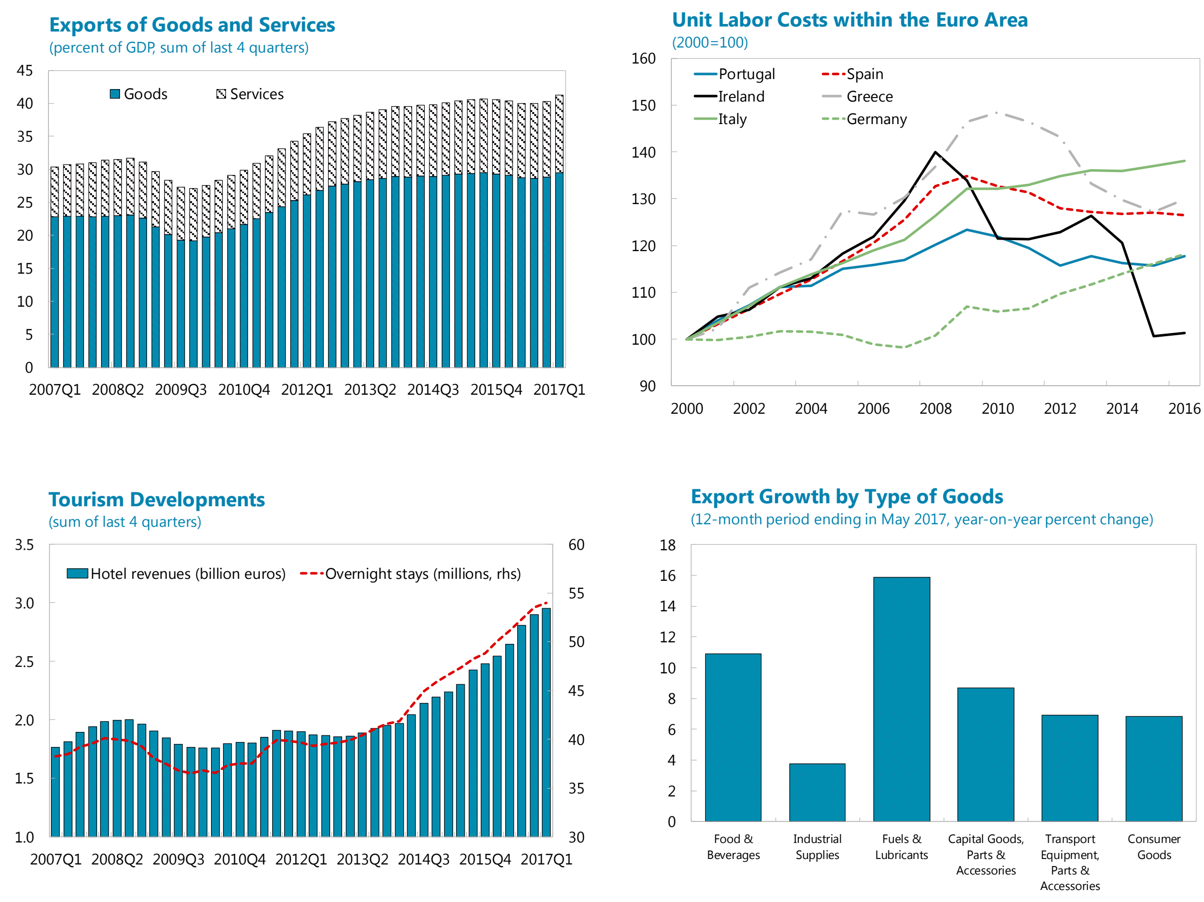
Figure 1. Portugal: Recent Macroeconomic Developments



Sources: Haver Analytics; and IMF staff calculations.

5. The current account remains on track to record a surplus in 2017, with the pickup in exports and sustained growth in tourism partly offsetting increased import demand. Non-fuel goods' exports rose 10 percent during January-June (y/y) compared with 2.5 percent during 2016, boosted both by the cyclical recovery in Europe and stronger demand in key markets outside the EU, including Angola, Brazil and China. Meanwhile, the remarkable expansion of the tourist sector appears set to continue in 2017, following average annual growth in tourism revenues of 11.1 percent during 2014-2016. This has partly reflected geopolitical developments that have increased the attractiveness of Portugal relative to competing destinations, but the tourist sector has also become increasingly diversified, with a range of higher value accommodations. While Portugal's negative net international investment position remains sizable, the shift to current account surpluses has contributed to an improvement from 118 percent of GDP at end-2014 to 105 percent of GDP at end-2016.

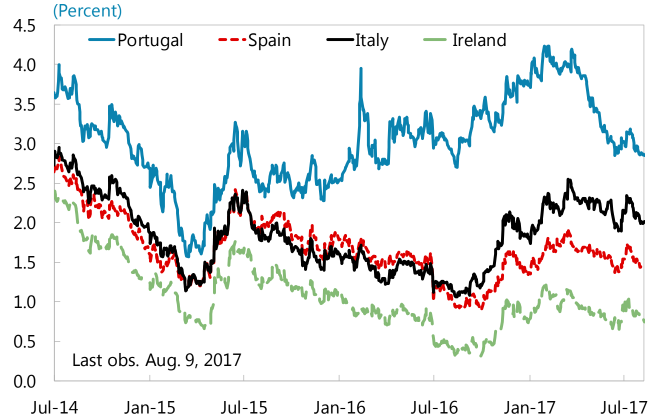
Figure 2. Portugal: External Developments



Sources: Haver Analytics; and IMF staff calculations.

6. Market conditions have improved, with yields and spreads falling sharply during 2017 and the ECB's PSPP still providing significant support to the sovereign debt market. Spreads on 10-year Portuguese bonds vis-à-vis Germany narrowed by 150 basis points from mid-March to around 235 basis points at the end of July, their lowest level since early 2016, as recent macroeconomic developments and increased liquidity in the market have helped to improve investor sentiment. Spreads relative to other southern European economies have similarly narrowed considerably this year. The demand from retail investors has also remained strong this year, with the authorities expanding the issuance of the five-year retail bond introduced in 2016. The ECB's average monthly purchases of Portuguese debt are set to decline by roughly 40-50 percent in 2017, but they will continue to offset about 90 percent of Portugal's net bond issuance and more than 40 percent of gross bond issuance this year.

10-Year Government Bond Yields
(Percent)



Source: Haver Analytics.

Staff's views

7. Portugal's downturn and ongoing economic recovery—now in its fifth year—has been defined by three distinct phases. In the first phase, unit labor costs (ULCs) declined sharply as employment fell by more than output during the downturn.[1] In the second phase, this gain in competitiveness translated into a strong recovery in employment and output, which in turn contributed to downward pressure on ULCs.[2] The economy now appears to be entering a third phase of the recovery, with ULCs rising by 1.7 percent on average in the twelve months through March (y/y) as the rise in aggregate wages has outpaced growth in productivity. In addition, labor cost pressures appear to be emerging in key sectors as the labor market has tightened. Firms appear to have taken advantage of past declines in ULCs, while product prices continued to rise, to increase internal capital generation to finance working capital and investment. This suggests that the ability of firms to continue to increase investment without greater availability of bank financing might be constrained as rising ULCs begin to weigh on corporate savings.

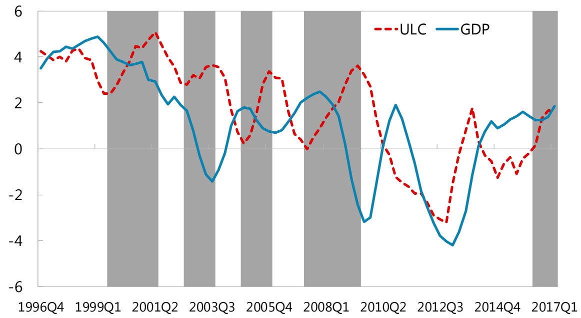
[1] Indeed, the dramatic fall in employment as firms were forced to shed labor during the crisis caused a temporary spike in ULCs in late 2013 as compensation per employee temporarily spiked.

[2] The increase in unemployment in the downturn and decrease in the upturn, in excess of what the Okun's coefficient would predict, is discussed in EBS/14/156, Portugal – Staff Report for the First Post-Program Monitoring Discussions.

Figure 3. Portugal: Unit Labor Costs

Real GDP and Unit Labor Cost

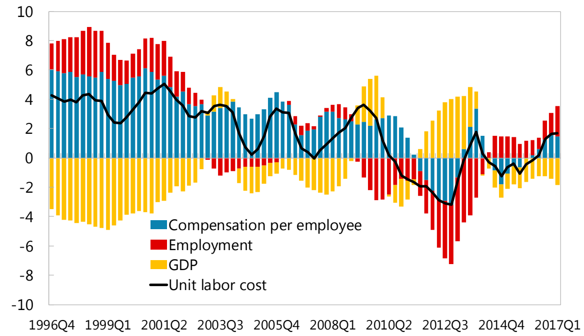
(yoy percent change; 4-quarter moving average)



1/ Grey areas signify where ULCs are rising and associated GDP growth rates.

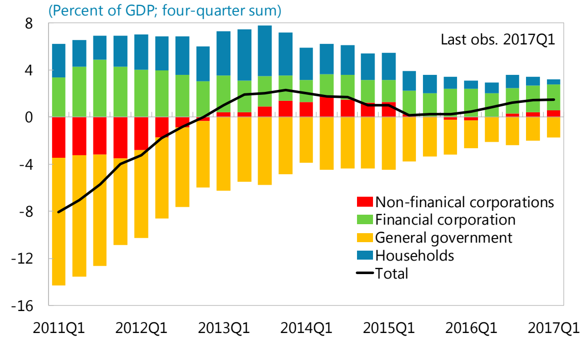
Unit Labor Cost

(yoy percent change; 4-quarter moving average)



Net Lending Excluding One-Off Operations[1]

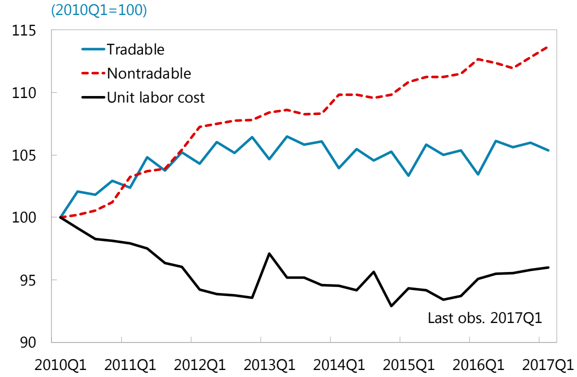
(Percent of GDP; four-quarter sum)



[1] Excludes the recapitalization of Novo Banco (2014) and the Banif resolution (2015).

Unit Labor Cost and CPI

(2010Q1=100)



Sources: Haver Analytics; INE; and IMF staff calculations.

8. **Raising Portugal's growth potential remains central to reducing the significant vulnerabilities that cloud the medium-term outlook.** While the near-term outlook has improved, the country's high public and private debt and large annual financing needs leave it vulnerable to a range of shocks over the medium-term. These are magnified by Portugal's low potential growth. The medium-term policy challenge remains to break the vicious circle between weak banks, high NPLs and low investment that continues to constrain medium-term growth. Sustaining higher investment will require concerted efforts to improve financial sector intermediation, minimize fiscal risks and address persistent structural rigidities.

9. Risks to the growth outlook are broadly balanced in the near-term, but tilted to the downside over the longer-term. The prospect of a stronger-than-expected recovery in the EU would improve the near-term growth outlook, with Portuguese exports increasingly responsive to stronger demand in large EU markets. In addition, large investments in the automobile industry are expected to come online in the next two years. However, the growth in tourism that has underpinned the recovery is likely to moderate over the medium-term, with the number of arrivals having increased by one-third in the past three years. The recovery has also been supported by strong consumption, which was accompanied by a record low household savings rate; this is likely to rise over the medium-term as households look to rebuild their depleted savings. There is also a risk of structurally weak growth in key trading partners, which would dampen medium-term growth prospects (Annex II). Although the ongoing momentum may cause the output gap to turn temporarily positive, medium-term growth is expected to converge to staff's estimated potential growth rate of 1.2 percent without more ambitious efforts to address the structural impediments to investment, which remains well below the euro area average. This compares with average annual growth of 0.8 percent during 2000-2010. Staff calculations show that increasing potential growth to 2 percent by 2021 (in line with the authorities' medium-term framework) would require average annual investment growth of roughly 6½ percent, assuming total factor productivity continues to rise at the current pace (see Selected Issues Paper, "Investment and the Medium-Term Growth Outlook").

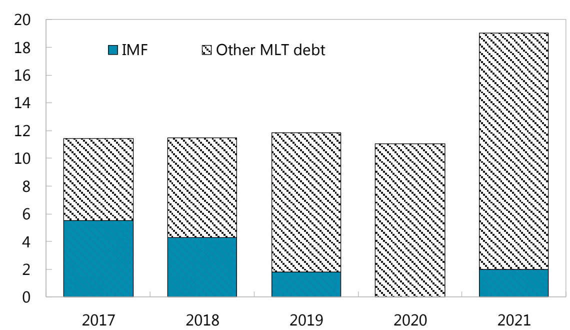
Investment Needed to Achieve a Growth Rate of 2%
(average growth rate, percent)

TFP growth	Investment growth
0	7.9
0.2	**6.4**
0.4	4.8
0.6	3.2
0.8	1.5
1	-0.2

Source: Staff calculations.

10. The financing environment is likely to be less benign over the medium-term as monetary accommodation is reduced. While the relatively favorable maturity structure of Portugal's public debt limits the near-term impact of rising yields, debt redemptions will rise significantly in 2021.[3] Borrowing costs are expected to remain manageable under the baseline of a gradual reduction in monetary accommodation, but a less supportive financing environment increases the risk of sudden fluctuations in market conditions in the event of negative domestic surprises or external shocks such as geopolitical uncertainty or European bank distress, and generally tighter global financial conditions. Spreads have declined during 2017

Public Debt Amortization
(billion euros)



Sources: IGCP and IMF staff calculations. Projected repayments to the IMF include additional advanced repurchases planned for 2018-2019.

[3] To smooth the medium-term repayment profile and lower financing costs, the authorities have made advanced repurchases of SDR 4.3 billion this year, bringing total repurchases since the end of the program to SDR 14.4 billion. In agreement with their European partners, the authorities are planning to make additional repurchases of SDR 4.7 billion by mid-2019. This would leave Portugal's credit outstanding to the Fund at SDR 3.9 billion, above the SDR 1.5 billion threshold where countries are expected to engage in the IMF's Post-Program Monitoring framework.

despite the reduction in PSPP purchases as last year's strong fiscal performance and progress in stabilizing the financial system have improved market sentiment toward Portugal; further efforts to improve financial sector resilience, ensure durable fiscal consolidation and raise potential growth will be essential to maintain investor confidence and reduce medium-term vulnerabilities (see Selected Issues Paper, "Public Financing in a New Environment").

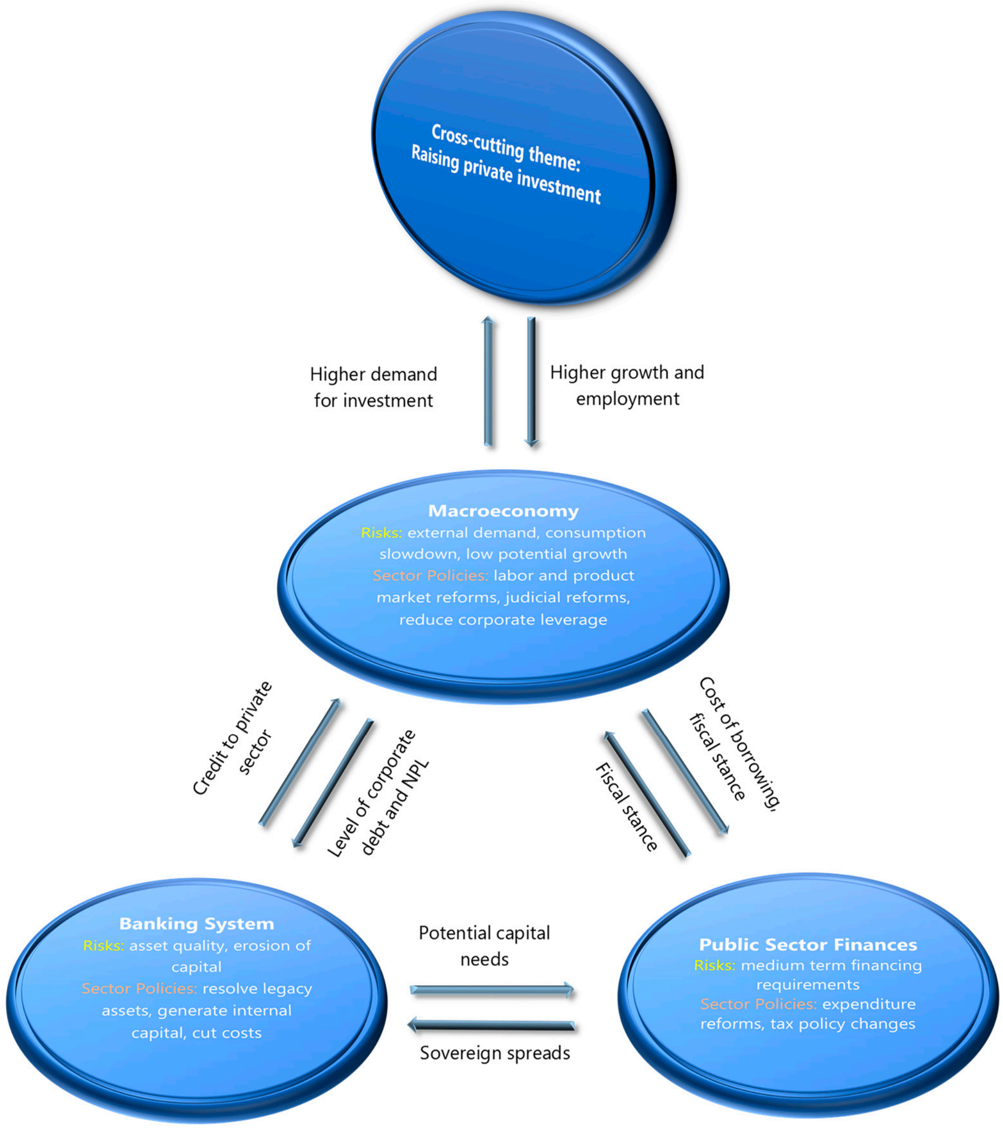
11. Portugal's external position remains weaker than implied by medium-term fundamentals and desirable policy settings. EBA model-based estimates suggest a current account gap of less than 1 percent, representing a deterioration of about ½ percentage point of GDP (see Annex 3). Nevertheless, staff assesses the current account surplus to be insufficient in view of the large NIIP deficit, which needs to be put on a sustained downward trajectory. Staff assesses a current account shortfall of about 2-4 percent of GDP, relative to the level of surplus that will need to be sustained to achieve a meaningful medium-term reduction in the NIIP stock. This is also consistent with EBA results on the REER suggesting an overvaluation of 5-10 percent. This will require policies for sustained fiscal consolidation and structural reforms to improve Portugal's competitiveness and potential growth, as discussed below.

Authorities' views

12. The authorities are confident that structural changes to the economy in recent years have put Portugal on a higher growth path. They emphasized the higher skill levels of new entrants to the labor force, as well as ongoing initiatives to provide mid-career training to current employees, and believe that this will provide the basis for a sustained increased in productivity growth. In addition, they consider that the latest developments in the financial sector will improve lending decisions and the efficiency of capital allocation, and are confident that access to financing is not a constraint on investment. They also highlighted recent export performance as an indication that exporters were gaining market share, competing in higher value added segments in industries such as textiles based on quality and product differentiation, and expect that this will continue to strengthen Portugal's external position over the medium-term. The authorities see a limited relationship between ULCs and export competitiveness, and believe that further gains in market share will be achieved more through quality and innovation than price competition.

13. The authorities consider that growing market confidence in the macroeconomic outlook will support continued favorable access to financing. They noted the successful execution of their borrowing program despite volatility at times over the past year, and were confident that progress in addressing fiscal and financial sector risks had materially strengthened investors' perceptions of Portugal's economy and the strength of public finances. They also highlighted the recent increase in retail issuance as an important development to both diversify their sources of financing and provide an alternative vehicle for household savings. The authorities noted that retail issuance was approaching an optimal level and was likely to moderate in 2018. The debt management office agreed that the ECB's PSPP had in the past, at times, been important in supporting the bond market, but believe that it is now playing a more limited role and expect that any tapering will be gradual. The authorities consider that the maturity structure of public debt and their large cash buffer (at about 50 percent of financing needs over the next 12 months)[4] leave them well-positioned to withstand fluctuations in market conditions, and emphasized that debt management will continue to be proactive in lengthening maturities.

Figure 4. Portugal: Linkage and Policy Focus



[4] As of end-July 2017, excluding rollover of Treasury bills.

POLICY DISCUSSIONS

A. Financial Sector

14. There have been positive steps over the past 6 months to attract new capital into the banking system. The state-owned bank CGD completed a subordinated debt issue of €0.5 billion at end-March[5] (albeit at a relatively high coupon of 10.75 percent), allowing the authorities to move forward with their contribution to the €5 billion recapitalization package agreed with the European Commission. The authorities have also agreed to sell a 75 percent stake in Novo Banco to the U.S. private equity firm Lone Star, in exchange for a €1 billion capital injection (although the terms of the sale and regulatory and supervisory approvals remain to be finalized).[6] Meanwhile, BCP has received a capital injection of €1.5 billion and BPI has been taken over by Spain's CaixaBank.

15. In addition to the recent increases in capital, Portuguese banks are liquid and continue to make progress on shrinking their balance sheets. Nevertheless, they face numerous challenges, including low asset quality, weak profitability and limited capital buffers. There has been a modest decline in the outstanding stock of NPLs since end-2015, supported by the pickup in growth, but they remain elevated at 16.4 percent of total loans at end-March 2017[7] per the EBA definition (accounting for both overdue and unlikely-to-pay loans). This weakness in asset quality remains particularly concentrated in the corporate sector, with corporate NPLs at 29.0 percent at end-March 2017, compared with 6.7 percent on household loans for house purchase and 10.0 percent for consumer and other loans. The coverage ratio increased modestly to 45.5 percent of NPLs as of end-March 2017, with provisioning still much lower for unlikely-to-pay loans than for overdue loans (according to data from the Portuguese Banking Association). Banks have reduced operational costs, but this has been insufficient to offset the drag on profitability from low interest margins and higher loan loss impairments.

Staff views

16. Ambitious efforts are needed by banks to strengthen their balance sheets, which would improve financial intermediation and help raise potential growth. While the recent increases in capital have addressed regulatory requirements, total capital still appears low given the burden of legacy NPLs and upcoming regulatory hurdles. The steps to raise capital need to be accompanied by a comprehensive, time-bound plan to clean up banks' balance sheets and deal with the corporate debt overhang (see Selected Issues Paper, "Challenges for Portuguese Banks"). Staff would recommend speeding up the efforts already undertaken, with a view to:

- ***Boosting internal capital generation***. This will require both cost-cutting and higher earnings. Cost cutting has already started, but further downsizing of domestic and foreign networks,

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[5] A second tranche of convertible subordinated debt is scheduled in 18 months' time for €0.43 billion.

[6] At the time of the mission, the mechanism for sharing responsibility was still being prepared. In addition, the sale is still conditional on a €0.5 billion voluntary conversion of senior into subordinated debt.

[7] The NPL ratio for the six banks covered by EBA stood at 19.5 percent at end-2016.

divestment of non-core assets and business lines, and reducing overhead is needed. Higher earnings will also require banks to diversify their income toward fee-generating financial products and services.

- ***Removing the impediments to NPL resolution.*** The modest improvement in NPL ratios despite the pickup in growth highlights the need for further progress on removing the barriers to NPL resolution, including those recently identified by the ECB stocktaking exercise and guidance. This would primarily entail implementing the recent measures aimed at further improving the legal framework: facilitating workouts for distressed but viable SMEs; improving judicial and extra-judicial insolvency and recovery processes, and collateral enforcement; removing tax disincentives to impairment and write-offs; removing disincentives for public creditors to participate in debt workouts, and developing the NPL market. In addition to streamlining internal workout strategies, the recent increase in banks' provisioning coverage of NPLs should be taken forward to incentivize banks to develop their NPL sales to third parties. The creation of an enhanced creditors' coordination platform (to foster coordination between a distressed borrower's common creditors), alongside legislative efforts to facilitate corporate debt restructuring, should be encouraged. The alternative of a market-wide solution – in the form of a private sector-led Asset Management Company – could also be explored, with due consideration to the lack of fiscal space to allow public financing, key constraints related to the BRRD and State-aid rules, the lengthy foreclosure processes that hinder asset recovery, and difficulties assuring market-based pricing of troubled assets.[8]

- ***Addressing the forthcoming regulatory challenges.*** The most urgent challenge will be to absorb the impact of IFRS 9 rules, which will require banks to set aside provisions based on expected losses instead of incurred losses. Subsequently, the implementation of fully loaded Basel III will likely necessitate new equity issuance to offset the reduction in capital ratios, while the setting of MREL[9] targets will also likely require Portuguese banks—predominantly deposit-funded—to tap wholesale markets to comply with the minimum required level of liabilities that can absorb losses in the event of resolution.

Authorities' views

17. The Portuguese and European authorities considered that with banks' immediate capital needs addressed, the process of cleaning bank balance sheets is likely to proceed gradually. The Portuguese authorities pointed to the on-going adjustment of the banking system, as evidenced by continued deleveraging, increased solvency, ample liquidity, higher cost-efficiency and pre-impairment profitability. They emphasized that the long phasing-in of Basel III and the transition period envisaged for IFRS 9 will allow banks to meet their capital requirements smoothly as ongoing cost-cutting efforts will boost banks' profitability and internal capital generation. The authorities

[8] See forthcoming Working Paper, "Can the Capital Structure of Asset Management Companies Lead to a Solution to High Non-Performing Loans?"

[9] The minimum requirement for own funds and eligible liabilities. This will be determined by late-2017, but with transition periods still undetermined.

noted that the cost of MREL cannot yet be estimated reliably. The Portuguese authorities also considered their initiatives to facilitate NPL workout processes as a promising way to resolve the core legacy NPLs. They noted that the largest banks' ambitious NPL reduction plans were illustrative of a positive change in internal governance. They were also optimistic that the NPL platform will facilitate coordination among banks related to the resolution of common exposures. Both the Portuguese and European authorities remain cautious about the pace of NPL resolution, warning against NPL fire sales that would destroy bank capital. The Portuguese authorities were vigilant about possible risks from the increase in new lending to households, and have cautioned banks against any loosening in lending standards.

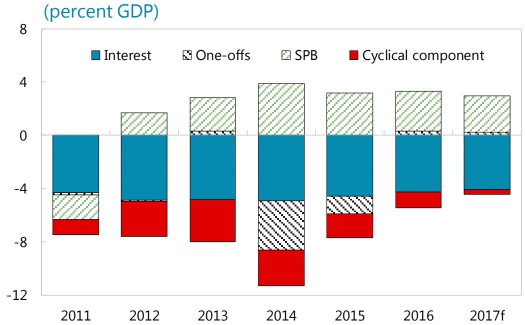
B. Fiscal Policy

18. This year's headline fiscal deficit target of 1.5 percent of GDP appears well within reach.[10] With real GDP growth projected at 2.5 percent, compared with 1.8 percent assumed in the Stability Program, risks to revenue targets have receded considerably. In addition, the authorities are again freezing part of line ministries' spending appropriations this year to ensure that the headline deficit is achieved, to be released only as they are confident that revenue performance is as projected. The sharp decline in bond yields so far in 2017, together with additional planned prepayments to the Fund, is also likely to result in further savings on interest costs. As a result, public debt is projected to decline from 130.3 percent of GDP at end-2016 to around 126 percent at end-2017. The authorities' Stability Program for 2017-2021 targets a further decline in the headline deficit to 1 percent of GDP in 2018, based primarily on savings in intermediate consumption and a modest reduction in public sector employment.

Staff views

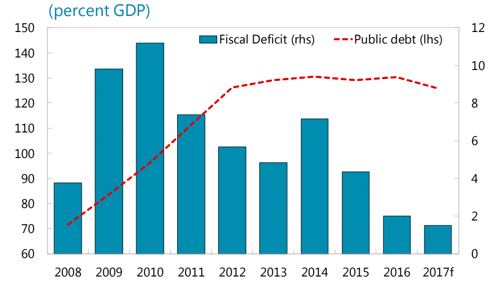
19. Structural fiscal consolidation remains essential to keep public debt on a firmly downward trajectory after 2017. While the enhanced growth outlook has improved near-term debt dynamics, high public debt remains a significant vulnerability. The reduction in the headline

Fiscal Balance
(percent GDP)



Source: IMF staff calculations.

Fiscal Deficit and Public Debt
(percent GDP)



Sources: INE and IMF staff calculations.

[10] Discussions with Eurostat on the fiscal accounting of this year's recapitalization of CGD (2.1 percent of GDP) remain ongoing. The EC's finding that the operation was sufficiently market-based to not count as state aid appears to provide scope to classify the operation as a financial transaction that does not impact the fiscal deficit.

fiscal deficit during 2016 and 2017 has been largely accounted for by the upturn in growth and a decline in interest payments, with a modest loosening of the fiscal stance in primary structural terms since 2015. The favorable cyclical conditions provide an auspicious opportunity for more ambitious structural consolidation, with any revenue overperformance applied to a faster reduction in public debt. For 2018, staff would advise a structural primary adjustment of 0.5 percent of GDP, in line with Portugal's commitments under the Stability and Growth Pact.

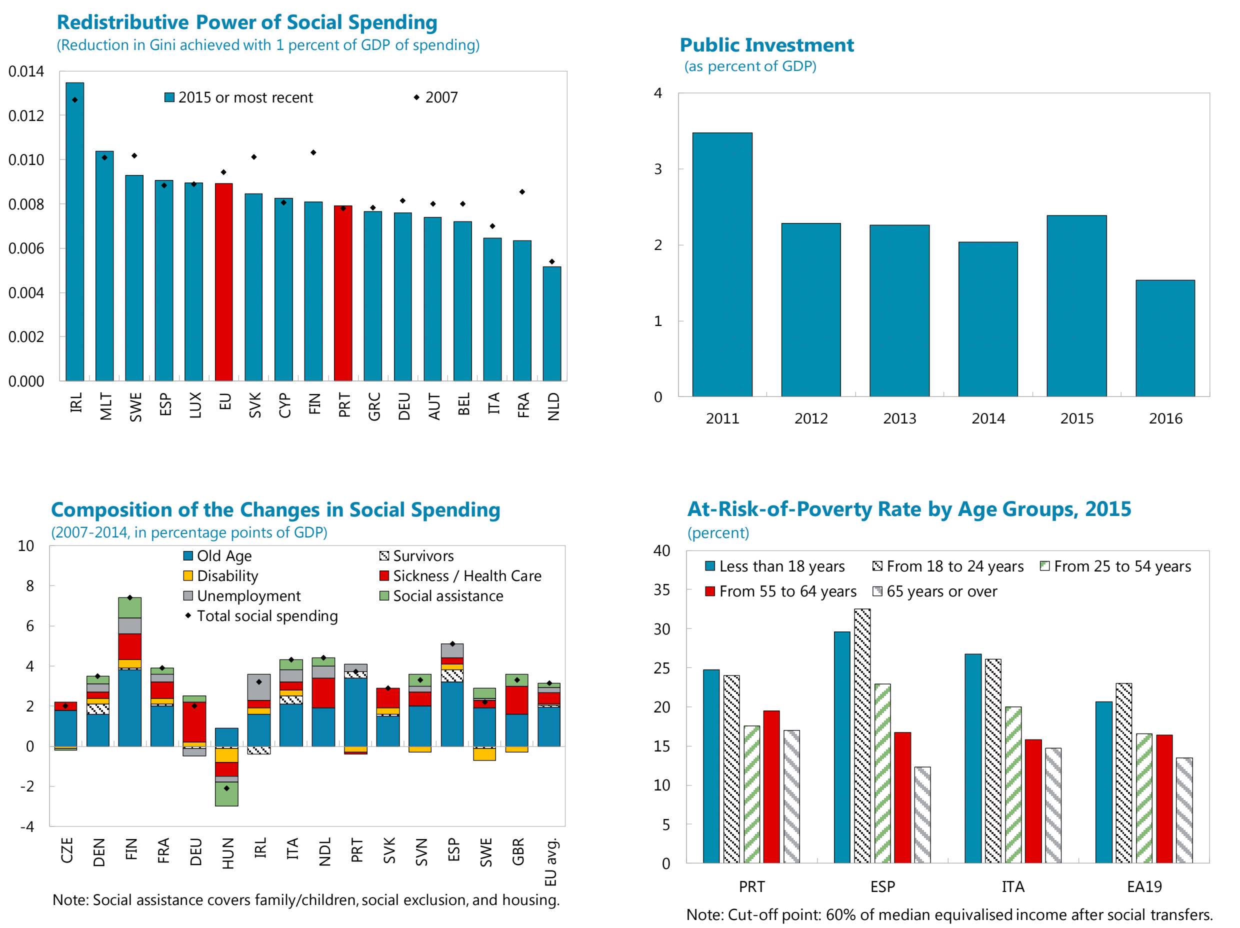
20. Staff would recommend fiscal consolidation based on durable spending reform to reduce overlap and improve the efficiency of public spending. The fiscal effort in 2016 depended heavily on under-execution of intermediate consumption and public investment, which is likely to prove difficult to repeat over successive years. Public investment spending in Portugal since 2012 is below the euro area average (2.1 percent compared to 2.7 percent of GDP), and fell to a historically low level in 2016 (1.5 percent of GDP) as current spending has largely crowded out public investment.[11] Current expenditure rationalization is therefore needed to protect public investment and support long-term growth.

- **a.** ***Containing the public wage bill***. Over the last two years, Portugal did not reduce public employment as planned to offset the cost of reversing past wage cuts. Going forward, public wages will be fueled by the gradual unfreezing of career progression from 2018, and employment rationalization will be difficult to achieve without structural reforms to adjust public employment across sectors (see Selected Issues Paper, "The Public Sector Wage Bill in Portugal.") Stronger wage bill planning and public sector restructuring are needed to adjust the level and composition of public employment to generate the planned fiscal savings, while improving service delivery. Containing public compensation, which still benefits from a wage premium relative to the private sector, will require structural wage measures to streamline allowances and improve equity among civil servants.
- **b.** ***Improving the efficiency of social spending***. The redistributive power of social spending has remained below the EU average, pointing to inefficiencies in reducing inequality. Youth (18-24 years) were especially affected by the downturn, and insufficiently protected from unemployment and poverty risks, resulting in a growing income and poverty gap across generations (see Selected Issues Paper, "The Youth in Portugal through the Crisis"). Priority should be given to improving labor prospects for young adults in Portugal and rebalancing fiscal redistribution toward the youth.
- **c.** ***Revisiting recent pension reforms to reduce grandfathering.*** The authorities' plans to reduce penalties for early retirement and to better account for career longevity are likely to improve equity at a somewhat limited fiscal cost (less than 0.2 percent of GDP). However, broader reform to reduce pension spending in Portugal, one of the highest in Europe at 15.6 percent of GDP in 2014, is needed. While recent reforms

[11] While the public capital stock in Portugal compares favorably with peers in the EU, a minimum level of public investment is required to maintain the quality of public infrastructure.

should help contain pension spending in the long run,[12] the adjustment effort was backloaded to protect current pensioners. The pension benefit ratio will start being reduced only after 2025, with the large share of the adjustment borne by the current working-age population (see 2016 Selected Issues Paper, "Policy Options to Mitigate the Impact of Adverse Demographic Developments").

Figure 5. Public Expenditure in Portugal



Sources: Eurostat; Euromod; INE; Haver Analytics; and IMF staff calculations.

[12] They include curtailing access to early retirement, increasing the pensionable age and introducing an automatic indexation to life expectancy.

Authorities' views

21. The authorities were confident that this year's headline fiscal deficit target will be achieved. They agreed that public debt reduction remains the key fiscal challenge and emphasized their commitment to medium-term fiscal consolidation to bring down public debt. They considered that stronger growth should allow them to reach this year's headline deficit target, but preferred to maintain a conservative revenue projection at this stage. The authorities re-affirmed their commitment to a headline deficit target of 1 percent of GDP for 2018, and were confident that they will be able to achieve the planned reduction in public sector employment. They also expect positive results from the ongoing spending review, and were confident that this will effectively underpin the planned rationalization of intermediate consumption over the medium-term. The authorities disagree with the estimates of potential output by the IMF, the EC, and the OECD, maintaining that they understate the structural change in the economy and the underlying fiscal adjustment that has been achieved.

C. Structural Reforms

22. The authorities' structural agenda focuses on improving the comparatively low skill level of the Portuguese labor force and fostering greater innovation. The National Reform Program includes several key components: (i) Development of human capital, through better formal education, lifelong learning and improvements in information technology skills; (ii) Recapitalization of the corporate sector, including incentives to increase equity and reduce reliance on bank financing; (iii) Modernization of the public sector, including simplification of administrative and licensing procedures for enterprises; and (iv) Encouraging R&D, innovation and entrepreneurship.

Staff views

23. The current upswing and supportive financing conditions provide a favorable window to address impediments to higher investment. Structural reforms should focus on the bottlenecks that adversely impact investors' perceptions of the business environment, including rigidities in the labor market, an unpredictable regulatory environment and inefficient judicial processes.

- **a.** ***Labor market flexibility*****:** As a member of a currency union with limited fiscal space, it is essential that labor markets have sufficient flexibility for adjustment. Program-era policy changes to make hiring and collective bargaining more flexible should be safeguarded, with the gap between temporary and permanent contracts addressed by making permanent contracts more flexible rather than simply restricting temporary contracts. Moreover, policies should aim at facilitating the movement of labor across firms and sectors without excessively penalizing the workforce.

- **b.** ***Judicial sector efficiency:*** There is a discrepancy between the official data on enforcement and insolvency cases, which show a positive trend in recent years, and anecdotal evidence suggesting that frequent delays and low pay-outs continue to discourage creditors from initiating enforcement and liquidation processes. The mission advised the authorities to commission an in-depth survey on the efficiency of the judicial system by an outside firm to develop an accurate assessment of the reality on the ground. The decree law with changes in the codes of commercial societies and of firms' insolvency and liquidation under the *Capitalizar* program is a welcome step to increase the judicial sector efficiency to help the corporate sector to deleverage.

c. ***Corporate debt overhang*****:** The corporate sector continues to deleverage at a slow pace. Speeding up NPL resolution would help reduce the debt overhang. However, this alone would not be enough, with more than 50 percent of outstanding debt owed to non-bank creditors. Corporate governance reforms are needed to encourage firm owners to retain more earnings and inject new equity into their companies. To reduce the tax debt bias, the authorities could build on their on-going efforts to offset the distortion of the deductibility of debt interest.

d. ***Public sector payments discipline*****:** The authorities reduced the stock of outstanding arrears to 0.5 percent of GDP at end-2016, but these have continued to accumulate in early 2017, particularly in the health sector, with an increase of 0.1 percent of GDP through end-June. The authorities should implement a more forceful strategy to prevent new arrears in the hospital sector by reviewing budgeting policy, addressing inefficiencies, and further strengthening commitment controls. Lack of public sector payments discipline has been identified by corporates as an impediment to new projects, as it ties up their resources for extended periods of time.

Authorities' views

24. The authorities were confident that ongoing initiatives would support stronger labor productivity and address financing constraints in the corporate sector. They considered the recent pickup in growth an affirmation of the significant structural changes in the economy in recent years, and were confident that ongoing efforts would tackle some of the key structural impediments that remain. In particular, they noted the *Capitalizar* and *Semente* programs as key initiatives to alleviate financing constraints in the corporate sector and support increased investment. They noted concerns about labor market segmentation, but emphasized that any fine-tuning of policies in this area would not constitute a change in the direction of reforms, but were intended to address social inequities that had emerged from the erosion of labor protection following the financial crisis.

STAFF APPRAISAL

25. There has been notable progress in addressing the near-term fiscal and financial sector risks highlighted in last year's Article IV consultation. Portugal's exit from the Excessive Deficit Procedure, together with a marked improvement in stability and confidence in the banking system, have helped bolster investor confidence and contributed to a sharp narrowing in sovereign debt spreads since mid-March.

26. The near-term growth outlook has also improved considerably as the ongoing recovery continues to gain momentum. Tourism remains a key driver of growth, with nonresident inflows driving a pickup in tourism-related construction and renovation of rental properties. This has also been accompanied by a broad-based pickup in exports in recent quarters, supported by the euro area recovery.

27. The current recovery is expected to moderate over the medium-term without additional financing to support a sustained increase in the level of investment. The remarkable growth in tourism is likely to moderate, with the number of arrivals having increased by one-third over the past three years, while the recovery in investment and growth in exports has been driven by past declines in unit labor costs which are now being reversed. The inability of the banking system to provide credit to finance investment as labor costs rise and earnings decline is likely to constrain firms' ability to maintain the level of investment needed to sustain the recovery.

28. Increasing Portugal's growth potential remains central to addressing the significant vulnerabilities that continue to weigh on the medium-term outlook. While the near-term outlook has improved, the country's high public and private debt leave it vulnerable to a range of shocks over the medium-term. These are magnified by Portugal's low potential growth. The medium-term policy challenge remains to break the vicious circle between weak banks, high NPLs and low investment that continues to constrain medium-term growth. Sustaining higher investment will require concerted efforts to improve financial sector intermediation, minimize fiscal risks and address persistent structural rigidities.

29. The large stock of NPLs will continue to hinder the effective intermediation of savings by the financial sector to productive investment. Financial stability has improved after recent capital augmentations, but the gradual pace of cleaning banks' balance sheets reduction is likely to limit their ability to finance future growth and leave them vulnerable to downside risks. Total capital in the banking system still appears low given the burden of legacy NPLs and upcoming regulatory hurdles, highlighting the need for internal capital generation to maintain appropriate buffers.

30. Sustained fiscal consolidation is needed to ensure a firmly downward trajectory for public debt over the medium-term. The pickup in growth and supportive financial market conditions have facilitated a reduction in the headline fiscal deficit during 2016-2017 despite a modest loosening in the underlying fiscal stance. Public debt remains a significant vulnerability, however, and is set to remain elevated over the medium-term. The current cyclical conditions provide a favorable opportunity for more ambitious structural consolidation and a faster reduction in public debt. A fiscal consolidation based on durable expenditure reform would likely prove more sustainable and supportive of growth, and help reinforce investors' perceptions of the predictability of the tax regime over the investment horizon.

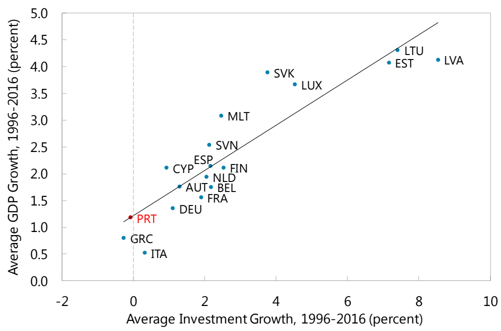
31. Raising the economy's growth potential will also require further structural reforms to address the still significant impediments to private long-term investment. Structural reforms should focus on the bottlenecks that adversely impact investors' perceptions of the business environment, including rigidities in the labor market, inefficient judicial processes, an unpredictable regulatory environment and delays in public sector payments.

32. Near-term financing risks have receded, but the financing environment is likely to be less benign over the medium term. While the relatively favorable maturity structure of Portugal's public debt limits the near-term impact of rising yields, a less supportive financing environment increases the risk of sudden fluctuations in market conditions in the event of negative domestic surprises or external shocks. The large cash buffer leaves Portugal well positioned to withstand temporary market fluctuations, but financing needs remain large and will rise in the medium-term. Borrowing costs are expected to remain manageable under the baseline of a gradual reduction in monetary accommodation, but further efforts to improve financial sector resilience, ensure durable fiscal consolidation and raise potential growth will be essential to maintain investor confidence and reduce medium-term vulnerabilities.

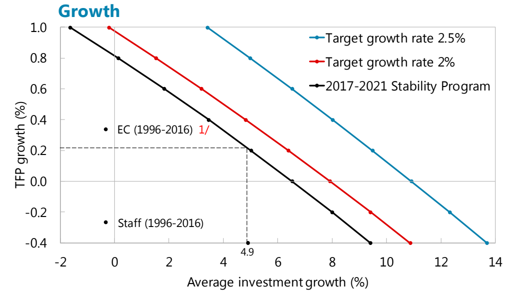
33. Staff recommends the next Article IV consultation be held on the standard 12-month cycle.

Box 1. Investment and the Medium-Term Growth Outlook[1]

Growth in Portugal has been moderate over the past two decades – the average growth rate of real GDP from 1996 to 2016 was 1.2 percent. When compared with the euro area peers, the low level of investment stands out as one of the key factors contributing to low real GDP growth rates. To derive the average annual growth rates of investment needed to achieve the real GDP growth path envisaged in the 2017 Stability Program, as well as the average real GDP growth rates of 2.5 percent during 2017-22, a standard Cobb-Douglas production function is utilized under varying assumptions of annual TFP growth; the lower the rate of TFP growth, the higher the rate of investment growth required to achieve the GDP growth target.



Sources: World Economic Outlook; and IMF staff calculations.



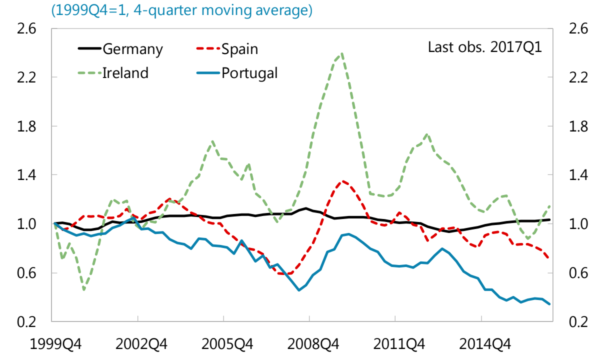
Sources: Haver Analytics, Bank of Portugal and IMF staff calculations.
1/ EC's figure for TFP is based on their production function estimates.

The average annual growth rate of investment in the Stability Program is 4.9 percent, implying that the TFP should grow at about 0.2 percent per year. Staff estimates, however, show that the average TFP growth in the past two decades was negative, at -0.26 percent. This is in line with Amador and Coimbra's (2007) conclusion that Portugal's economic growth during the pre-crisis boom was largely attributed to factor accumulation rather than productivity growth. Therefore, it is likely that the growth rate of investment must significantly exceed the projected 4.9 percent in order to achieve the real GDP growth path envisaged in the 2017 Stability Program. On the other hand, if the annual TFP growth could accelerate to 0.4 percent, then an around 4 percent growth rate of investment would suffice. This suggests that policies aimed at raising investment should be introduced in tandem with policies aimed at raising productivity, such as fostering human capital accumulation, increasing labor market flexibility, improving judicial sector efficiency, reducing corporate debt overhang, enhancing public sector payments discipline, and reducing energy costs.

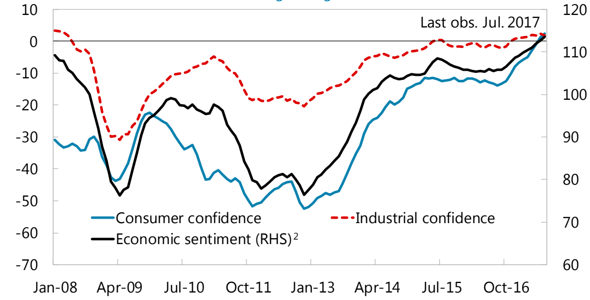
[1] See Selected Issues Paper, "Investment and the Medium-Term Growth Outlook".

Figure 6. Portugal: Real Sector Indicators

Normalized Household Saving Rates
(1999Q4=1, 4-quarter moving average)

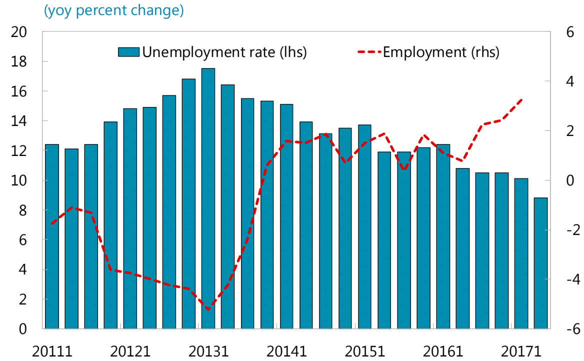


Confidence Indicators
(Percent balance, 3-month moving average)[1]

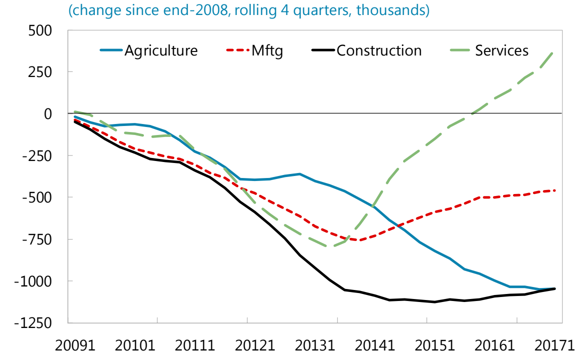


[1]Percent balance equals percent of respondents reporting an increase minus the percent of respondents reporting a decrease.
[2]Long-term average = 100.

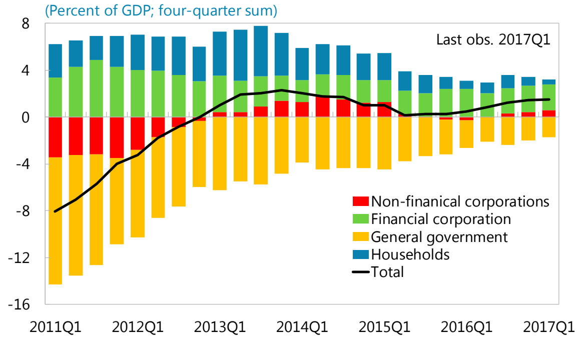
Employment
(yoy percent change)



Employment by Sector
(change since end-2008, rolling 4 quarters, thousands)

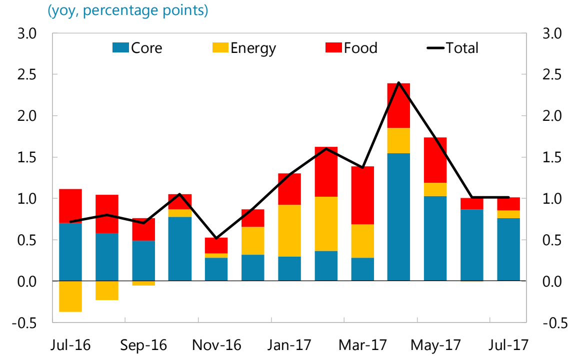


Net Lending Excluding One-Off Operations[1]
(Percent of GDP; four-quarter sum)



[1] Excludes the recapitalization of Novo Banco (2014) and the Banif resolution (2015).

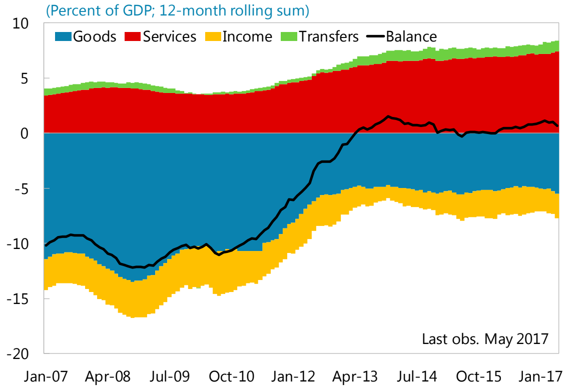
Portugal: Contributions to Inflation
(yoy, percentage points)



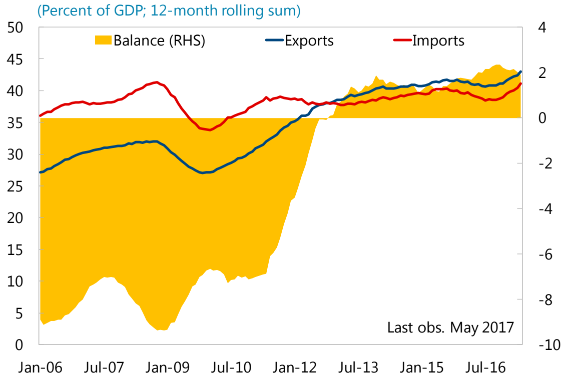
Sources: INE; Haver Analytics; and IMF staff calculations.

Figure 7. Portugal: External Sector Indicators

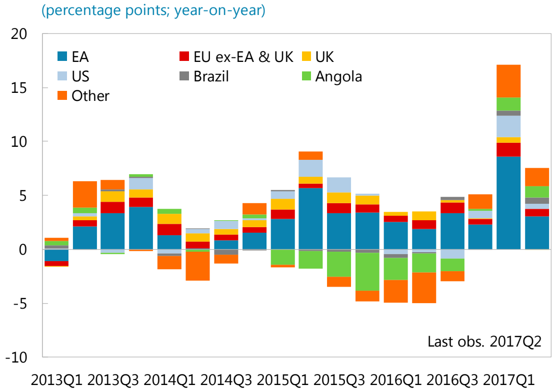
Current Account
(Percent of GDP; 12-month rolling sum)



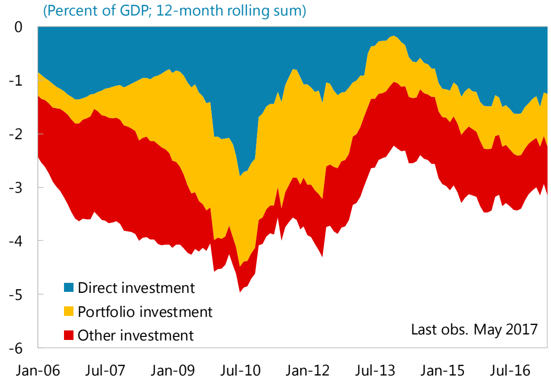
Trade in Goods and Services
(Percent of GDP; 12-month rolling sum)



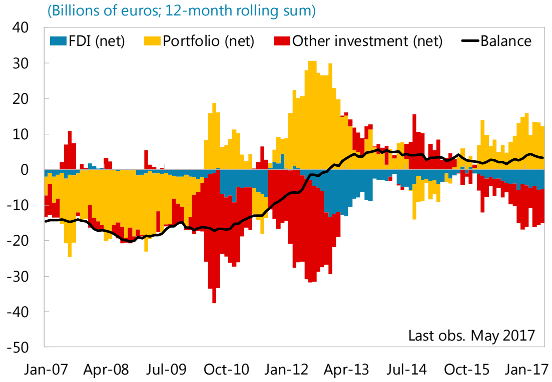
Contribution to Growth in Exports of Goods, by Destination
(percentage points; year-on-year)



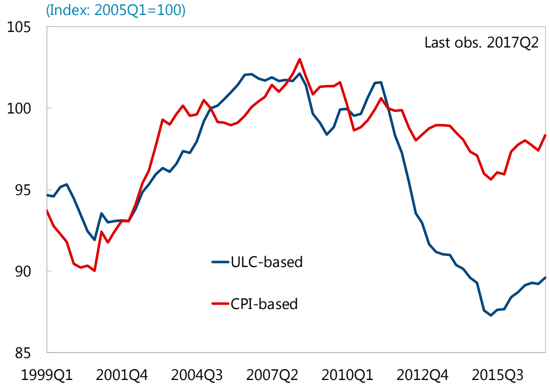
Income Account
(Percent of GDP; 12-month rolling sum)



Financial Account
(Billions of euros; 12-month rolling sum)

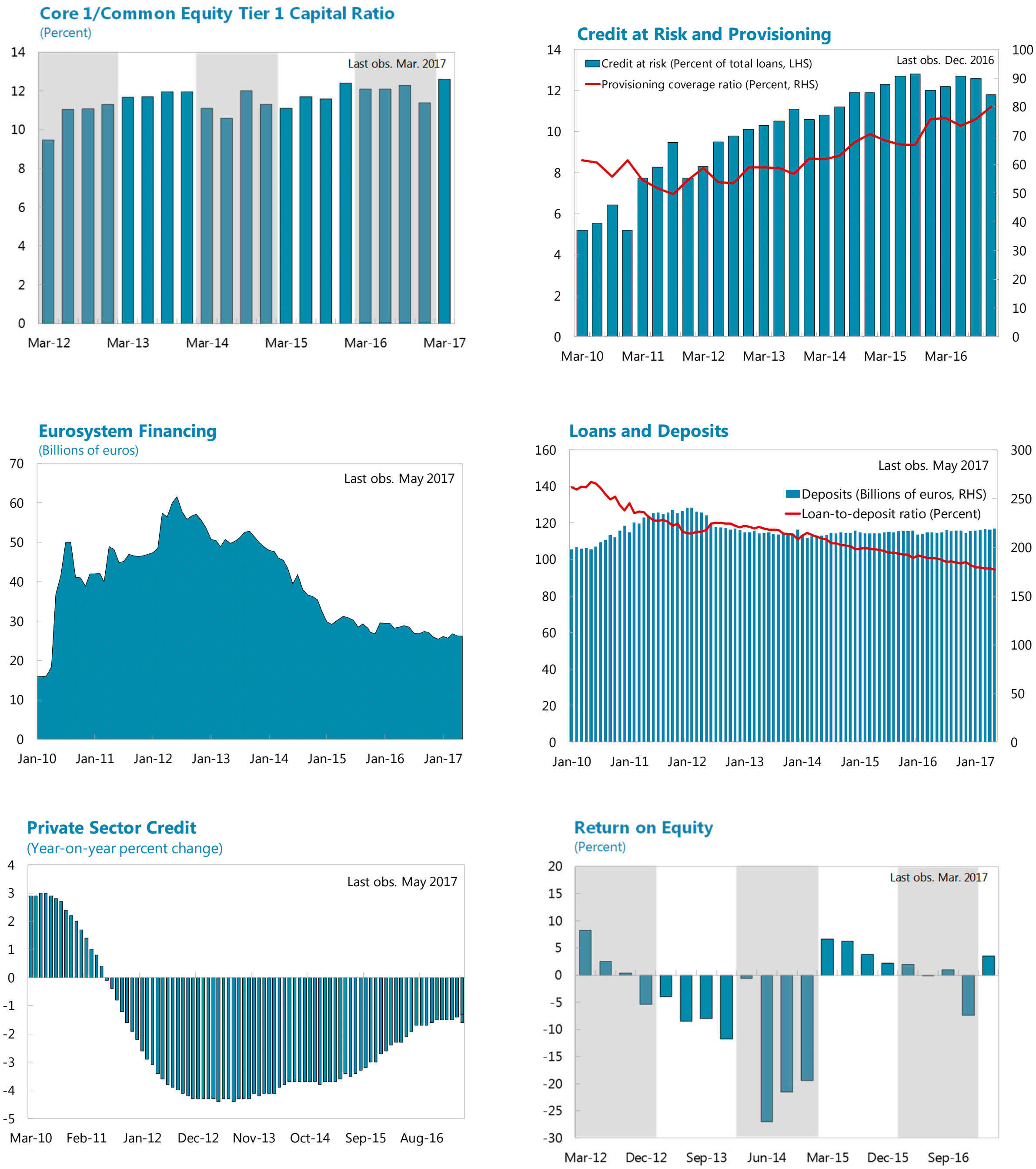


Real Effective Exchange Rate
(Index: 2005Q1=100)



Sources: Haver Analytics; and IMF staff calcuations.

Figure 8. Portugal: Financial Sector Indicators



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

Table 1. Portugal: Selected Economic Indicators, 2014-2022

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

	2014	2015	2016	2017 Projections 5th PPM	2017 Article IV	2018	2019	2020	2021	2022
Real GDP	0.9	1.6	1.4	1.3	2.5	2.0	1.7	1.5	1.2	1.2
Total domestic demand	2.2	2.5	1.5	1.4	2.6	2.1	1.8	1.6	1.3	1.2
Private consumption	2.3	2.6	2.3	1.3	2.2	1.8	1.4	1.4	1.1	0.8
Public consumption	-0.5	0.7	0.5	0.6	0.6	0.5	0.2	-0.1	0.0	0.0
Gross fixed investment	2.3	4.5	0.1	2.8	6.9	5.7	4.8	4.0	3.0	3.7
Private	2.9	2.0	3.3	2.9	7.2	6.0	4.9	4.0	3.3	4.1
Government	-1.3	20.2	-17.6	2.2	5.0	3.5	4.1	3.8	1.2	1.2
Exports	4.3	6.1	4.4	3.6	7.6	5.2	4.5	4.2	4.1	4.1
Imports	7.8	8.2	4.5	3.5	7.3	5.1	4.5	4.3	4.1	3.9
Contribution to Growth										
Total domestic demand	2.2	2.6	1.5	1.4	2.6	2.2	1.8	1.7	1.3	1.2
Private consumption	1.5	1.7	1.5	0.9	1.4	1.2	0.9	0.9	0.7	0.5
Public consumption	-0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Gross fixed investment	0.4	0.7	0.0	0.4	1.1	0.9	0.8	0.7	0.5	0.7
Foreign balance	-1.4	-1.0	-0.1	0.0	-0.1	-0.1	-0.1	-0.2	-0.1	0.0
Savings-investment balance (Percent of GDP)										
Gross national savings	15.4	15.5	15.8	15.4	17.0	17.8	18.1	18.2	18.2	18.4
Private	17.3	16.3	16.3	15.5	16.5	17.2	17.5	17.6	17.5	17.7
Public	-2.0	-0.8	-0.6	-0.1	0.5	0.7	0.6	0.7	0.7	0.6
Gross domestic investment	15.3	15.5	14.9	15.9	16.5	17.4	18.0	18.5	19.0	19.6
Private	13.2	13.1	13.0	13.9	14.5	15.3	15.9	16.4	16.8	17.4
Public	2.1	2.4	1.9	2.0	2.0	2.0	2.1	2.2	2.2	2.2
Resource utilization										
Potential GDP	0.6	0.9	0.1	0.2	0.4	0.8	1.0	1.1	1.2	1.2
Output Gap (Percent of potential)	-4.5	-3.8	-2.6	-1.4	-0.6	0.6	1.4	1.8	1.8	1.8
Employment	1.6	1.1	1.2	1.0	1.6	0.9	0.5	0.5	0.5	0.5
Unemployment rate (Percent)	13.9	12.4	11.1	10.6	9.7	9.0	8.5	8.1	7.6	7.2
Prices										
GDP deflator	0.8	2.1	1.6	1.4	2.2	1.7	1.6	1.8	1.8	1.8
Consumer prices (Harmonized index)	-0.2	0.5	0.6	1.1	1.6	2.0	2.1	2.2	2.3	2.4
Compensation per worker (Whole economy)	-1.8	0.0	1.6	1.5	1.7	3.2	3.2	3.1	2.9	3.0
Labor productivity	-0.6	0.4	-0.1	0.3	-0.1	1.3	1.2	1.0	0.7	0.7
Unit labor costs (Whole economy)	-1.2	-0.4	1.7	1.2	1.8	1.9	2.0	2.1	2.2	2.3
Money and credit (End of period, percent change)										
Private sector credit	-8.0	-4.1	-3.7	-0.5	-1.5	0.1	0.8	1.6	1.6	1.6
Broad money	-0.4	4.1	-0.4	2.2	4.3	3.3	2.8	2.8	2.5	2.5
Interest rates (Percent)										
Short-term deposit rate	1.6	0.8	0.4	...	...	...	...	...	...	...
Government bond rate, 10-year	3.8	2.4	3.2	...	...	...	...	...	...	...
Fiscal indicators (Percent of GDP)										
General government balance	-7.2	-4.4	-2.0	-2.1	-1.5	-1.4	-1.5	-1.5	-1.4	-1.5
Revenues	44.6	44.0	43.0	43.7	43.0	42.8	42.6	42.5	42.5	42.4
Expenditures	51.8	48.3	45.1	45.7	44.5	44.2	44.1	43.9	43.9	43.9
Primary government balance	-2.3	0.2	2.2	2.2	2.6	2.7	2.5	2.5	2.5	2.5
General government debt	130.6	129.0	130.3	129.8	125.7	122.5	119.8	117.6	115.8	114.0
External sector (Percent of GDP)										
Trade balance (Goods)	-5.5	-5.2	-4.9	-5.9	-5.6	-6.0	-6.4	-6.8	-7.2	-7.7
Trade balance (Goods and Services)	1.1	1.8	2.2	1.3	1.9	1.7	1.5	1.3	1.0	0.7
Current account balance	0.1	0.1	0.8	-0.6	0.6	0.5	0.1	-0.3	-0.8	-1.2
Net international investment position	-117.7	-112.0	-105.1	-101.7	-98.7	-93.6	-89.5	-86.0	-83.3	-81.2
REER based on ULC (2010=100)	89.9	87.6	88.9	88.9	89.4	90.2	91.0	92.1	92.9	94.6
(Rate of growth)	-1.5	-2.6	1.5	0.0	0.6	0.8	0.9	1.2	0.9	1.8
REER based on CPI (2010=100)	98.5	95.9	97.8	97.7	97.5	98.1	98.5	99.0	99.5	101.4
(Rate of growth)	-1.2	-2.6	1.9	-0.1	-0.3	0.6	0.5	0.5	0.5	1.9
Nominal GDP (Billions of euros)	173.1	179.5	184.9	189.7	193.8	201.1	207.7	214.6	221.0	227.6

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

Table 2a. Portugal: General Government Accounts, 2014-2022[1/]

(Billions of euros)

				Projections					
	2014	2015	2016	2017	2018	2019	2020	2021	2022
Revenue	77.2	78.9	79.6	83.4	86.1	88.5	91.2	93.9	96.5
Taxes	43.6	45.7	46.3	47.8	49.6	51.0	52.5	54.0	55.5
Taxes on production and imports	24.6	26.2	27.3	28.3	29.4	30.2	31.1	32.0	32.8
Current taxes on income, wealth, etc. and capital taxes	19.0	19.4	19.1	19.5	20.2	20.8	21.4	22.0	22.7
Social contributions	20.5	20.8	21.6	22.6	23.5	24.1	24.9	25.7	26.4
Grants and other revenue	13.2	12.5	11.7	12.9	13.0	13.4	13.8	14.2	14.7
Property income	1.7	1.3	1.2	1.4	1.5	1.5	1.5	1.6	1.6
Sales of goods and services	6.3	6.6	6.7	6.9	7.2	7.4	7.7	7.9	8.2
Other current revenue	3.4	3.2	2.8	3.3	3.4	3.5	3.6	3.7	3.8
Capital transfers and investment grants	1.7	1.3	0.9	1.3	0.9	1.0	1.0	1.0	1.0
Expenditure	89.6	86.7	83.3	86.2	88.8	91.6	94.3	97.0	99.9
Expense	91.2	87.7	85.8	88.1	90.7	93.4	96.1	98.9	101.8
Compensation of employees	20.5	20.3	20.8	21.4	21.8	22.5	23.0	23.7	24.4
Use of goods and services	9.8	10.3	10.6	10.7	11.1	11.4	11.8	12.2	12.5
Consumption of fixed capital	5.1	5.2	5.3	5.7	5.9	6.1	6.3	6.5	6.7
Interest	8.5	8.2	7.8	7.9	8.1	8.3	8.4	8.6	9.0
Subsidies	1.2	1.1	1.0	1.1	1.1	1.2	1.2	1.3	1.3
Social benefits	34.1	34.6	35.0	35.7	36.6	37.7	38.9	40.0	41.2
Grants and other expense	11.9	8.0	5.2	5.7	6.0	6.2	6.4	6.6	6.8
Other current expense	4.7	4.6	4.4	4.9	5.2	5.4	5.6	5.7	5.9
Capital transfers	7.2	3.4	0.8	0.8	0.8	0.8	0.8	0.9	0.9
Net acquisition of nonfinancial assets	-1.6	-1.0	-2.4	-1.9	-1.9	-1.8	-1.8	-1.8	-1.9
Gross fixed capital formation	3.4	4.0	2.8	3.8	4.1	4.3	4.5	4.7	4.8
(-) Consumption of fixed capital	-5.1	-5.2	-5.3	-5.7	-5.9	-6.1	-6.3	-6.5	-6.7
Acquisitions less disposals of other nonfinancial assets	0.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-8.9	-3.5	-0.9	1.0	1.3	1.2	1.4	1.5	1.4
Net lending (+)/borrowing (–)	-12.4	-7.8	-3.7	-2.8	-2.7	-3.1	-3.1	-3.1	-3.4
Net acquisition of financial assets	-6.6	-4.0	5.1	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	0.0	-3.1	4.6	...	...	...	...	...	...
Debt securities	-4.7	-1.0	0.0	...	...	...	...	...	...
Loans	-0.3	0.1	-0.1	...	...	...	...	...	...
Equity and investment fund shares	-2.1	-0.1	-0.1	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.1	-0.3	-0.5	...	...	...	...	...	...
Other accounts receivable	0.3	0.3	1.2	...	...	...	...	...	...
Net incurrence of liabilities	5.8	3.8	8.8	...	...	...	...	...	...
SDRs	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	4.9	4.0	4.0	...	...	...	...	...	...
Debt securities	-1.8	11.2	11.4	...	...	...	...	...	...
Loans	3.6	-9.4	-5.9	...	...	...	...	...	...
Equity and investment fund shares	0.0	-0.1	0.0	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	0.0	...	...	...	...	...	...
Other accounts payable	-1.0	-1.8	-0.6	...	...	...	...	...	...
Memorandum items:									
Primary balance	-3.9	0.4	4.1	5.1	5.4	5.2	5.3	5.5	5.6
Debt at face value (EDP notification)	226.0	231.5	241.1	243.6	246.3	248.9	252.3	255.8	259.4
Nominal GDP	173.1	179.5	184.9	193.8	201.1	207.7	214.6	221.0	227.6

Sources: INE; Bank of Portugal; and IMF staff projections.

[1] GFSM 2001 presentation.

Table 2b. Portugal: General Government Accounts, 2014-2022[1/]

(Percent of GDP, unless otherwise noted)

	2014	2015	2016	Projections 2017	2018	2019	2020	2021	2022
Revenue	44.6	44.0	43.0	43.0	42.8	42.6	42.5	42.5	42.4
Taxes	25.2	25.4	25.1	24.7	24.7	24.5	24.5	24.4	24.4
Taxes on production and imports	14.2	14.6	14.7	14.6	14.6	14.5	14.5	14.5	14.4
Current taxes on income, wealth, etc. and capital taxes	11.0	10.8	10.3	10.1	10.1	10.0	10.0	10.0	10.0
Social contributions	11.8	11.6	11.7	11.7	11.7	11.6	11.6	11.6	11.6
Grants and other revenue	7.6	6.9	6.3	6.7	6.4	6.4	6.4	6.4	6.4
Property income	1.0	0.7	0.6	0.7	0.7	0.7	0.7	0.7	0.7
Sales of goods and services	3.6	3.7	3.6	3.6	3.6	3.6	3.6	3.6	3.6
Other current revenue	2.0	1.8	1.5	1.7	1.7	1.7	1.7	1.7	1.7
Capital transfers and investment grants	1.0	0.7	0.5	0.7	0.5	0.5	0.5	0.5	0.5
Expenditure	51.8	48.3	45.1	44.5	44.2	44.1	43.9	43.9	43.9
Expense	52.7	48.9	46.4	45.5	45.1	45.0	44.8	44.7	44.7
Compensation of employees	11.9	11.3	11.3	11.0	10.9	10.8	10.7	10.7	10.7
Use of goods and services	5.7	5.7	5.7	5.5	5.5	5.5	5.5	5.5	5.5
Consumption of fixed capital	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9
Interest	4.9	4.6	4.2	4.1	4.0	4.0	3.9	3.9	3.9
Subsidies	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Social benefits	19.7	19.3	18.9	18.4	18.2	18.2	18.1	18.1	18.1
Grants and other expense	6.9	4.4	2.8	2.9	3.0	3.0	3.0	3.0	3.0
Other current expense	2.7	2.5	2.4	2.6	2.6	2.6	2.6	2.6	2.6
Capital transfers	4.2	1.9	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Net acquisition of nonfinancial assets	-0.9	-0.5	-1.3	-1.0	-0.9	-0.9	-0.8	-0.8	-0.8
Gross fixed capital formation	2.0	2.3	1.5	2.0	2.0	2.1	2.1	2.1	2.1
(-) Consumption of fixed capital	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9
Acquisitions less disposals of other nonfinancial assets	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-5.1	-2.0	-0.5	0.5	0.7	0.6	0.7	0.7	0.6
Net lending (+)/borrowing (–)	-7.2	-4.4	-2.0	-1.5	-1.4	-1.5	-1.5	-1.4	-1.5
Net acquisition of financial assets	-3.8	-2.3	2.7	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	0.0	-1.7	2.5	...	...	...	...	...	...
Debt securities	-2.7	-0.5	0.0	...	...	...	...	...	...
Loans	-0.2	0.1	0.0	...	...	...	...	...	...
Equity and investment fund shares	-1.2	-0.1	-0.1	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.1	-0.2	-0.3	...	...	...	...	...	...
Other accounts receivable	0.2	0.2	0.6	...	...	...	...	...	...
Net incurrence of liabilities	3.3	2.1	4.8	...	...	...	...	...	...
SDRs	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	2.8	2.2	2.1	...	...	...	...	...	...
Debt securities	-1.1	6.2	6.2	...	...	...	...	...	...
Loans	2.1	-5.2	-3.2	...	...	...	...	...	...
Equity and investment fund shares	0.0	-0.1	0.0	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	0.0	...	...	...	...	...	...
Other accounts payable	-0.6	-1.0	-0.3	...	...	...	...	...	...
Memorandum items:									
Primary balance	-2.3	0.2	2.2	2.6	2.7	2.5	2.5	2.5	2.5
Structural balance (Percent of potential GDP)	-0.8	-1.4	-1.1	-1.3	-1.5	-2.1	-2.3	-2.4	-2.5
Structural primary balance (Percent of potential GDP)	3.9	3.0	3.0	2.7	2.5	2.0	1.7	1.6	1.5
Debt at face value (EDP notification)	130.6	129.0	130.3	125.7	122.5	119.8	117.6	115.8	114.0
Nominal GDP (Billions of euros)	173.1	179.5	184.9	193.8	201.1	207.7	214.6	221.0	227.6

Sources: INE; Bank of Portugal; and IMF staff projections.

[1] GFSM 2001 presentation.

Table 3. Portugal: Monetary Survey, 2014–2022

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

	2014	2015	2016	2017	2018	2019	2020	2021	2022
			Projections						
			Aggregated Balance Sheet of Monetary Financial Institutions (MFIs)[1]						
Assets	405,636	389,637	369,654	372,640	374,970	380,879	389,468	395,884	402,854
Claims on Bank of Portugal	5,093	9,353	7,235	7,018	7,228	7,445	7,669	7,899	8,136
Claims on non-residents	71,467	63,875	55,401	55,955	56,515	57,080	57,651	58,227	58,809
Claims on non-monetary resident sector	307,488	296,203	285,508	288,567	290,288	295,335	303,130	308,766	314,899
General government	41,504	39,948	40,488	43,628	46,039	49,003	53,501	55,937	58,568
Central government	34,990	33,634	34,078	37,218	39,386	42,321	46,819	49,090	51,721
Loans	3,092	2,547	2,562	5,221	7,406	11,761	15,446	18,719	21,001
Securities	30,072	29,087	29,336	29,817	29,801	28,380	29,193	28,191	28,540
General government, excluding central government	6,514	6,314	6,410	6,409	6,653	6,683	6,683	6,847	6,847
Private sector	224,396	215,174	207,316	204,206	204,410	206,046	209,342	212,692	216,095
Non-financial corporations	100,711	95,950	90,321	92,036	93,566	94,961	96,196	97,173	98,436
Private individuals[2]	123,685	119,224	116,995	112,170	110,844	111,085	113,146	115,519	117,659
Non-monetary financial institutions	43,414	41,081	37,703	40,733	39,839	40,286	40,286	40,137	40,236
Other assets	21,587	20,206	21,509	21,101	20,939	21,020	21,020	20,993	21,011
Liabilities	405,636	389,637	369,654	372,640	374,970	380,879	389,468	395,884	402,854
Liabilities to Bank of Portugal	32,503	29,616	25,450	24,687	23,946	23,228	22,531	21,855	21,199
Liabilities to non-residents	68,369	59,750	56,181	55,057	53,956	52,877	51,820	50,783	49,768
Liabilities to non-monetary resident sector	216,942	216,963	216,246	220,904	223,917	228,115	233,051	238,386	244,311
General government	12,741	11,545	9,563	7,163	6,453	5,413	5,213	5,213	5,213
Central government	9,120	6,667	4,239	3,175	2,860	2,399	2,311	2,311	2,311
General government, excluding central government	3,621	4,878	5,324	3,988	3,593	3,014	2,902	2,902	2,902
Private sector[2]	163,138	168,061	172,097	176,376	180,919	185,747	190,883	196,354	202,188
Non-monetary financial institutions	41,062	37,358	34,586	37,365	36,545	36,955	36,955	36,819	36,910
Securities other than capital	28,638	24,092	15,985	15,026	15,477	15,941	16,419	16,912	17,419
Capital and reserves	59,184	59,216	55,792	56,966	57,674	60,719	65,648	67,948	70,158
			Money and Credit						
Broad money (M3)	147,174	153,193	152,601	159,142	164,328	168,932	173,687	178,004	182,411
Intermediate money (M2)	144,449	150,413	149,912	156,338	161,432	165,956	170,626	174,867	179,197
Narrow money (M1)	54,988	66,400	66,639	69,495	71,760	73,771	75,847	77,732	79,657
Private sector credit	224,396	215,174	207,316	204,206	204,410	206,046	209,342	212,692	216,095
Public sector credit	41,504	39,948	40,488	43,628	46,039	49,003	53,501	55,937	58,568
			(Percent of GDP)						
Broad money	85.0	85.3	82.5	82.1	81.7	81.3	80.9	80.5	80.2
Private sector credit	129.6	119.9	112.1	105.4	101.7	99.2	97.6	96.2	95.0
Public sector credit	24.0	22.3	21.9	22.5	22.9	23.6	24.9	25.3	25.7
			(Percentage change)						
Broad money	-0.4	4.1	-0.4	4.3	3.3	2.8	2.8	2.5	2.5
Private sector credit	-8.0	-4.1	-3.7	-1.5	0.1	0.8	1.6	1.6	1.6
Public sector credit	7.3	-3.7	1.4	7.8	5.5	6.4	9.2	4.6	4.7
Memorandum items:									
ECB access (Percent of assets)	8.0	7.6	6.9	6.6	6.4	6.1	5.8	5.5	5.3
Credit to deposits (Percent)	122.6	117.6	114.6	112.2	111.8	111.8	112.8	112.7	112.4
Loan to deposits (Percent)	105.4	100.6	96.7	94.5	94.3	95.2	96.1	96.8	96.7
Wholesale market funding (Percent of assets)[3]	19.6	16.5	17.4	15.2	15.5	15.8	15.9	16.1	16.3

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

[1] Excludes Bank of Portugal.

[2] Including emigrants.

[3] Includes foreign interbank borrowing and securities issued.

Table 4. Portugal: Balance of Payments, 2014–2022

(In billions of euros)

				Projections					
	2014	2015	2016	2017	2018	2019	2020	2021	2022
Current and Capital account	2.6	2.2	3.2	3.1	3.0	2.3	1.4	0.4	-0.6
Current account	0.1	0.1	1.6	1.1	0.9	0.2	-0.7	-1.7	-2.7
Balance of goods and services	1.9	3.2	4.1	3.7	3.4	3.1	2.7	2.1	1.6
Trade balance	-9.5	-9.3	-9.1	-10.8	-12.1	-13.2	-14.5	-15.9	-17.4
Exports fob	47.3	49.1	49.5	52.9	56.0	59.1	62.2	65.4	68.8
Imports fob	56.8	58.4	58.6	63.8	68.0	72.3	76.7	81.4	86.2
Services, net	11.4	12.4	13.1	14.5	15.5	16.3	17.2	18.1	19.0
Exports	23.4	25.2	26.3	28.9	30.7	32.4	34.2	36.0	37.9
Imports	12.0	12.7	13.1	14.3	15.2	16.1	17.0	17.9	18.9
Of which:									
Tourism	7.1	7.8	8.8	9.7	10.4	10.9	11.5	12.1	12.7
Exports	10.4	11.5	12.7	13.9	14.8	15.6	16.5	17.4	18.3
Imports	3.3	3.6	3.8	4.2	4.5	4.7	5.0	5.2	5.5
Primary income, net	-3.4	-4.5	-4.0	-4.0	-3.9	-4.3	-4.7	-5.2	-5.5
Secondary income, net	1.6	1.5	1.5	1.4	1.4	1.4	1.3	1.3	1.2
Private remittances, net	3.0	3.2	3.2	3.2	3.3	3.3	3.3	3.4	3.3
Official transfers, net	-1.4	-1.6	-1.7	-1.8	-1.9	-1.9	-2.0	-2.0	-2.1
Capital account	2.5	2.1	1.6	2.0	2.1	2.2	2.0	2.1	2.1
Financial account	8.1	2.2	3.1	3.1	3.0	2.3	1.4	0.4	-0.6
Direct investment	-2.6	-1.1	-4.1	-4.1	-4.1	-4.1	-4.1	-3.9	-3.9
Direct investment assets	7.2	0.9	3.6	3.7	3.9	4.0	4.2	4.3	4.3
Direct investment liabilities	9.8	2.0	7.6	7.8	8.0	8.1	8.3	8.3	8.3
Portfolio investment, net	-1.2	0.4	14.8	-2.7	-1.1	0.1	1.6	-1.8	-1.0
Financial derivatives	1.9	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Other investment, net	8.3	1.0	-12.8	8.5	6.8	4.7	2.2	4.4	2.4
Reserve assets	1.7	1.5	4.7	0.8	1.0	1.1	1.1	1.1	1.4
Errors and omissions	0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	5.2	...	...	...	...	...	...	...	...
European Union	3.5	...	...	...	...	...	...	...	...
IMF	1.8	...	...	...	...	...	...	...	...
Memorandum items:				(Percent GDP)					
Current account	0.1	0.1	0.8	0.6	0.5	0.1	-0.3	-0.8	-1.2
Current account (Including capital transfers)	1.5	1.2	1.7	1.6	1.5	1.1	0.6	0.2	-0.3
Of which: Balance of goods and services	1.1	1.8	2.2	1.9	1.7	1.5	1.3	1.0	0.7
Net international investment position[1]	-117.7	-112.0	-105.1	-98.7	-93.6	-89.5	-86.0	-83.3	-81.2
Direct investment, net	-31.1	-30.8	-32.0	-32.6	-33.5	-34.4	-35.2	-36.0	-36.7
Portfolio investment, net	-10.6	-9.2	0.8	-0.6	-1.2	-1.1	-0.3	-1.1	-1.5
Financial derivatives	-1.0	0.1	-0.1	0.2	0.4	0.7	0.9	1.1	1.3
Other investment, net	-84.3	-82.0	-86.6	-78.3	-72.1	-67.5	-64.3	-60.5	-57.7
Reserve assets	9.3	9.9	12.9	12.7	12.8	12.9	13.0	13.1	13.3

Sources: Bank of Portugal; and IMF staff projections.

1/ End-of-period data.

Table 5. Portugal: Financial Soundness Indicators, 2013:Q1-2017:Q1[1/]

(Percent)

	2013				2014				2015				2016				2017
	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.
Capital adequacy																	
Regulatory capital to risk-weighted assets	13.0	13.1	13.4	13.3	12.3	12.0	13.0	12.3	12.0	12.6	12.6	13.3	13.0	13.1	13.2	12.3	13.9
Common Equity Tier 1 capital to risk-weighted assets					11.1	10.6	12.0	11.3	11.1	11.7	11.6	12.4	12.1	12.1	12.3	11.4	12.6
Regulatory tier 1 capital to risk-weighted assets	11.7	11.7	12.0	11.9	11.1	10.7	12.2	11.4	11.2	11.8	11.7	12.6	12.3	12.4	12.6	11.7	13.2
Capital to assets 2/	6.9	6.8	7.1	6.8	6.4	6.2	6.9	6.4	6.5	6.8	6.9	7.2	7.0	7.0	7.1	6.5	7.1
Asset composition and quality																	
Non-performing loans to total gross loans												17.6	18.0	18.0	17.7	17.2	16.4
Credit at risk 3/	10.0	10.5	10.9	11.3	11.1	11.6	12.4	12.8	11.7	11.9	12.2	12.0	12.2	12.7	12.6	11.8	n/a
Sectoral distribution of loans																	
Residents	83.2	83.9	86.7	86.8	86.1	85.8	84.8	85.6	85.7	86.0	87.7	88.0	88.5	88.5	88.6	89.1	88.3
Nonresidents	16.8	16.1	13.3	13.2	13.9	14.2	15.2	14.4	14.3	14.0	12.3	12.0	11.5	11.5	11.4	10.9	11.7
Earnings and profitability																	
Return on assets	-0.3	-0.6	-0.5	-0.8	-0.1	-1.8	-1.5	-1.4	0.5	0.4	0.3	0.2	0.2	0.0	0.1	-0.6	0.3
Return on equity	-4.2	-9.3	-8.5	-12.5	-0.8	-27.4	-21.9	-19.7	6.3	5.9	3.6	2.1	1.9	-0.1	1.0	-7.4	3.5
Interest margin to gross income	42.2	44.4	46.9	48.8	46.8	48.7	49.7	50.6	45.2	46.8	50.0	46.1	56.2	51.6	52.9	50.3	54.3
Noninterest expenses to gross income	66.3	68.2	69.7	71.9	60.0	68.0	67.8	68.0	53.7	55.6	60.1	63.0	68.1	65.6	65.0	62.0	70.4
Liquidity																	
Liquid assets to total assets 4/	8.1	7.8	9.3	9.8	8.4	8.0	9.0	14.4	11.8	11.4	11.1	10.8	10.6	10.5	10.1	10.7	11.5
Liquid assets to short-term liabilities 4/	13.4	12.9	14.8	15.4	13.1	12.4	13.5	20.3	16.8	16.4	15.7	15.5	15.3	15.4	14.9	15.6	17.2
Loans to deposits 5/	119.0	117.7	115.8	111.8	112.3	109.0	106.8	102.1	101.7	101.0	98.8	96.1	95.2	95.4	94.2	95.5	94.3
Foreign-currency-denominated liabilities to total liabilities 6/	4.5	4.4	4.4	4.3	4.3	4.7	4.8	4.5	4.6	4.5	4.4	4.1	4.1	4.0	3.9	3.8	3.7

Source: Bank of Portugal.

1/ The banking system data present a break in time series in 2014Q3 due to the resolution measure applied to Banco Espírito Santo (BES). The break in time series stems, in particular, from the fact that the assets/liabilities not transferred to the balance sheet of Novo Banco (NB) are not considered in the aggregate of the banking system from August 2014 onwards. In the absence of accounting information for BES on a consolidated basis for the period from 30 June 2014 to the day of implementation of the resolution measure (closing balance sheet and statement of profit or loss), the reporting of BES on an individual basis, with reference to 31 July 2014, was considered when determining the aggregate results of the banking system for 2014Q3. However, the adjustments stemming from the resolution measure applied to BES were also not considered.

2/ On accounting basis; consolidated.

3/ National concept of asset quality.

4/ Data reflects the information from Instruction No 13/2009 of Banco de Portugal until 2015Q3, which was adapted to be comparable with the latter data from ITS reporting framework (from 2015Q4 onwards). This fact implied a slight change in the reporting universe of institutions.

5/ Data reflects the information from Instruction No 23/2004 of Banco de Portugal (until 2015Q3). From 2015Q4, data is based on the ITS reporting framework. The reported data follows EBA's proposal on the mapping from ITS on Supervisory Reporting to FSI.

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

Table 6. Portugal: External Debt Sustainability Framework, 2014-2022

(Percent GDP unless otherwise indicated)

	2014	2015	2016	Projections 2017	2018	2019	2020	2021	2022	Debt-stabilizing non-interest current account[6]
Baseline: External debt	236.5	222.9	215.7	202.3	195.2	189.6	184.5	180.8	177.0	2.1
Change in external debt	9.6	-13.6	-7.2	-13.3	-7.1	-5.6	-5.1	-3.7	-3.9	
Identified external debt-creating flows (4+8+9)	-3.8	-11.4	-6.5	-4.9	-3.6	-2.6	-1.8	-0.8	-0.4	
Current account deficit, excluding interest payments	-5.4	-5.0	-4.9	-4.1	-3.8	-3.4	-2.6	-2.9	-2.1	
Deficit in balance of goods and services	-1.1	-1.8	-2.2	-1.9	-1.7	-1.5	-1.3	-1.0	-0.7	
Exports	40.9	41.4	41.0	42.2	43.1	44.0	44.9	45.9	46.9	
Imports	39.8	39.6	38.8	40.3	41.4	42.5	43.7	44.9	46.2	
Net non-debt creating capital inflows (negative)	-0.1	-2.9	0.9	0.8	0.8	0.7	0.6	0.6	0.5	
Automatic debt dynamics[1]	1.6	-3.5	-2.5	-1.6	-0.6	0.1	0.1	1.5	1.1	
Contribution from nominal interest rate	5.3	4.9	4.1	3.6	3.4	3.3	2.9	3.7	3.3	
Contribution from real GDP growth	-2.0	-3.6	-3.0	-5.1	-3.9	-3.2	-2.8	-2.2	-2.1	
Contribution from price and exchange rate changes[2]	-1.7	-4.8	-3.5	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3)[3]	13.5	-2.2	-0.7	-3.7	-0.1	0.0	0.0	0.3	-0.4	
External debt-to-exports ratio (Percent)	578.9	538.5	526.3	479.3	452.9	430.5	410.8	394.0	377.7	
Gross external financing need (Billions of Euros)[4]	188.6	162.6	170.3	168.5	171.6	166.9	168.6	176.0	176.5	
Percent of GDP	109.0	90.6	92.1	87.0	85.4	80.3	78.6	79.6	77.6	
Scenario with key variables at their historical averages[5]				214.0	216.1	218.3	220.5	223.2	225.0	2.0
Key Macroeconomic Assumptions Underlying Baseline										
Real GDP growth (Percent)	0.9	1.6	1.4	2.5	2.0	1.7	1.5	1.2	1.2	
GDP deflator in Euros (Percent)	0.8	2.1	1.6	2.2	1.7	1.6	1.8	1.8	1.8	
Nominal external interest rate (Percent)	2.4	2.2	1.9	1.7	1.7	1.8	1.6	2.0	1.9	
Growth of exports (Euros, percent)	3.1	5.1	2.0	8.0	5.9	5.6	5.4	5.2	5.1	
Growth of imports (Euros, percent)	5.2	3.3	0.8	8.9	6.6	6.2	6.0	6.0	5.8	
Current account balance, excluding interest payments	5.4	5.0	4.9	4.1	3.8	3.4	2.6	2.9	2.1	
Net non-debt creating capital inflows	0.1	2.9	-0.9	-0.8	-0.8	-0.7	-0.6	-0.6	-0.5	

Source: Fund staff estimates.

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency--not used here), and a = share of domestic-currency denominated debt in total external debt.

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

3/ For projection, line includes the impact of price and exchange rate changes.

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

5/ The key variables include real GDP growth; nominal interest rate; deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

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

Table 7. Portugal: Indicators of Fund Credit, 2012–2022[1/]

(Millions of SDR, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Disbursements	6,899	2,977	1,563	…	…	…	…	…	…	…	…
(Percent of quota)	670	289	152	…	…	…	…	…	…	…	…
(Projected debt service to the Fund, based on existing and prospective drawings)											
Total	373	527	716	7,263	4,065	4,635	3,380	1,700	63	1,608	1,566
Interest and charges	373	527	716	684	505	377	279	119	63	61	30
Repayments[2]	0	0	0	6,579	3,560	4,257	3,101	1,582	0	1,547	1,536
Total debt service, in percent of											
Exports of goods and services	0.7	0.9	1.2	12.4	6.7	7.1	4.9	2.3	0.1	2.0	1.8
GDP	0.3	0.4	0.5	5.1	2.8	3.0	2.1	1.0	0.0	0.9	0.8
(Projected level of credit outstanding based on existing and prospective drawings)											
Outstanding stock	18,402	21,379	22,942	16,363	12,803	8,545	5,444	3,862	3,862	2,315	779
Percent of quota[3]	1,787.1	2,076.2	2,228.0	1,589.1	621.5	414.8	264.3	187.5	187.5	112.4	37.8
Percent of GDP	12.8	14.1	15.7	11.6	8.8	5.5	3.4	2.3	2.2	1.3	0.4
Memorandum Items (Billions of SDR)											
Exports of goods and services	54	60	62	59	60	65	70	74	78	82	86
GDP	141	149	151	141	147	155	162	167	173	178	185

Source: IMF staff estimates.

[1] Exchange rates reflect actual exchange rates where available, otherwise historical and projected WEO annual averages for flows and end-of-period values for stocks.

[2] Projected repayments to the IMF include additional advanced repurchases planned for 2018-19.

[3] Quota increase in 2016

Table 8. Portugal: General Government Financing Requirements and Sources, 2017-2022[1]

(Billions of euros)

	2017	2018	2019	2020	2021	2022
Gross borrowing need	35.6	31.7	34.0	31.0	39.8	32.2
Overall balance	2.8	2.7	3.1	3.1	3.1	3.4
Amortization	28.2	28.3	30.3	27.4	36.0	28.5
Medium- and long-term	7.9	9.5	13.4	12.4	19.2	11.6
Residents	3.2	3.7	6.4	4.7	10.0	7.1
Non-residents	4.7	5.8	7.0	7.8	9.2	4.6
Short-term[2]	15.0	15.0	15.0	15.0	15.0	15.0
Residents	10.1	9.6	9.6	9.6	9.6	9.6
Non-residents	4.9	5.4	5.4	5.4	5.4	5.4
EU and IMF[3]	5.3	3.9	2.0	0.0	1.9	1.9
Other (Net)[4]	4.5	0.7	0.6	0.5	0.6	0.3
Gross financing sources	35.6	31.7	34.0	31.0	39.8	32.2
Privatization receipts	0.0	0.0	0.0	0.0	0.0	0.0
Market access	31.0	31.1	33.0	30.8	39.7	32.1
Medium- and long-term	16.0	16.2	18.1	15.9	24.7	17.1
Residents	6.9	6.8	8.8	7.2	11.3	9.0
Non-residents	9.2	9.4	9.3	8.7	13.5	8.1
Short-term[2]	15.0	15.0	15.0	15.0	15.0	15.0
Residents	9.6	9.6	9.6	9.6	9.6	9.6
Non-residents	5.4	5.4	5.4	5.4	5.4	5.4
Use of deposits[5]	4.6	0.6	1.0	0.2	0.1	0.1
Net placement (Market access-amortization)	2.8	2.8	2.7	3.4	3.6	3.6
Residents	0.5	1.2	1.9	2.5	0.8	1.5
Medium- and long-term	1.0	1.2	1.9	2.5	0.8	1.5
Short-term (Net increase)	-0.5	0.0	0.0	0.0	0.0	0.0
Non-residents	2.3	1.6	0.8	0.9	2.9	2.1
Medium- and long-term	1.8	1.6	0.8	0.9	2.9	2.1
Short-term (Net increase)	0.5	0.0	0.0	0.0	0.0	0.0

Source: Portuguese authorities and IMF staff estimates.

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

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

3/ For EFSF loans, outstanding loans are assumed to be rolled over for an additional 7 years, as agreed with the EU. Projected repayments to the IMF include additional advanced repurchases planned for 2018-19.

4/ Includes net financing from retail government securities programs, as well as adjustments for cash-accrual differences and consistency between annual projections and preliminary quarterly accounts.

5/ Changes in government deposits.

Table 9. Portugal: External Financing Requirements and Sources, 2017-2022 1/

(Billions of euros)

	Projections					
	2017	2018	2019	2020	2021	2022
Gross financing requirements	166.8	165.5	166.5	168.5	176.0	176.7
Current account deficit	-1.1	-0.9	-0.2	0.7	1.7	2.7
Medium- and long-term debt amortization	24.7	30.9	33.4	36.6	41.2	40.7
Public sector	4.7	5.8	7.0	7.8	9.2	4.6
Banks	15.6	19.7	19.9	20.2	20.5	20.8
Other private	4.4	5.4	6.5	8.7	11.6	15.4
Short-term debt amortization	137.8	131.6	131.3	131.2	131.2	131.3
Public sector	85.9	81.7	81.0	80.3	79.6	78.9
Central Bank	81.1	76.3	75.6	74.9	74.2	73.5
Of which: ECB access	25.9	21.2	20.4	19.7	19.0	18.3
General government and SOEs	4.9	5.4	5.4	5.4	5.4	5.4
Banks	36.0	35.6	37.5	39.3	41.2	43.1
Other private	15.8	14.3	12.8	11.6	10.4	9.4
EU and IMF[1]	5.3	3.9	2.0	0.0	1.9	1.9
Sources of financing	166.8	165.5	166.5	168.5	176.0	176.7
Capital account (Net)	2.0	2.1	2.2	2.0	2.1	2.1
Foreign direct investment (Net)	-4.1	-4.1	-4.1	-4.1	-3.9	-3.9
Inward	7.8	8.0	8.1	8.3	8.3	8.3
New borrowing and debt rollover	161.1	166.9	168.0	169.9	178.0	177.0
Medium and long-term borrowing	29.5	35.6	36.9	38.7	46.7	45.4
General government	9.2	9.4	9.3	8.7	13.5	8.1
Banks	15.5	20.8	21.1	21.3	21.6	21.9
Other private	4.8	5.4	6.5	8.7	11.6	15.4
Short-term borrowing	131.6	131.3	131.2	131.2	131.3	131.6
Public sector	81.7	81.0	80.3	79.6	78.9	78.2
Central bank	76.3	75.6	74.9	74.2	73.5	72.8
Of which: ECB access	21.2	20.4	19.7	19.0	18.3	17.7
General government	5.4	5.4	5.4	5.4	5.4	5.4
Banks	35.6	37.5	39.3	41.2	43.1	45.0
Other private	14.3	12.8	11.6	10.4	9.4	8.4
Other (Includes asset operations)	7.7	0.6	0.5	0.6	-0.1	1.5
Of which: Net errors and omissions	0.0	0.0	0.0	0.0	0.0	0.0
Rollover rates						
General government	151.9	131.3	118.6	107.2	129.6	135.5
Private	97.7	102.0	102.2	102.3	102.4	102.4
Banks	99.0	105.4	105.2	105.0	104.9	104.8
Other private	94.3	92.8	93.4	94.3	95.3	96.2

Sources: Bank of Portugal and IMF staff estimates.

1/ For EFSF loans, outstanding loans are assumed to be rolled over for an additional 7 years, as agreed with the EU. Projected repayments to the IMF include additional advanced repurchases planned for 2018-19.

Annex I. Public Debt Sustainability Analysis (DSA)

Staff's analysis, applying the Public DSA framework for Market-Access Countries, suggests that Portugal's gross debt trajectory is subject to significant risks, in the context of a sizable debt burden and gross financing needs. Debt dynamics remain vulnerable to adverse yet plausible macro-fiscal and contingent liabilities shocks, including the possible need for further fiscal support for the financial sector. While immediate risks have receded in the context of an improved near-term growth outlook and recent increases in bank capital, the risk of a contingent liabilities shock materializing over the medium-term remains elevated given financial sector vulnerabilities. Staff's baseline projections reflect the authorities' current fiscal policies; durable structural fiscal consolidation remains critical to anchor debt safely on a downward-sloping path, boosting policy credibility and strengthening the country's resilience to reversals in market sentiment.

A. Baseline Scenario

1. **The public debt ratio remains sizable, but is expected to decline by about 5 percent of GDP in 2017, boosted by the improved growth and fiscal outlook.** Public debt is projected to decline to 125.7 percent of GDP at end-2017, the lowest level since 2011, reflecting the decline in headline deficit and improved growth dynamics with real GDP growth expected to accelerate to 2.5 percent this year. A further steady decline in public debt is projected through 2022 as the headline fiscal deficit stabilizes at around 1.5 percent of GDP, but public debt would still remain elevated at 114 percent of GDP in 2022. The projected debt reduction is larger than at the time of the 5th PPM, primarily reflecting the upward revision to real GDP growth for 2017-20. Deposits are expected to decline in 2017 to fund the recapitalization of CGD, but the further drawdown of cash deposits from 2018–22 is projected to be modest, reflecting the authorities' intention to maintain cover for 6 months' refinancing needs.

B. Risk Assessment

2. **Portugal's sizable debt burden and gross financing needs continue to pose significant risks to debt sustainability and leave debt dynamics very sensitive to macro shocks**. As shown in Figure 1, Portugal's debt ratio already exceeds the debt burden benchmark for advanced economies of 85 percent of GDP under the baseline scenario. However, Portugal's public gross financing needs now fall below the relevant benchmark of 20 percent of GDP during the projection period, as the combination of longer-term issuance and shorter-term debt buybacks (including advanced repurchases to the Fund) has helped to moderate near-term refinancing needs and smooth the redemption profile of public debt. The debt profile remains subject to medium to low risks in terms of market perception, projected change in short-term debt, and the share of public debt held by nonresidents.[1] Moreover, in the case of Portugal, since bank vulnerabilities are below the relevant thresholds identified by the MAC DSA template, the standardized contingent liabilities

[1] The total (public and private) external financing requirements exceed significantly the relevant benchmark under the baseline. However, in the case of Portugal, the figure includes, among others, non-residents bank deposits, accounting for about 45 percent of GDP.

shock does not apply. Nevertheless, this is replaced by a customized shock given the risks posed by the materialization of contingent liabilities from SOEs and PPPs (please refer to the stress test customized scenario).

C. Realism of Baseline Assumptions and Alternative Scenarios

3. **Realizing the potential growth rate assumed in the current projection has important implications for the debt adjustment path.** Portugal's growth forecast track record shows a relatively large median error compared with other countries with Fund-supported programs, especially during the pre-crisis period (Figure 2). The achievement of a growth rate of 1.2 percent over the medium term, as per staff's updated projection, is consistent with moderate growth convergence. If growth were to turn out lower than currently projected—for instance as a result of reversal of structural reforms or shocks to external demand—the rate of debt decline would significantly slow down, as also shown in Figures 4 and 5. Similarly, risks from a protracted period of negative inflation in Portugal could further impede the repair of already-weak private and public balance sheets, as highlighted by the customized deflation scenario in Figure 5.

4. **Given Portugal's sizable debt burden and financing needs, the primary balance is expected to exceed its debt-stabilizing threshold over the projection period.** Under staff's baseline scenario,[2] the fiscal primary balance is expected to stabilize at around 2.5 percent of GDP over the medium term. Nevertheless, Portugal's debt profile remains highly vulnerable to a primary balance shock (Figures 4 and 5), as also highlighted by the asymmetric fan chart analysis in Figure 1, which shows the risks to the debt outlook if only negative shocks to the primary balance were to materialize. The authorities' medium-term fiscal strategy under the Stability Program for 2017–21 envisages a reduction in public debt to 109.4 percent of GDP by 2021. However, this projection is based on an ambitious timetable for fiscal adjustment with largely unspecified cost savings and optimistic assumptions on medium-term growth. The Stability Program assumes annual real GDP growth of 2.0 percent in 2017–21, as opposed to staff's baseline projection of average annual growth of 1.7 percent over the same period.

D. Stress Test

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

- Under a *growth shock* that lowers output by nearly 4.5 percentage points in 2017–18 (and in turn inflation by a cumulative 1 percentage point), debt would peak at about 130 percent of GDP in 2019, 11 percentage points higher than under the baseline. However, debt dynamics would be severely compromised under a *deflation scenario* where a sharper growth shock (that lowers output by 5½ percentage points in 2017–18) is associated with deflationary pressures (with inflation lower by cumulative 4 percentage points), in the context of a widening output gap and

[2] In line with the WEO guidelines, medium-term assumptions that are not backed up by well-defined fiscal measures are not incorporated by the team under the baseline scenario.

high unemployment. Under this scenario, debt would rise to 139 percent of GDP by 2019 and remain close to this level over the medium-term.

- The *interest rate shock* is particularly relevant for Portugal, as a less supportive financing environment as monetary accommodation is reduced increases the risk of sudden fluctuations in market conditions. A sustained interest rate shock of 280 basis points throughout the projection period is not expected to have a large immediate effect, reflecting the relatively long-term maturity of public debt, but it would slow down the rate of debt decline in the medium term, so that by 2022 the debt-to-GDP ratio is about 3 points higher compared with the baseline. Under the baseline, borrowing costs are projected to gradually increase in line with German bund yields; the impact during the projection period is relatively muted due to the maturity structure of public debt, but would increase after 2022 as a larger share of debt is rolled over.

- Further materialization of contingent liabilities would also have implications for Portugal's debt dynamics. While the recent debt management operation for SOEs has significantly addressed fiscal risks from the transport and infrastructure sectors, staff's assessment suggests that, under a severe scenario, further contingent liabilities could potentially materialize of about 10 percent of GDP, due to financial sector risks, SOEs, and State guarantees.[3] A contingent liabilities shock of this magnitude would push the 2018 debt ratio to 130 percent of GDP.

- A severe combined shock that incorporates the macro-fiscal and contingent liabilities adverse scenarios mentioned above would significantly affect the country's debt dynamics, with debt rising to 139 percent of GDP in 2019 and then remaining at this level over the medium term.

6. The authorities took note of the risks highlighted by staff, but also stressed the divergence of their medium-term outlook from staff's baseline scenario. The authorities were optimistic that reforms in recent years have laid the foundation for stronger export-oriented growth, which would underpin a larger improvement in medium-term debt dynamics than projected by staff. Over the medium-term, the authorities reiterated their commitment to medium-term fiscal consolidation as outlined in their 2017 Stability Program. In the near-term, they were optimistic that Portugal's record of fiscal adjustment and reform implementation had strengthened their credibility with investors, and would enable them to avoid any prolonged deterioration in market access. They also emphasized the progress made in recent years to reduce borrowing costs and considered that the maturity structure of public debt and large cash buffer left them well-positioned to withstand any fluctuations in market conditions that might result from a tapering of PSPP.

[3] Staff's assumptions for the adverse contingent liabilities scenario include (i) the hypothetical cost of further financial sector operations; (ii) the hypothetical settlement of the outstanding stock of arrears; (ii) staff's estimate of potential contingent liabilities from other non-bank debt directly guaranteed by the State and/or classified outside the general government perimeter.

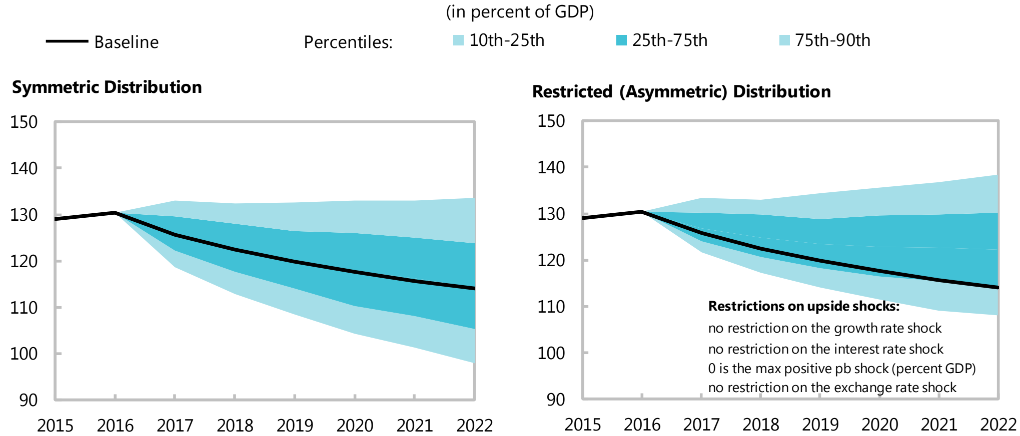
Figure 1. Portugal: Public DSA Risk Assessment, 2015–2022

Heat Map

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

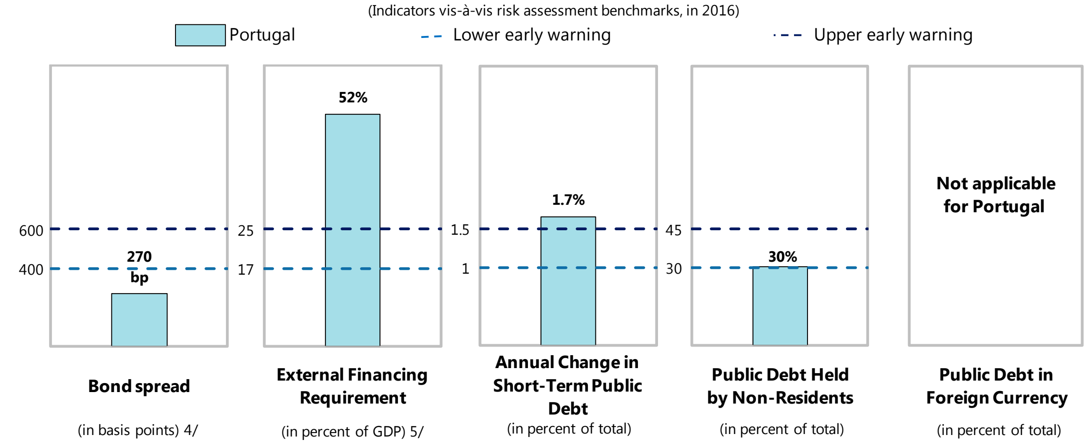
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2016)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

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

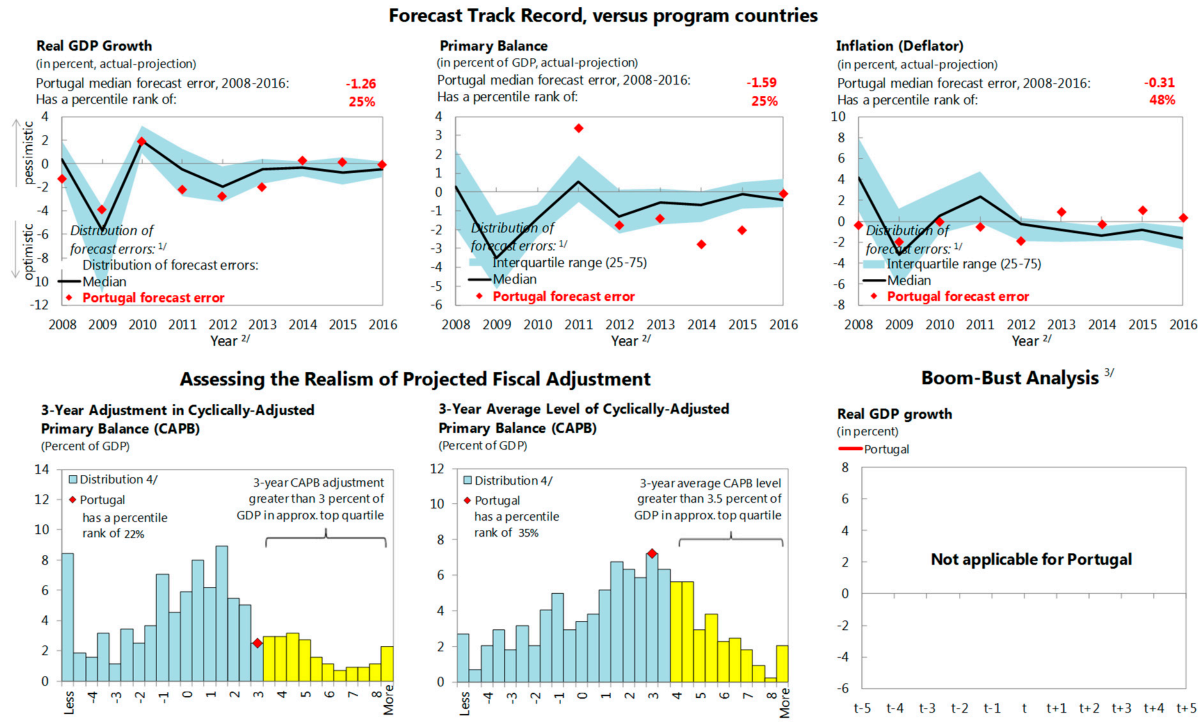
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 02-May-17 through 31-Jul-17.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure 2. Portugal: Public DSA - Realism of Baseline Assumptions I



Source : IMF Staff.

1/ Plotted distribution includes program countries, percentile rank refers to all countries.

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

3/ Not applicable for Portugal, as it meets neither the positive output gap criterion nor the private credit growth criterion.

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

Figure 3. Portugal: Public Sector Debt Sustainability Analysis (DSA) Baseline Scenario, 2006–2022

(Percent of GDP, unless otherwise indicated)

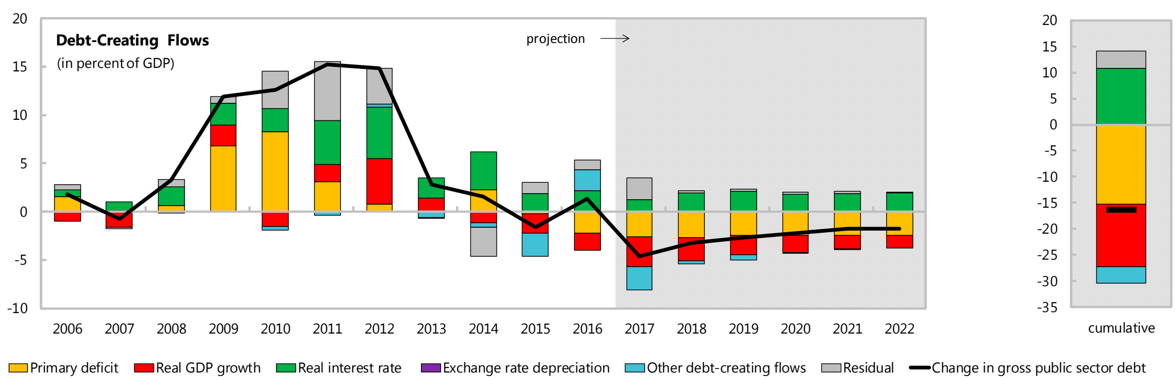
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2006-2014 [2/]	2015	2016	2017	2018	2019	2020	2021	2022
Nominal gross public debt	98.5	129.0	130.3	125.7	122.5	119.8	117.6	115.8	114.0
Public gross financing needs	24.2	24.5	18.5	16.0	15.4	16.1	14.2	17.7	14.0
Real GDP growth (in percent)	-0.3	1.6	1.4	2.5	2.0	1.7	1.5	1.2	1.2
Inflation (GDP deflator, in percent)	1.3	2.1	1.6	2.2	1.7	1.6	1.8	1.8	1.8
Nominal GDP growth (in percent)	1.0	3.7	3.0	4.8	3.8	3.3	3.3	3.0	3.0
Effective interest rate (in percent) [4/]	4.2	3.6	3.4	3.3	3.3	3.4	3.4	3.4	3.5

As of July 31, 2017		
Sovereign Spreads		
EMBIG (bp) 3/		235
5Y CDS (bp)		240
Ratings	Foreign	Local
Moody's	Ba1	Ba1
S&Ps	BB	BB
Fitch	BB+	BB+

Contribution to Changes in Public Debt

	Actual			Projections							
	2006-2014	2015	2016	2017	2018	2019	2020	2021	2022	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	7.0	-1.6	1.4	-4.6	-3.3	-2.7	-2.3	-1.8	-1.8	-16.4	
Identified debt-creating flows	5.6	-2.7	0.3	-6.9	-3.5	-2.9	-2.5	-2.0	-1.9	-19.6	
Primary deficit	2.6	-0.2	-2.2	-2.6	-2.7	-2.5	-2.5	-2.5	-2.5	-15.2	0.6
Primary (noninterest) revenue and grants	42.2	44.0	43.0	43.0	42.8	42.6	42.5	42.5	42.4	255.9	
Primary (noninterest) expenditure	44.9	43.8	40.8	40.4	40.1	40.1	40.0	40.0	40.0	240.7	
Automatic debt dynamics [5/]	3.2	-0.1	0.5	-1.9	-0.5	0.1	0.1	0.5	0.6	-1.2	
Interest rate/growth differential [6/]	3.2	-0.1	0.5	-1.9	-0.5	0.1	0.1	0.5	0.6	-1.2	
Of which: real interest rate	2.7	1.9	2.2	1.2	1.9	2.1	1.8	1.9	1.9	10.8	
Of which: real GDP growth	0.5	-2.0	-1.8	-3.1	-2.4	-2.0	-1.7	-1.4	-1.3	-12.0	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.2	-2.4	2.1	-2.4	-0.3	-0.5	-0.1	0.0	0.0	-3.3	
Privatization revenue (negative)	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Increase in deposits and other (- means drawn down of deposits)	0.2	-2.4	2.1	-2.4	-0.3	-0.5	-0.1	0.0	0.0	-3.3	
Residual, including asset changes [8/]	1.4	1.1	1.0	2.2	0.2	0.2	0.2	0.2	0.1	3.3	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Bond Spread over German Bonds.

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

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

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

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

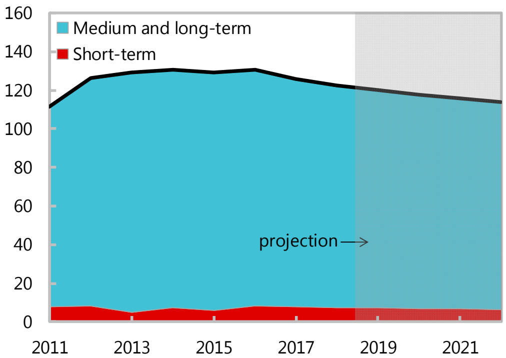
8/ For projections, this line includes exchange rate changes during the projection period.

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

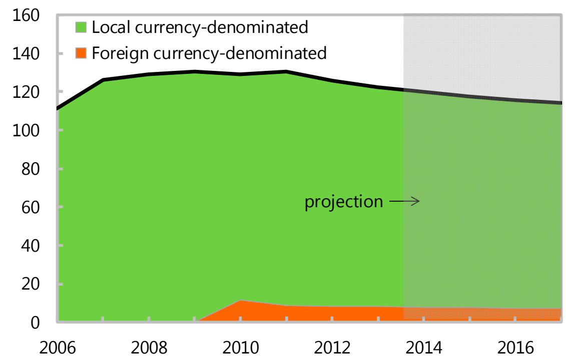
Figure 4. Portugal: Public DSA - Composition of Public Debt and Alternative Scenarios, 2011–2022

Composition of Public Debt

By Maturity
(in percent of GDP)



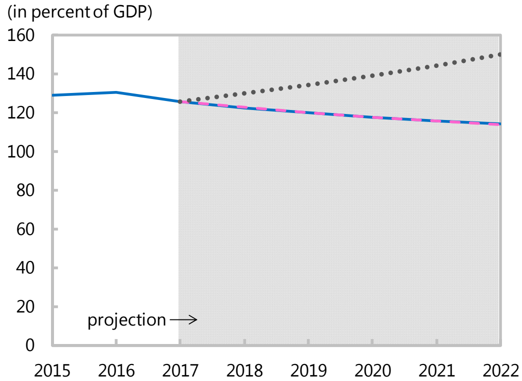
By Currency
(in percent of GDP)



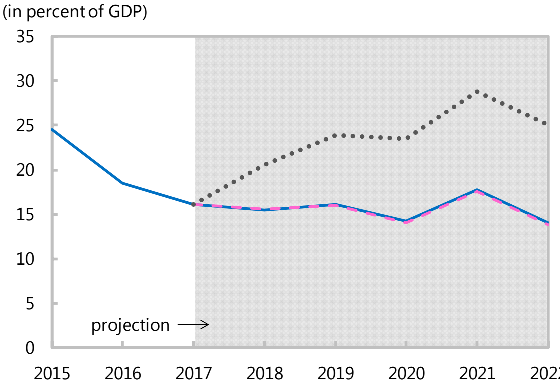
Alternative Scenarios

Baseline   Historical   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

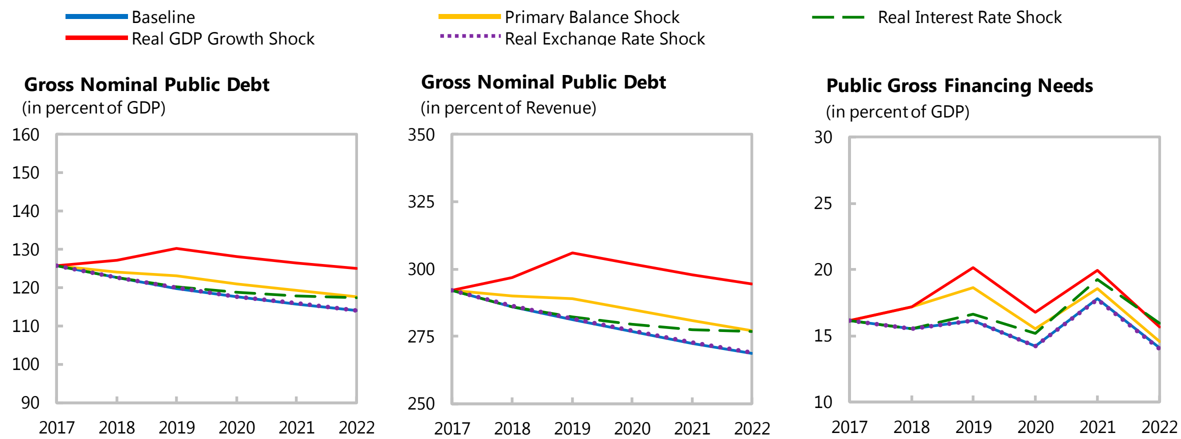
Baseline Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	2.5	2.0	1.7	1.5	1.2	1.2
Inflation	2.2	1.7	1.6	1.8	1.8	1.8
Primary Balance	2.6	2.7	2.5	2.5	2.5	2.5
Effective interest rate	3.3	3.3	3.4	3.4	3.4	3.5
Constant Primary Balance Scenario						
Real GDP growth	2.5	2.0	1.7	1.5	1.2	1.2
Inflation	2.2	1.7	1.6	1.8	1.8	1.8
Primary Balance	2.6	2.6	2.6	2.6	2.6	2.6
Effective interest rate	3.3	3.3	3.4	3.4	3.4	3.5

Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	2.5	-0.1	-0.1	-0.1	-0.1	-0.1
Inflation	2.2	1.7	1.6	1.8	1.8	1.8
Primary Balance	2.6	-1.9	-1.9	-1.9	-1.9	-1.9
Effective interest rate	3.3	3.3	3.5	3.7	3.8	4.1

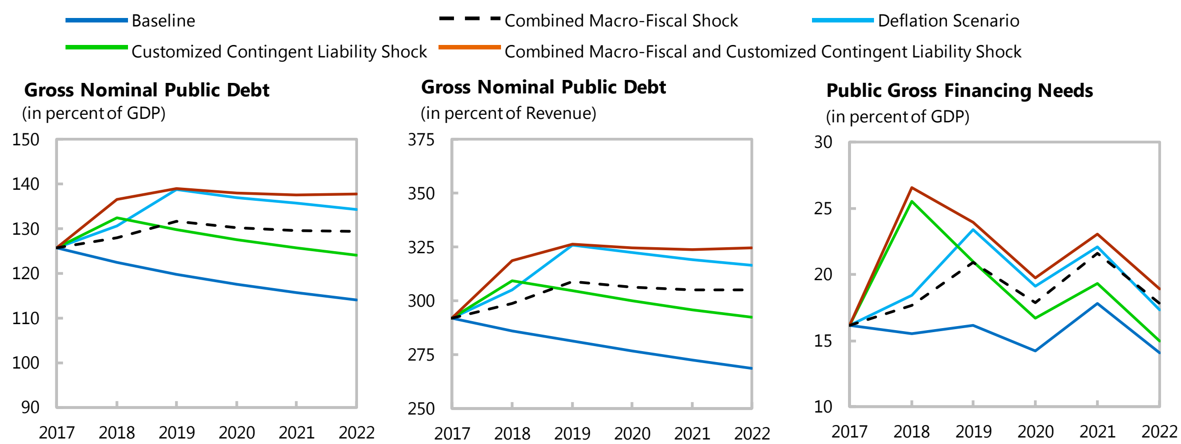
Source: IMF staff estimates.

Figure 5. Portugal: Public DSA - Stress Tests, 2017–2022

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	2.5	2.0	1.7	1.5	1.2	1.2
Inflation	2.2	1.7	1.6	1.8	1.8	1.8
Primary balance	2.6	1.0	0.8	2.5	2.5	2.5
Effective interest rate	3.3	3.3	3.4	3.5	3.5	3.6
Real Interest Rate Shock						
Real GDP growth	2.5	2.0	1.7	1.5	1.2	1.2
Inflation	2.2	1.7	1.6	1.8	1.8	1.8
Primary balance	2.6	2.7	2.5	2.5	2.5	2.5
Effective interest rate	3.3	3.3	3.8	4.0	4.2	4.7
Combined Shock						
Real GDP growth	2.5	-0.2	-0.5	1.5	1.2	1.2
Inflation	2.2	1.2	1.0	1.8	1.8	1.8
Primary balance	2.6	1.0	0.2	2.5	2.5	2.5
Effective interest rate	3.3	3.3	3.8	4.1	4.3	4.7
Customized Contingent Liability Shock						
Real GDP growth	2.5	2.0	1.7	1.5	1.2	1.2
Inflation	2.2	1.7	1.6	1.8	1.8	1.8
Primary balance	2.6	-7.3	2.5	2.5	2.5	2.5
Effective interest rate	3.3	3.3	3.3	3.4	3.4	3.6

Real GDP Growth Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	2.5	-0.2	-0.5	1.5	1.2	1.2
Inflation	2.2	1.2	1.0	1.8	1.8	1.8
Primary balance	2.6	1.5	0.2	2.5	2.5	2.5
Effective interest rate	3.3	3.3	3.4	3.5	3.5	3.6
Real Exchange Rate Shock						
Real GDP growth	2.5	2.0	1.7	1.5	1.2	1.2
Inflation	2.2	1.8	1.6	1.8	1.8	1.8
Primary balance	2.6	2.7	2.5	2.5	2.5	2.5
Effective interest rate	3.3	3.3	3.4	3.4	3.4	3.5
Deflation Scenario						
Real GDP growth	2.5	-0.8	-1.1	1.5	1.2	1.2
Inflation	2.2	-0.4	-0.5	1.8	1.8	1.8
Primary balance	2.6	0.7	-1.6	2.5	2.5	2.5
Effective interest rate	3.3	3.3	3.5	3.8	3.7	3.8
Combined Macro-Fiscal and Customized Contingent Liability Shock						
Real GDP growth	2.5	-0.2	-0.5	1.5	1.2	1.2
Inflation	2.2	1.2	1.0	1.8	1.8	1.8
Primary balance	2.6	-7.9	1.9	2.5	2.5	2.5
Effective interest rate	3.3	3.3	3.9	4.2	4.5	4.9

Source: IMF staff estimates.

Annex II. Risk Assessment Matrix

Source of Risks	Relative Likelihood	Impact	Policy response
Loss of investor confidence due to reform reversals or other negative surprises potentially including difficulties in the banking sector or loss of sole investment-grade rating: • Increase in sovereign bonds yields and reduction in foreign direct investment. • Tighter than expected ECB policies, including a reduction in asset purchases	**Medium**	**High** Significant funding distress higher public and private borrowing costs.	Strengthen policy buffers and avoid backtracking on reforms to prevent negative domestic shocks. Step up efforts to implement policies that supports growth, lasting fiscal adjustment, and a strong banking sector, which all would contributing to shoring up investor confidence, and ease financing conditions and restraints.
Financial distress in one or more banks, requiring intervention.	**Medium**	**High** Loss of confidence in the banking system, resulting in potentially high fiscal costs.	Proactive bank supervision to ensure balance sheet clean-up, a build-up of capital buffers in banks and of fiscal buffers. Strengthen oversight of banks' risk management practices. Shore up the banks using the existing toolkit, while ensuring public debt dynamics are not compromised.
Policy and geopolitical uncertainties: • **Policy uncertainty and divergence.** Two-sided risks to U.S. growth with difficult-to-predict policies and global spillovers. In Europe, uncertainty associated with negotiating post-Brexit arrangements and with upcoming major elections. Policy divergence could lead to rising global imbalances and exacerbate exchange rate and capital flow volatility.	**High**	**High** Increased investor uncertainty, exacerbating low investment, weak productivity and undermining cyclical recovery. Lower growth due to trade barriers. Escalation of euro skepticism, leading to less cooperation and a reversal of integration.	Accelerate structural reforms to support investment and growth. Strengthen fiscal policy adjustment to support investor confidence. Step up efforts to clean up corporate and bank balance sheets.

Source of Risks	Relative Likelihood	Impact	Policy response
Financial conditions: **Significant further strengthening of the US dollar and/or higher interest rates.** As investors reassess policy fundamentals, as term premia decompress, or if there is a more rapid Fed normalization, leveraged firms, lower-rated sovereigns and those with un-hedged dollar exposures could come under stress. Could also result in capital account pressures for some economies. **European bank distress:** Strained bank balance sheets amid a weak profitability outlook could lead to financial distress in one or more major banks with possible knock-on effects on the broader financial sector and for sovereign yields in vulnerable economies.	**High** **Medium**	**High** Higher borrowing costs for the public and private sector as the ECB normalizes monetary policy. Loss of market confidence, leading to wider spreads. Less favorable financial conditions as global conditions tighten. Given its high corporate and private debt levels, Portugal would be highly susceptible to financial contagion. The result would be a heightened financial stress in the Portuguese banking system, as balance sheet fragilities in both banking and corporate sectors are still significant.	Step up efforts to implement policies that supports growth, lasting fiscal adjustment, and a strong banking sector, which all would contributing to shoring up investor confidence, and ease financing conditions and restraints. Proactive bank supervision to ensure balance sheet clean-up, a build-up of capital buffers in banks and of fiscal buffers. Strengthen oversight of banks' risk management practices. Shore up the banks using the existing toolkit, while ensuring public debt dynamics are not compromised.
Weaker-than-expected global growth: • **Structurally weak growth in key advanced and emerging economies:** Low productivity growth (U.S., the Euro Area, and Japan), a failure to fully address crisis legacies and undertake structural reforms, and persistently low inflation (the Euro Area, and Japan) undermine medium-term growth in advanced economies (high likelihood). Resource misallocation and policy missteps, including insufficient reforms, exacerbate declining productivity growth in emerging markets (medium likelihood).	**High (US, euro area, and Japan)** **Medium (Emerging Markets)**	**High** Low growth would imperil debt dynamics in all sectors, with the euro area accounting for 60 percent of total exports putting the current account balance and IIP at risk.	Step up structural reforms to improve competitiveness and reduce debt overhang. Step up efforts to clean up corporate and bank balance sheets, to minimize drag on investment and growth.

Source of Risks	Relative Likelihood	Impact	Policy response
Lower energy prices, Production cuts by OPEC and other major producers may not materialize as agreed while other sources of supply could increase production.	Low	Medium A low fuel import bill is potentially offset by greater difficulties in Angola, a key economic and financial partner.	Step up efforts to clean up corporate balance sheets, including the reduction of exposures to Angola. Shore up the banks using the existing toolkit, while ensuring public debt dynamics are not compromised. Renewed structural reform effort to expand exports to other markets.

*/ The Risk Assessment Matrix shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of the staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more).

Annex III. External Stability Report

<table>
<tr><th></th><th></th><th>Overall Assessment</th></tr>
<tr><td>Foreign asset and liability position and trajectory</td><td>Background. The negative net international investment position (NIIP) declined from its peak in 2014 of 118 percent of GDP to 105 percent of GDP at the end of 2016. This improvement has been driven by the reversal of the current account balance through the crisis, but offset by improving external debt valuations. Gross external debt remains high at 215½ percent of GDP. Both are expected to continue to decline, but at a decelerating rate over the medium-term as the current account moves to deficit.
Assessment. The large negative NIIP comes with external vulnerabilities, including from valuation changes and the large gross financing needs from external debt. Past debt management efforts to reduce sovereign external risk, including by smoothing the profile for redemptions and lengthening the average maturity have mitigated this risk somewhat although most recently the average residual maturity of non-EU-IMF loans have gone down slightly, and Portugal remains exposed to a loss in confidence by external investors.</td><td rowspan="5">Overall Assessment:
The external position in Portugal in 2016 was weaker than that consistent with medium-term fundamentals and desirable policy settings. In 2017 the CA is projected to deteriorate somewhat with rising import demand.
In particular, despite the strong improvement in the current account since the crisis, reaching a more sustainable NIIP position would require a weaker effective exchange rate.

Potential policy responses:
Sustained fiscal consolidation and structural reforms to improve Portugal's competitiveness and potential growth are needed. Diminished reform momentum in 2015 gave way to partial reversals in 2016 which have moderated the outlook for sustained competitiveness gains. An effective work out of longstanding NPLs, accelerated judicial procedures, reduced electricity costs and improved transport links would help drive investment. Labor market reforms to better integrate the low-skilled and long-term unemployed while maintaining past reforms to collective bargaining would help improve competitiveness on the cost side. Fiscal consolidation through high quality measures, using the remaining window of accommodative ECB monetary policies, would help reduce net interest payments, facilitate external deleveraging, and boost confidence about Portugal among investors.</td></tr>
<tr><td>Current account</td><td>Background. The Portuguese current account has been in a surplus since 2013 after an extended period of deficits in the range of 10 percent of GDP, driven by a significant improvement in the balance of trade in goods and services, including on the heels of strong growth in tourism. The current account registered a surplus of 0.8 percent of GDP in 2016, which is expected to moderate in 2017-19 and shift to a deficit beginning in 2020 as import growth outstrips export growth.
Assessment. EBA model-based estimates suggest a cyclically adjusted current account balance of -0.4 percent of GDP, compared to a norm of 0.4 percent of GDP, resulting in a negative current account gap of less than 1 percent. Nevertheless, staff assesses the current account surplus to be insufficient in view of the large NIIP deficit which needs to be put on a sustained downward trajectory. Relative to a current account surplus of 2½ percent, and assuming continued capital account surpluses, which would achieve a meaningful medium-term reduction in the NIIP deficit, bringing it to below 50 percent over the next 5 to 10 years, staff assesses a current account short fall of about 2-4 percent of GDP. Key to strengthen the external position, including the high level of public debt, is sustained fiscal adjustment paired with structural reforms to support growth and investment, and continued efforts to address remaining financial sector challenges.</td></tr>
<tr><td>Real exchange rate</td><td>Background. Both the CPI-based real effective exchange rate (REER) and the unit labor cost (ULC) - based REER are still well below their pre-crisis peaks – CPI-based REER 5½ percent below, and ULC-based REER 12 percent below. However, both REER measures have been on an appreciating trend since the post crisis low points in early 2015, and although the appreciation around 3½ percent since then is limited, competitiveness will deteriorate if the trend continues.
Assessment. The EBA's index and level REER regression models indicate an overvaluation of 6½ and 5 percent respectively for 2016. These metrics are at the lower end of what is needed, given current policies, to put the NIIP deficit on a decisive downward trajectory, which suggest an overvaluation of the REER in a range of 5 to 10 percent. With appropriate structural, fiscal, and financial policies in place the adjustment could be less through price competitiveness and more through continued and sustained quality upgrades and innovation.</td></tr>
<tr><td>Capital and financial accounts: flows and policy measures</td><td>Background. Financing conditions have eased dramatically since the resumption of sovereign market access in 2014, but sovereign spreads to bunds were still about 235 basis points at end-July. This reflects continued market concerns about the high level of public and still significant reliance on ECB purchases under the PSPP. Wholesale funding of banks has continued to decline.
Assessment. A current account surplus and ECB policy actions have helped support external financing rollover needs for the immediate future. Further policy action will be needed over the medium term to maintain investor confidence and rule out negative equilibria.</td></tr>
<tr><td>FX inter-vention and reserves level</td><td>Background. The euro has the status of a global reserve currency.
Assessment. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.</td></tr>
</table>

INTERNATIONAL MONETARY FUND

PORTUGAL

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

August 16, 2017

Prepared By

European Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of July 31, 2017)

Membership Status: Joined: March 29, 1961; Article VIII

General Resources Account:	**SDR Million**	**Percent Quota**
Quota	2,060.10	100.00
Fund holdings of currency	10,808.14	524.64
Reserve position in Fund	465.65	22.60

SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	806.48	100.00
Holdings	535.62	66.42

Outstanding Purchase and Loans:	**SDR Million**	**Percent Quota**
Extended Arrangements	9,213.67	447.24

Financial Arrangements:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
EFF	May 20, 2011	June 30, 2014	23,742.00	22,942.00
Stand-By	Oct 07, 1983	Feb 28, 1985	445.00	259.30
Stand-By	Jun 05, 1978	Jun 04, 1979	57.35	0.00

Projected Payments to Fund[1]:

(SDR Million; based on existing use of resources and present holdings of SDRs)

	Forthcoming[2]				
	2017	**2018**	**2019**	**2020**	**2021**
Principal	0	0	0	3,542.58	3,356.08
Charges/Interest	174.89	309.11	309.11	266.96	102.60
Total	**174.89**	**309.11**	**309.11**	**3,809.54**	**3,458.69**

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

[2] Does not include possible early repurchases.

Exchange Rate Arrangement:

Portugal's currency is the euro, which floats freely and independently against other currencies. Portugal has accepted the obligations of Article VIII, Section 2, 3, and 4, and maintains an exchange system free of restrictions on payments and transfers for current international transactions, other than restrictions notified to the Fund under Decision No. 144 (52/51).

Article IV Consultations:
Portugal is on the standard 12-month consultation cycle. The previous consultation discussions took place during June 15-29, 2016, and the staff report (Country Report No. 16/300) was discussed on September 16, 2016.

Post-Program Monitoring Discussions:
The Fifth Post-Program Monitoring Discussions were held in Lisbon during November 29 – December 7, 2016, and the staff report (Country Report No. 17/58) was discussed on February 17, 2016.

Resident Representative:
The resident representative office in Portugal closed in September 2015.

Safeguards Assessment:
The first-time safeguards assessment of the Bank of Portugal (BdP), finalized in September 2011, found relatively strong safeguards in place. It recommended changes to the BdP Law to strengthen provision on BdP's autonomy and oversight, and to extend supervisory responsibilities of the Audit Board to other tasks such as oversight of internal control functions, financial reporting and audit. The BdP implemented all safeguards recommendations, including formally proposing amendments to the BdP law; however, these have not been enacted.

STATISTICAL ISSUES

As of July 31, 2017

I. Assessment of Data Adequacy for Surveillance
General. Data provision to the Fund is adequate for surveillance purposes.
Real sector. Since September 2014, the National Institute of Statistics (INE) publishes a full set of national accounts based on the *ESA 2010* methodology, including quarterly GDP estimates. The data are available beginning in the first quarter of 1995; the quarterly and annual data are consistent. INE publishes the Consumer Price Index, and the Harmonized Index of Consumer Prices (HICP) according to the methodology of EU Member States. Control and quality assessment are ensured through the supervision of Eurostat.
Fiscal sector. Data have undergone a number of revisions during the transition to the *ESA 2010*, sizably altering revenue and expenditure and hampering comparisons across years. From 2001 onward, budgets have been presented in a manner consistent with recent changes in national and fiscal accounting methodology. Quarterly general government statistics on an accrual basis are available as derived from the national accounts statistics.
Trade and balance of payments. Data are provided according to the IMF's sixth edition of the *Balance of Payments Manual*. The portfolio investment data collection system encompasses transactions of resident banks, domestic securities transactions undertaken by nonresidents (through the resident custodians), external securities transactions undertaken by residents (through the resident investor or custodian), as well as residents' issuance of securities in foreign markets.
Monetary and financial sector. Data on the central bank balance sheet and on the consolidated balance sheet of other monetary financial institutions are available from the Bank of Portugal's BPStat website. Portugal also provides monthly monetary statistics to the IMF for the central bank and other depository corporations through the ECB. Data for other financial corporations is not reported.
Financial sector surveillance: Portugal reports eleven core FSIs (excluding the net open position in foreign exchange capital), twelve encouraged FSIs for the deposit takers as well as ten encouraged FSIs for the other sectors on a quarterly basis.

II. Data Standards and Quality	
Portugal is subject to the statistical requirements and timeliness and reporting standards of Eurostat and the European Central Bank (ECB). Portugal adheres to the Special Data Dissemination Standard Plus (SDDS+), and the relevant metadata have been posted on the Dissemination Standards Bulletin Board.	No data ROSC is available.

Portugal: Table of Common Indicators Required for Surveillance
(As of July 31, 2017)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	07/31/17	07/31/17	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	6/17	7/17	M	M	M
Reserve/Base Money	5/17	7/17	M	M	M
Broad Money	5/17	7/17	M	M	M
Central Bank Balance Sheet	6/17	7/17	M	M	M
Consolidated Balance Sheet of the Banking System	5/17	7/17	M	M	M
Interest Rates[2]	6/17	7/17	M	M	M
Consumer Price Index	6/17	7/17	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	5/17	7/17	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	5/17	7/17	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	5/17	7/17	M	M	M
External Current Account Balance	5/17	7/17	M	M	M
Exports and Imports of Goods and Services	5/17	7/17	M	M	M
GDP/GNP	2017:Q1	6/17	Q	Q	Q
Gross External Debt	2017:Q1	5/17	Q	Q	Q
International Investment Position	2017:Q1	5/17	Q	Q	Q

[1]Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and sta and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I); and not available (NA).

Statement by Mr. Cottarelli, Executive Director for Portugal,
and Ms. Lopes, Advisor to the Executive Director
September 11, 2017

I. Overview

The Portuguese Government takes note of the Staff Report for the Article IV Consultation and reiterates its commitment to economic and fiscal policies that promote competitiveness, economic growth and social cohesion, together with sound and sustainable public finances.

As anticipated during the last interaction with the Fund in February, following the 5th Post-Program Monitoring Discussions, Portugal is delivering on the objectives it set out in its Stability Program and National Reform Program. The Staff Report acknowledges that uncertainties were reduced over the past year and notes that growth is buoyant thanks to strong external performance and growing investment. The Government feels, however, that Staff did not accurately represent the structural drivers of growth, an aspect discussed in more detail below.

Staff rightly points out there are remaining challenges the Portuguese economy has to face. Portugal clearly recognizes these challenges, which are currently being addressed, particularly regarding the financial sector management and the debt burden. The **stabilization of the financial sector** has been a top priority of the Portuguese Government. More recently, important achievements included a strengthening of the capital base of all major banks and the stabilization of their shareholder structures and measures taken to guarantee the solvency of the Resolution Fund. The Portuguese authorities are also dealing with Non-Performing Loans, in line with European practices, and in line with the need to preserve the existing economic value.

Regarding **debt management**, Portugal reiterates its commitment towards an active policy in which windfall gains are directed towards abating the more expensive credits. Portugal made a 1.7 billion EUR early repayment to the IMF in February 2017; a 1 billion EUR repayment in June; and a 2.6 billion EUR repayment in August. As a result, around 63 percent of the 2011 26.3 billion EUR IMF loan has been fully repaid. These early repayments are projected to continue until 2019. In total, the repayments will allow for savings in interests of about 750 million EUR. The overall Government debt is set to decline on the back of solid budgetary primary surpluses (2.2 percent in 2016, 2.7 percent in 2017, 3.1 percent in 2018). In 2017, debt is actually expected to decline to 127.7 percent, the largest yearly decline in 19 years.

The Portuguese Government has always pledged to adopt a **growth friendly fiscal consolidation strategy**. In 2016, the headline deficit was 2 percent and GDP growth 1.4 percent. In 2017, the headline deficit is expected to stand at 1.5 percent, while growth is expected to be clearly above the 1.8 percent included in the 2017 Draft Budget Law (it may reach 2.5 percent according to the IMF's projections). Present results and the foreseeable trajectory prompted the European Union Council to close the Excessive Deficit Procedure on Portugal, which had been open since 2009. Moreover, growth is inclusive, with **improved labor market conditions**. The unemployment stood at 8.7 percent in July 2017, down from a peak of 17.9 percent in January 2013. Permanent employment makes 91 percent of the 155 thousand net salaried employment gains since the second quarter of 2016. Export **performance** in 2017 continues to be encouraging, with goods exports growing 12.1 percent in nominal terms in the 1st semester of 2017 when compared to the same period of 2016. Exports of goods and services are expected to represent around 42 percent of GDP in 2017, from around 30 percent only seven years ago.

The **structural bottlenecks** of the Portuguese economy are being steadily addressed by the Government. The 2017 National Reform Program (NRP) was considered by the European Commission to be ambitious and able to tackle Portugal's imbalances. The 2017 NRP aims to overcome structural constraints that prevent the economy from growing even further. It has a strong focus on improving **human capital**, **skills** and **competitiveness** – taking the long-term view. Coupled with the changes being implemented in the financial sector, these reforms will facilitate structural changes in the Portuguese economy that will accelerate its growth potential.

All in all – past, present and future commitments – growth is underpinned by strong fundamentals and **Portugal is in the best condition to grow sustainably ever since it joined the Euro**. This will be possible with the continuous commitment to designing and implementing policies and reforms that promote inclusive growth, in a context of fiscal consolidation.

II. Drivers of Growth

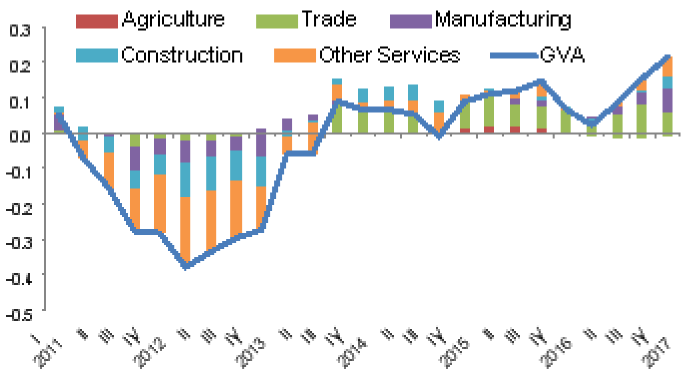
Portugal registered 15 quarters of consecutive growth, a clear indicator of the resilience of the current recovery. In 2016, GDP grew by 1.4 percent and accelerating in the second half of the year, allowing Portugal to **converge in real terms with the Euro Area**. Growth will remain robust in 2017: in the **2nd quarter of 2017 the economy grew by 2.9 percent y-o-y** (above EA average of 2.2 percent), the highest rate in 17 years.

More importantly, **growth is broad-based, founded on growing investment and on greater external non-price competitiveness**. Investment is picking-up, with a 10.3 percent y-o-y growth in the 2nd quarter of 2017, the highest growth rate in 20 years. Taking a longer-term view, in recent years, growth has been widely spread across different sectors, including trade, manufacturing and services. There has been a rebalancing of the economy towards the tradable sector, with strong performance of exports (13.2 percent nominal growth, y-o-y, in the quarter to May 2017), with sustained and significant gains in market shares. The export share in GDP increased by 12 percentage points in the last decade. This strong export performance has taken place alongside a relatively stable real effective exchange rate, suggesting that price competition has not been a decisive factor.

The Staff Report identifies tourism as a key driver of growth. Tourism is a very successful industry, with an outstanding performance in the last decade and quite likely with a bright future ahead. Yet, it represents less than 7 percent of GDP. The fundamentals of the Portuguese economy are broad based, as the goods exports performance shows. The growth process is currently driven by investment, increasingly spread across a wider range of services and industries, a strong focus on export-oriented sectors, and government support to improve skills and innovation.

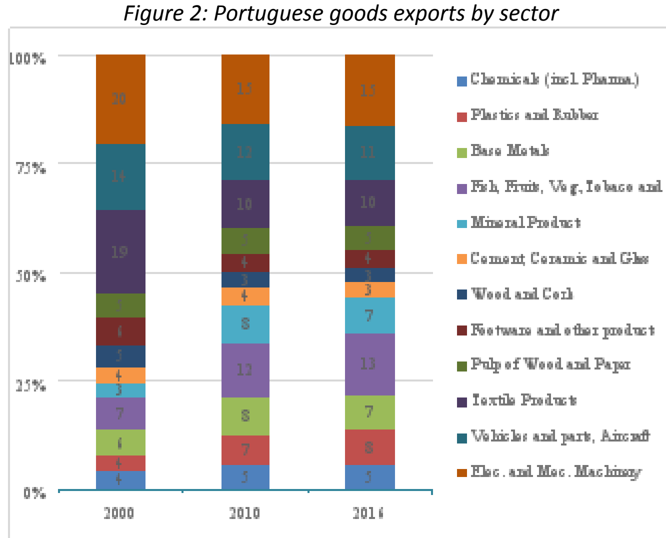
Broad-Based Economic Growth and Greater Openness

Figure 1: GVA (constant prices)



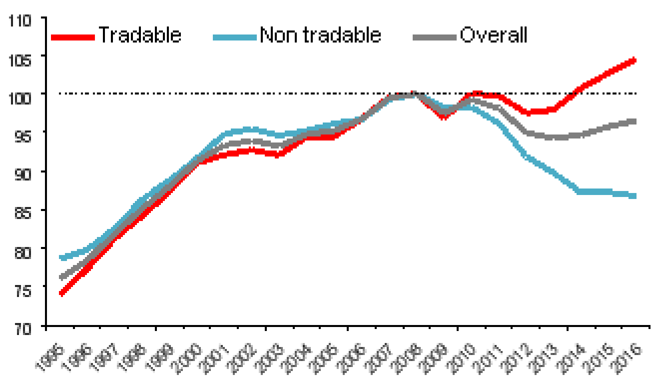
Source: Statistics Portugal

Figure 2: Portuguese goods exports by sector



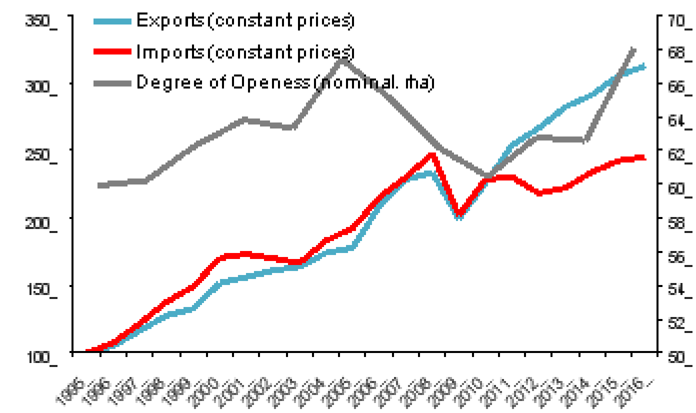
Source: Statistics Portugal

Figure 3: GVA tradable vs non tradable (constant prices; 2008=100)



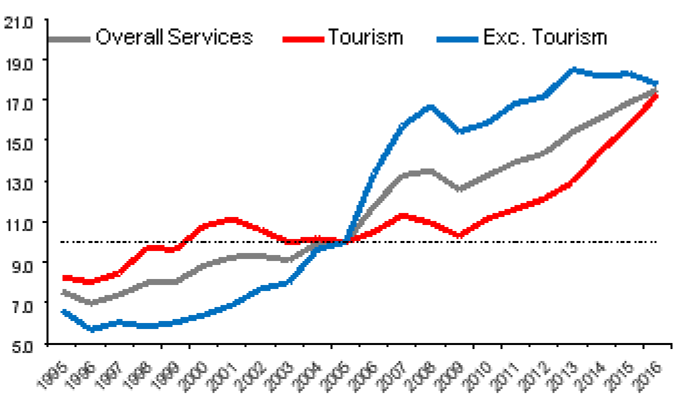
Source: Eurostat

Figure 4: Exports, Imports and Degree of Openness



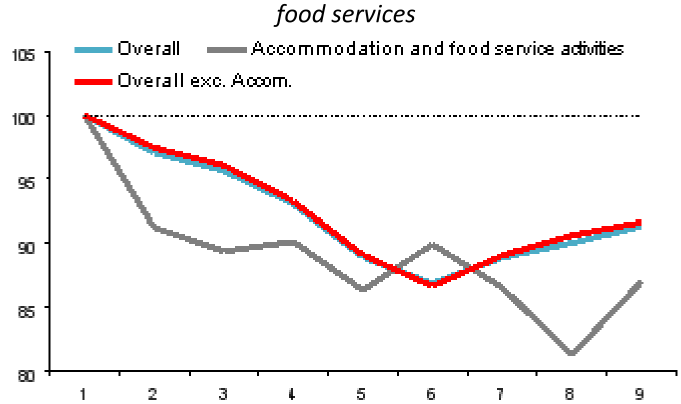
Source: Statistics Portugal

Figure 5: Exports of Services



Source: Statistics Portugal

Figure 6: Employment with and without accommodation and food services



Source: Eurostat

III. Competitiveness

The Staff Report associates Portugal's downturn and ongoing economic recovery to movements in unit labor costs (ULCs) and their (alleged) impact on external competitiveness and on firms' ability to finance working capital and investment. It is suggested that this explains the downturn and the economic recovery that followed. Yet, my authorities believe that the report provides very little robust empirical evidence to support this thesis.

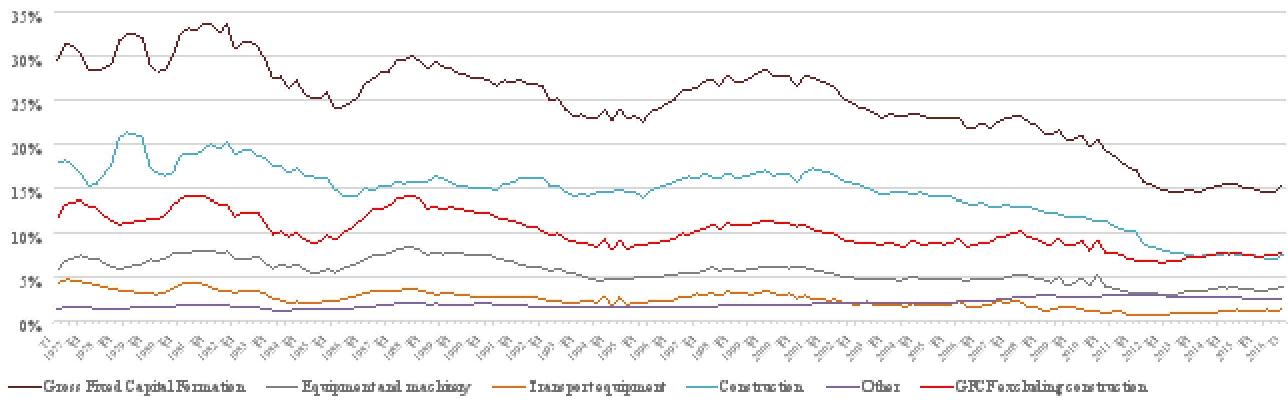
In contrast, the Portuguese government underscores that: (i) it is now well established in relevant academic literature, that ULCs are an overly simplistic and potentially misleading indicator of external competitiveness; and (ii) other, more suitable measures, including Real Effective Exchange Rates with suitable deflators are available and portray a very different picture of structural changes in the Portuguese economy and their effects on external competitiveness.

On the alleged "vicious circle between weak banks, high NPLs and low investment that continues to constrain medium-term growth", the Portuguese authorities note that, if one excludes the construction sector, whose decline predates the downturn, investment proved relatively resilient to the crisis, has improved considerably in recent quarters (e.g. 9.3 percent real growth in 2017Q2 compared to 2016Q2), and has been shifting to the tradable sector – a trend that started before the crisis and continues unabated.

While financial sector policies will be addressed in more detail in the following section, it should be stressed that there is evidence suggesting that its role in supporting investment has changed dramatically in the last few years – e.g. ECB's Survey on Access to Finance of Enterprises shows that the share of SMEs that identify access to finance as a problem decreased from 49 percent in 2012Q1 to 33 percent to 2016H2 (it is about 30 percent in the euro area); also, the stock of credit to export-oriented firms has been increasing since 2009 (the first year for which data is available).

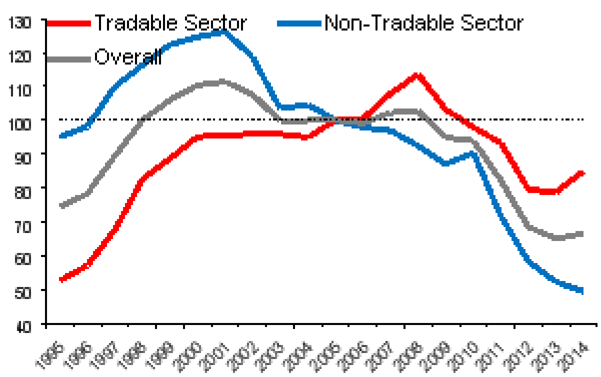
Economic Competitiveness and Investment Indicators

Figure 7: Gross Fixed Capital Formation (% GDP)



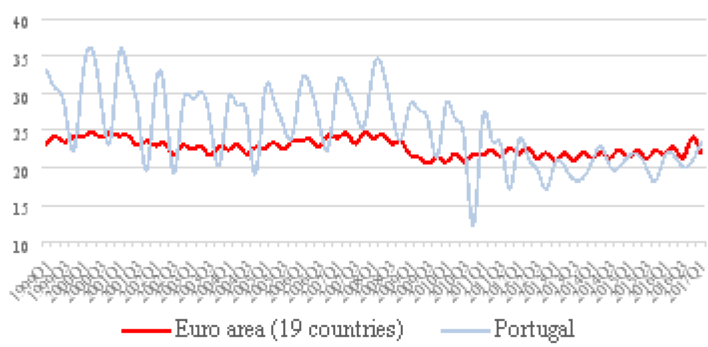
Source: Banco de Portugal

Figure 8: Gross Fixed Capital Formation
(tradable vs non-tradable, 2008=100; constant prices)



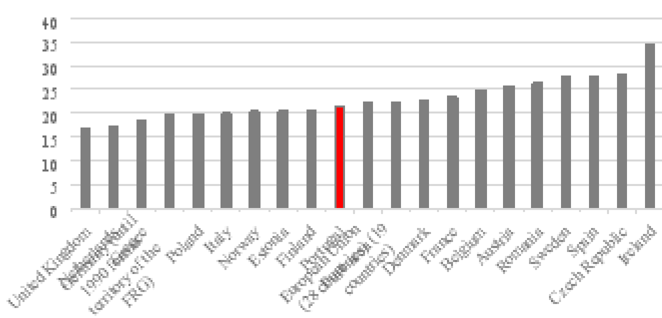
Source: Eurostat

Figure 9: Business Investment
(% GVA non-financial corporations)



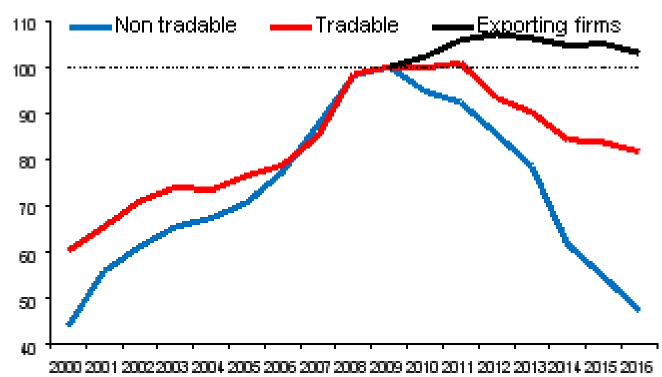
Source: Eurostat - business investment rate: gross investment (gross fixed capital formation) divided by gross value added of non-financial corporations.

Figure 10: Business Investment
(% GVA non-financial corporations, average 2016Q1-2017Q1)



Source: Eurostat - business investment rate: gross investment (gross fixed capital formation) divided by gross value added of non-financial corporations.

Figure 11: Stock of credit
(tradable, non-tradable, export-oriented firms, 2009=100)



Source: Banco de Portugal

Note: figures for export-oriented firms are only available from 2009.

IV. Financial Sector Policies

As already stressed, following a deep adjustment process, the Portuguese banking system is now better positioned to fulfil its core intermediation role in the economy, facilitating an efficient reallocation of resources, thereby contributing to the sustained recovery of the Portuguese economy. The recent operations reinforcing own funds and changes in the corporate governance in some significant banks are conducive to increased resilience in the sector. Liquidity and the ability to withstand shocks in market sentiment remain at comfortable levels, with a further decline in the loan-to-deposit ratio in 2016. Reliance on Eurosystem financing declined again in 2016 to levels much lower than the ones observed during the adjustment program.

Nonetheless, significant challenges remain. In fact, the still high level of NPLs weighs on profitability and the ensuing uncertainty concerning the quality of assets is detrimental to market financing. The persistently low interest rate environment remains a drag on profitability, while the increasing regulatory demands against the background of low profitability pose relevant constraints to banks' activity.

While banks are the key players, it is critical to involve all relevant stakeholders and pursue a comprehensive and coordinated strategy to promote the decrease of NPLs. This entails improving overall conditions through legal/judicial, tax and other relevant reforms, and prudential supervisory action. Currently, a platform to enhance coordination of NPLs management is being developed by a number of banks.

Profitability, after returning to positive levels in 2015, posted negative values in 2016. Against the background of relatively stable net interest income and declining fees and commissions, the considerable reduction in income from financial operations and, most notably, the upsurge in impairments were underlying the lower profitability. The significant rise in impairments was booked primarily in Caixa Geral de Depósitos, following the reassessment of asset values that occurred in the context of the bank's recapitalization. It should be highlighted that increased efforts to book impairments are paramount to decrease the high level of NPLs through write-offs and to narrow the gap between the book value of assets and the value investors are willing to pay for them, thus facilitating the disposal of NPLs. Cost cutting accelerated in 2016, with emphasis on staff costs. Despite that, the cost-to-income ratio remained stable, at around 60 percent, on account of a decline in operating profits.

Capital ratios declined in 2016, with CET 1 ratio edging down by 0.9 percentage points to 11.4 percent. This was associated with weak profitability (mainly stemming from the decrease in profits in Caixa Geral de Depósitos, due to the aforementioned rise in impairments) and the gradual elimination of transitional provisions for eligibility of own funds, as foreseen in CRD/CRR. The 2016 capital ratio decline was, however, temporary, as both Caixa Geral de Depósitos and Banco Comercial Português conducted capital increase operations in early 2017, rising the banking system's aggregate CET 1 ratio by 1.4 percentage points.

These capital increases, together with the developments concerning the sale of Novo Banco and the takeover of BPI by CaixaBank, represent a significant improvement in the banking system, enhancing the ability to deal with the NPLs and favoring market perception. The NPL ratio has been steadily declining from 17.5 percent at end-2015 to 17.2 percent at end-2016 and at 16.7 percent and end-march 2017. This decline has been mainly driven by write-offs and, to a lesser extent, by outright sales, more than compensating the denominator effect associated with the on-going deleveraging process. Furthermore, the banking system's impairment coverage ratio also increased, from 41 percent in 2015 to 45 percent at end-march 2017.

In 2016, economic conditions improved in most non-financial sectors, particularly wholesale and retail trade, implying a strengthened ability to serve debt. In parallel, and against the background of lower exposures of the financial sector to non-financial corporations, the process of reshuffling banks' portfolio towards sectors with better economic and financial indicators persisted. In fact, the share of loans to the construction and real estate sectors declined, while the share of wholesale and retail trade and manufacturing increased. In addition, loans to exporting companies, which post economic and financial indicators better than average, also increased their share in banks' loan books. Moreover, the decline in households' overall indebtedness continued in 2016, although with mortgages and loans for consumption and other purposes following different trends: while the former continued the downward path initiated in 2011, the latter posted a positive growth rate. As Portuguese macro-prudential authority, Banco de Portugal is closely following the recent acceleration in consumer credit and the assessment of the risk of new credit flows.

V. Conclusion

The Portuguese Government will maintain its strong commitment towards sustainable economic growth, social cohesion and sound public finances. At the same time, structural reforms will continue to be implemented, based on the lessons learned from previous efforts, with fine-tuning as needed, and with the launching of new initiatives in order to maintain the economy on a competitive and balanced growth path.

The Portuguese authorities look forward to the next Article IV Consultation in 2018, which will constitute a good opportunity to closely working with the IMF, deepening our dialogue and promoting a closer mutual understanding.