INTERNATIONAL MONETARY FUND

IMF Country Report No. 18/273

PORTUGAL

September 2018

2018 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 2018 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 7, 2018 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 7, 2018, following discussions that ended on May 29, 2018, 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 21, 2018.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Portugal.

The documents 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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September 12, 2018

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IMF Executive Board Concludes 2018 Article IV Consultation with Portugal

On September 7, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Portugal.

Following robust growth in 2017, driven by investment and exports, activity is expected to moderate in 2018. Nevertheless, unemployment continues to fall on the back of sustained employment growth; and the output gap is estimated to turn positive this year. While rising energy prices have pushed up consumer prices, core inflation remains subdued. Strong import growth (linked to investment) has largely been offset by robust exports, particularly tourism, leaving the current account largely unchanged in 2017.

While the headline fiscal deficit deteriorated in 2017 owing to one-off' bank recapitalization costs, the primary structural balance is estimated to have improved by 0.4 percent of GDP reflecting strict budget execution. The headline deficit will continue to fall in 2018, although part of the structural improvement will be reversed. On constant policies, the ratio of public debt to GDP should steadily decline in the coming years. Sovereign funding costs have declined significantly since early 2017, but saw volatility in May and June owing to spillovers from political uncertainty in Italy.

Credit growth continues to lag the recovery in economic activity, as banks repair their balance sheets. However, rising capital ratios, falling rates of non-performing loans and lower impairments meant that the resilience of banks improved significantly in 2017. Further improvement is expected in 2018. Nevertheless, no significant acceleration in credit growth is expected, and the economy should continue deleveraging its external balance sheet.

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[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.

Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. They welcomed Portugal's strong economic performance, driven by investment and exports. This job-rich recovery has led to falling unemployment and broad-based employment creation. Directors noted that while, in the short term, growth prospects remain positive, external risks from a slowdown in trading partners' growth and financial-market spillovers have increased. They encouraged the authorities to sustain the policy and reform momentum to ensure resilience to shocks, reduce vulnerabilities, and facilitate convergence towards the average income level of the European Union.

Directors noted that the current favorable economic conditions provide an opportunity to frontload planned fiscal consolidation. This will not only avoid pro-cyclical adjustment but will also help build policy space to deal with contingent spending needs. They emphasized that to achieve lasting consolidation, policies should focus on restraining current expenditure, including via reforms to public employment and pensions. Efforts should also be made in improving budget monitoring and control, especially in the health-care sector. Directors welcomed the authorities' commitment to reducing public debt and bringing it back to more sustainable levels.

Directors welcomed that banking sector resilience has further improved, with higher capital and increased profitability. They noted that while progress has been made in reducing the stock of non-performing loans (NPLs), further steps are needed to strengthen the banking sector, including a concerted effort to bring down the level of NPLs. To prevent the emergence of new vulnerabilities, Directors encouraged the authorities to continue to focus on preserving credit standards, monitoring mortgage markets, and employing macro-prudential measures where necessary.

Directors emphasized the need to boost potential growth to both reduce balance sheet risks and converge to average EU levels of productivity and income. While acknowledging that the trend of improving educational attainment has the potential to offset the impact on growth of an ageing population, they recommended further structural reforms to foster investment and allow high-skilled workers to meet their potential. In this context, Directors highlighted additional gains that could be obtained by removing unnecessary regulatory barriers, lowering energy prices, better coupling wages to productivity, and further improving the debt enforcement and insolvency regime.

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[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.

Directors also noted the need to avoid the reemergence of external imbalances as a byproduct of increased investment. They encouraged policies to boost private saving and increase the incentive to finance projects through non-debt-creating flows.

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

Portugal: Selected Economic Indicators

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

		Projections	
	2017	2018	2019
Real GDP	2.7	2.3	1.8
Private consumption	2.3	1.9	1.6
Public consumption	-0.2	1.9	1.0
Gross fixed capital formation	9.2	7.6	6.3
Exports	7.9	6.2	4.7
Imports	7.9	6.8	5.5
Contribution to growth (Percentage points)			
Total domestic demand	2.9	2.9	2.4
Foreign balance	-0.2	-0.4	-0.5
Resource utilization			
Employment	3.3	1.9	1.2
Unemployment rate (Percent)	8.9	7.3	6.7
Prices			
GDP deflator	1.4	1.6	1.6
Consumer prices (Harmonized index)	1.6	1.7	1.6
Money and credit (End of period, percent change)			
Bank credit to non-financial private sector	-3.1	0.1	0.8
Broad money	7.5	3.4	2.9
Fiscal indicators (Percent of GDP)			
General government balance	-3.0	-0.7	-0.3
Primary government balance	0.9	2.8	3.1
Structural primary balance (Percent of potential GDP)	3.4	3.0	2.9
General government debt	125.7	120.8	117.2
Current account balance (Percent of GDP)	0.5	0.2	-0.1
Nominal GDP (Billions of euros)	193.1	200.6	207.5

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

INTERNATIONAL MONETARY FUND

PORTUGAL

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

August 21, 2018

EXECUTIVE SUMMARY

The Portuguese economy performed strongly in 2017. Investment and exports were the key drivers of growth. Labor market conditions continued to improve, with falling unemployment and broad-based employment creation. The underlying fiscal balance posted a strong improvement, which can be attributed to buoyant economic growth, controlled budget execution, and falling interest costs, and has contributed to more favorable financing terms throughout the economy. Stability and confidence in the banking system strengthened following successful efforts by banks to raise capital and reduce NPLs, and the sale of Novo Banco in 2017.

Prospects remain positive, but downside risks have increased lately. Growth is expected to ease in 2018 from its recent cyclical peak and gradually moderate over the medium term. The overall fiscal deficit is likely to fall in 2018, helping reduce public debt ratios. However, renewed market instability related to policy uncertainty in key euro area countries, or additional tightening of global financial conditions, could increase Portuguese bond yields, raise borrowing costs, and negatively affect firms, households, and banks. A significant weakening of growth in the euro area or a turn in the global economy toward protectionism could impact Portugal because of its linkages to other European countries. Policies need to remain strong in the face of heightened external risks, and of pressures to erode past reforms.

Strong macroeconomic policies have worked and should be sustained. Frontloading the fiscal consolidation envisaged in the Stability Program 2018–2022 would avoid procyclicality by taking advantage of current favorable cyclical conditions to adjust. It would also be prudent given future uncertainties. Similarly, addressing lingering vulnerabilities will also require perseverance in implementing the NPL-resolution strategy. To avoid future build-up of NPLs and the erosion of capital buffers, supervisors should continue to press banks to strengthen their risk management and corporate governance.

Faster sustainable growth is needed to continue to reduce vulnerabilities and converge towards the average levels of productivity and income of the EU. Strengthening growth will require fostering soundly financed investment and continuing improvements in productivity and skills. Investment can be spurred by enhancing business conditions, streamlining regulations, and increasing the flexibility and responsiveness of institutions and markets, building on past reforms.

Approved by	
Mahmood Pradhan (EUR) and Seán Nolan (SPR)	Discussions took place in Porto and Lisbon during May 16–29. The staff team comprised A. Cuevas (head), K. Kirabaeva, A. Pienkowski, A. Santos (all EUR); E. Lundback (SPR); W. Bergthaler (LEG); V. Crispolti (FAD); and M. Koulet-Vickot (MCM). A. Leipold and I. Lopes (OED) participated in the key meetings. Y. Cai, R. Dumo, and V. Bezerra de Menezes (all EUR) supported the mission from headquarters.

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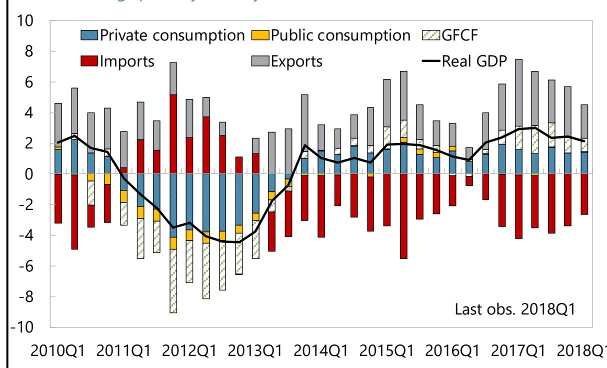
ANNEXES

RECENT DEVELOPMENTS

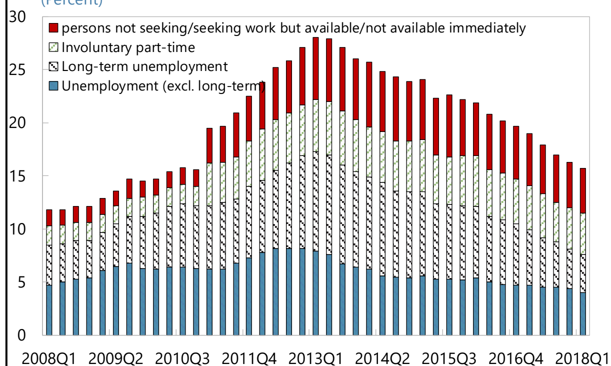
1. After growing strongly in 2017, the economy slowed somewhat in 2018:Q1. Real GDP growth reached 2.7 percent in 2017 reflecting re-energized investment, robust exports, and stable consumption. In addition to construction, investment in equipment and machinery grew vigorously in 2017 and 2018:Q1; tourism growth remained strong, but is beginning to face capacity constraints (for example, in Lisbon Airport). In 2018:Q1 growth decelerated to 2.1 y-o-y (0.4 percent q-o-q), owing to weaker exports reflecting slower activity in Europe and some temporary factors.[1] Unemployment fell from 10.1 percent in December 2016 to 7. 1 percent in April 2018, even as labor force participation was rising, thanks to broad-based employment growth. The output gap is estimated to have narrowed in 2017 and to turn positive this year.

Contribution to Real GDP Growth
(Percentage points, year-on-year)



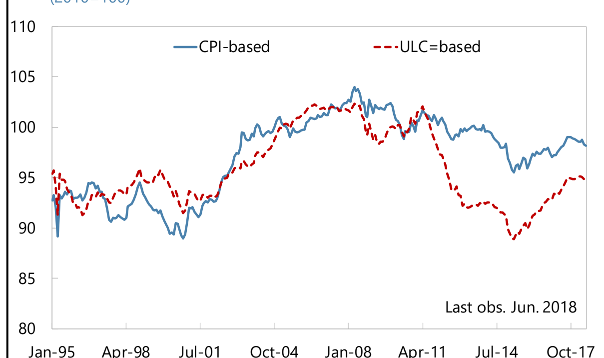
Source: Haver Analytics.

Labor Underutilization
(Percent)



Sources: Eurostat; and IMF staff calculations.

Real Effective Exchange Rate
(2010=100)

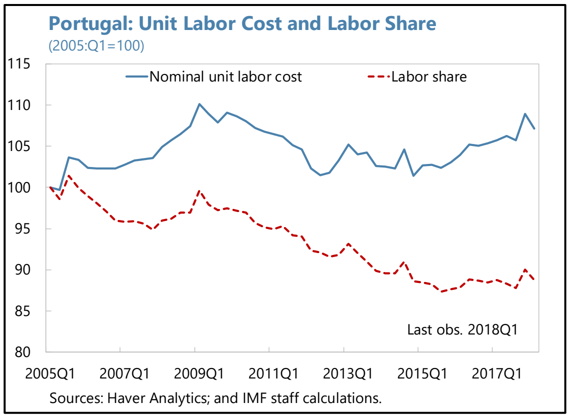


Sources: International Financial Statistics.

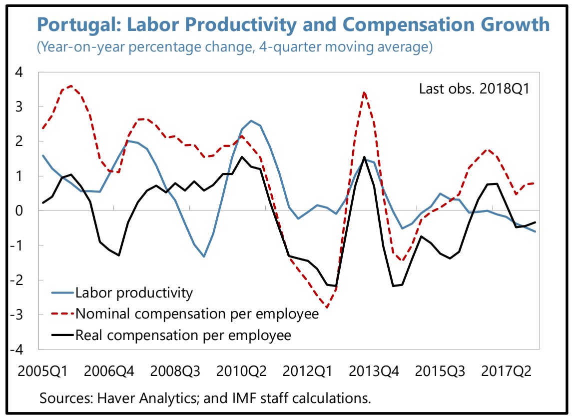
2. Consumer prices have been rising, though price competitiveness has stabilized recently. Headline inflation rose to 2 percent y-o-y in June 2018 driven in part by increases in energy prices, while core inflation was 1.5 percent. Unit labor costs (ULCs) continued to increase, both in nominal and real terms, reflecting wage growth outpacing gains in labor productivity (compensation per worker grew on average, while labor productivity declined in the past two years).[2] Price competiveness, as measured both by the CPI- and ULC-based real effective exchange rate (REER), had been deteriorating since mid-2015, although it appears to have stabilized in the last year. Imports of goods have increased strongly, resulting in a reduction of more than one-percentage point of GDP in the goods trade balance in 2017. Growth in exports of services has, however, been strong too since late 2016, led by booming tourism. As a result, the decline in the goods and services balance is a much smaller 0.3 percentage points. The current account balance was essentially unchanged in 2017.

[1] AutoEuropa and Galp had unscheduled production stoppages, and an unusually rainy March affected construction.

[2] These trends appear to be broad based, being visible both in goods and services sectors.

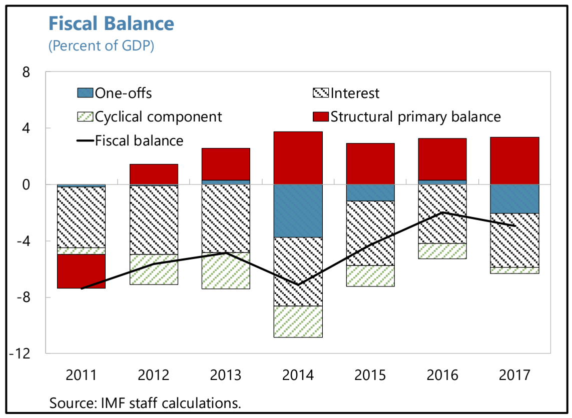


Portugal: Unit Labor Cost and Labor Share
(2005:Q1=100)
Sources: Haver Analytics; and IMF staff calculations.



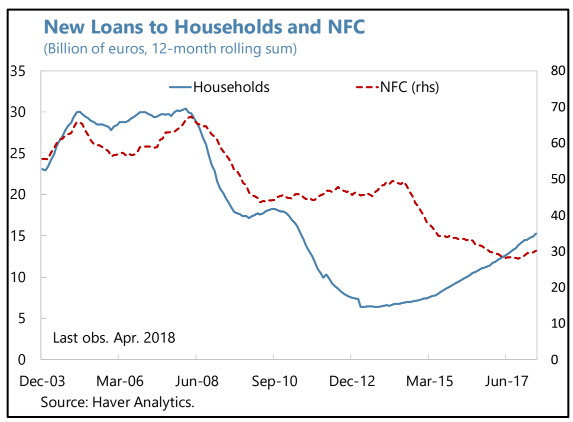
Portugal: Labor Productivity and Compensation Growth
(Year-on-year percentage change, 4-quarter moving average)
Sources: Haver Analytics; and IMF staff calculations.

3. The underlying fiscal balance improved in 2017. The fiscal performance in 2017 was robust, reflecting strong economic growth, prudent budget execution, and falling interest costs. Nevertheless, the headline fiscal deficit widened to 3.0 percent of GDP owing to one-off payments (2.0 percent of GDP), mainly associated with bank recapitalization costs. In primary structural terms, the fiscal stance tightened by 0.4 percent of GDP.



Fiscal Balance
(Percent of GDP)
Source: IMF staff calculations.

4. The sovereign's improved access to market financing has contributed to more favorable borrowing terms throughout the economy. 10-year sovereign spreads in late July were around 130 basis points vis-à-vis the German bund, having exceeded 300 bps in early 2017. S&P and FITCH both upgraded Portugal to investment grade in 2017. ECB purchases have also supported the bond markets (and thus aggregate demand), but their importance has waned.[3] Rates on new corporate and household loans are at multi-year lows. However, the sovereign spread experienced increased volatility in May and June owing to spillovers from political uncertainty in Italy.



New Loans to Households and NFC
(Billion of euros, 12-month rolling sum)
Source: Haver Analytics.

5. Credit continues to lag the recovery, although new lending is increasing. The contraction in bank credit has essentially halted, with rising new loans, especially to households,

[3] As noted in the Sixth Post-Program Monitoring Report, despite a halving of average monthly purchases of Portuguese bonds under the ECB's Public Sector Purchase Program in 2017, spreads over 10-year German bunds narrowed by about 200 bps through the year. The gradual phase-out of the Asset Purchase Program so far in 2018 does not seem to have affected spreads.

driven by both demand (responding to lower interest rates and improved confidence) and supply (improved bank capitalization) factors. In the nonfinancial corporate (NFC) sector, new loans to firms in dynamic tradable sectors with better risk profiles have accelerated.

6. **Banks' balance sheets strengthened in 2017 with capital augmentations and improved macroeconomic conditions.** The average CET1 ratio rose 2.5 percentage points since end-2016 to 13.9 percent at end-2017. During the same period, non-performing loans (NPLs) fell by EUR 9.4 billion from EUR 46.4 billion at end-2016, largely driven by write-offs and sales of business loans, and debt recovery (cures) for household loans, bringing the NPL ratio to 13.3 percent of gross loans from 17.2 percent. Most banks posted profits.[4] Meanwhile, the impairment coverage ratio increased to 49.4 percent in end-2017 from 45.3 percent at end-2016. The liquidity coverage ratio reached 173.4 percent at end-2017 (a minimum of 100 percent is required since January 2018).[5]

Authorities' Views

7. **The authorities noted in their Stability Program 2018–2022 that output growth has been generally strong, and that the deceleration in 2018:Q1 was temporary.** Growth has been accompanied by strong employment creation, boosting social security contributions and reducing unemployment claims. The deceleration registered in the first quarter was in their view largely due to temporary factors, and did not warrant a revision of growth forecasts for the year. Data for April and May 2018, they stressed, already indicated an acceleration of exports.

OUTLOOK AND RISKS

8. **Growth is expected to ease in 2018 from its recent cyclical peak and gradually moderate over the medium term.** Real GDP growth is projected to decelerate to 2.3 percent in 2018, 1.8 percent in 2019, and to moderate over the medium term under a baseline with no new significant reforms. Investment and exports should remain important drivers of growth, albeit at a slower pace, while private consumption eases somewhat. Employment growth is expected to decelerate, and the labor market should continue tightening in 2018, with average unemployment declining below 7.5 percent, supporting moderate real wage growth. Staff is projecting consumer inflation of 1.7 percent for 2018 and 2.1 percent over the medium term. In 2018 the external current account balance is expected to deteriorate somewhat owing to strong import demand.

9. **The fiscal deficit should fall in 2018, helping reduce public debt ratios, although the trajectory of public debt remains subject to significant risks.** Staff is projecting a headline fiscal deficit of 0.7 percent of GDP in 2018, and public debt of 121 percent of GDP at end-2018, down

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[4] In 2017, Novo Banco recorded a loss of nearly €1.4 billion, driven by impairments of €2 billion, most of which are related to the assets covered by the contingent capital agreement (see Box A2).

[5] Some contingent risks receded recently, as the authorities prevailed in litigation in the U.K involving a claim of about $835 million against Novo Banco pursuant to a facility agreement with Banco Espirito Santo under English law. The UK Supreme Court confirmed that the English courts had no jurisdiction as the legal dispute in connection with a bank reorganization action by Banco de Portugal is to be decided by the Portuguese courts.

from 126 percent in 2017. It should decline further to 103 percent by 2023 assuming a largely unchanged structural primary balance after 2018 and no major one-off expenditures. The trajectory of Portugal's public debt remains subject to risks which could delay debt reduction (Annex I).

10. Risks to the outlook, especially external, appear to be tilting downward (Annex II). Portugal would be negatively affected by a significant weakening of growth in the euro zone. Renewed market instability related to policy uncertainty in key euro area countries could increase Portuguese bond yields and raise borrowing costs for most agents. Similarly, additional tightening of global financial conditions would affect highly leveraged firms and households as short-term and variable-rate loans are repriced, and could weaken banks' balance sheets through higher NPLs and a reduction in the value of government bonds. A turn in the global economy toward protectionism would impact Portugal because of its increasingly strong linkages to European export-oriented value chains. Additional increases in real labor costs might hurt corporate sector profits (see Selected Issues paper) and competitiveness. As the expansion continues, there is a risk that excess confidence will build among policy makers and other stakeholders, leading to policy slippages or the erosion of past reforms. On the upside, exports could continue to surprise, including tourism if bottlenecks can be eased soon, and reforms might yet provide additional strength to the economy.

Authorities' Views

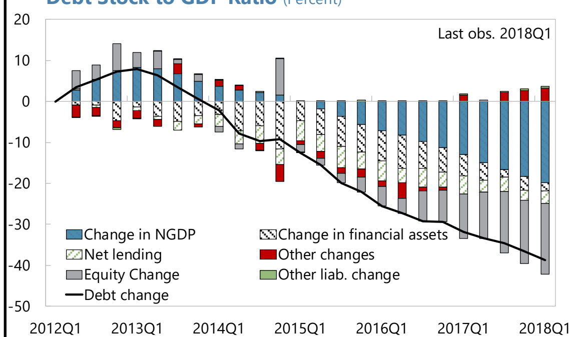
11. The authorities in their Stability Program 2018–2022 saw the economy maintaining growth above two percent in coming years, and pointed to downside developments in the EU as the main source of risk, while emphasizing their commitment to further reduce domestic vulnerabilities. They agreed that a slowdown in the EU would be a significant challenge, as would renewed uncertainty in European markets, but Portugal's ability to manage shocks has improved. They stressed that spreads are lower owing to strong policies, government cash buffers amount to at least 40 percent of prospective 12- month needs, and the public debt ratio, while still high, is on a declining trend. Similarly, they argued that the level of NPLs is high, but has been on a consistently declining trend, and continued policies to strengthen balance sheets would further mitigate risks. They also explained that recent non-price competitiveness gains, reflected in rising export market shares, make Portugal less vulnerable to fluctuations in price competitiveness. A global economic slowdown and tighter global financial conditions, especially in Europe, could affect Portugal, for example through their impact on foreign demand for Portuguese exports. Nevertheless, the authorities see market conditions remaining supportive through the ongoing monetary policy normalization, given muted wage and inflation pressures in the euro area. They also reiterated that Portuguese policies would continue to be strong and robust to risks, and that past reforms were not at stake.

POLICY DISCUSSIONS

A. Macro-Financial Issues and Policies

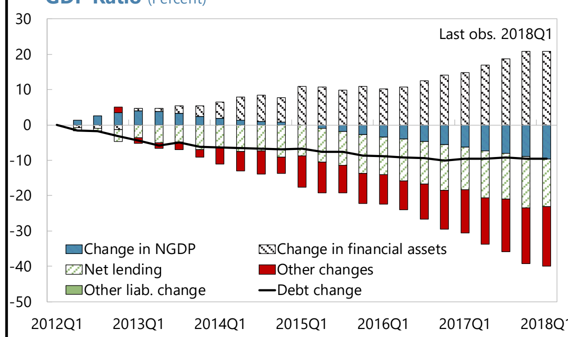
12. The pace of deleveraging is slowing amid benign financial conditions. In 2017, the net flow of loans to households turned positive for the first time since 2011, driven by consumer loans and mortgages. In the case of NFCs, the positive net flow of financial debt was due to intra-group lending by non-residents, while NFCs continued to reduce their borrowing from the domestic banking system. Household saving rates were low at 5.4 percent of disposable income in 2017. These developments translated into a slowdown in the deleveraging process. Private indebtedness, however, remains high: at end-2017, total household and NFC debts were 73.4 and 139.1 percent of GDP, respectively,[6] while the euro area medians of the household and NFC debt-to-GDP ratios were 56.2 and 124.9 percent. High leverage makes Portuguese households and firms vulnerable to negative shocks to income and spikes in interest rates. This is compounded, in the case of households, by the preponderance of floating rate loans, and long maturities for mortgages (33 years on average), which extend into the retirement years.

Non-financial Corporates: Cumulative Change in the Debt Stock to GDP Ratio (Percent)



Sources: ECB; and IMF staff calculations.

Households: Cumulative Change in the Debt Stock to GDP Ratio (Percent)



Sources: ECB; and IMF staff calculations.

13. The Banco de Portugal deployed macroprudential measures to prevent the financial sector from taking excessive risk in a context of low interest rates and heightened competition. Against the background of gradually rising loan maturities, loan-to-value (LTV) and loan-to-income ratios in mortgage and consumer credit, the measures aim at preventing overexposures to residential mortgage and consumer loans by financial institutions and minimizing the risk of default by households. The measures (Box 1) include limits on maturities and LTV and debt-service-to-income (DSTI) ratios, and their design considers the risk that debt service burdens may rise as interest rates normalize. Early in July, banks started to implement the limits under this measure. Staff welcomes the activation of these macroprudential tools at this juncture, when credit standards were starting to ease. The introduction of tighter LTV, DSTI, and loan maturities will contain such easing, bolstering the resilience of financial institutions and households to variations in real estate prices, interest rates, and incomes. While supporting the measured approach taken, staff calls on the authorities to closely monitor the effectiveness of these measures and to supplement them if warranted.

14. Although declining, the stock of NPLs remains a concern. At end-2017, the stock of NPLs stood at EUR 37 billion (13.3 percent of total loans), with about half of the NPLs covered by provisions. The majority of NPLs correspond to loans to NFCs (SMEs), with the bulk concentrated in three banks. The elevated stock of NPLs is tying up resources in the economy, and holding back

[6] Non-consolidated data for the NFCs.

bank profitability. The authorities have been pursuing an NPL resolution strategy based on three pillars: (i) supervisory actions (under the SSM), which includes requesting regular updates of banks' NPL reduction strategies, setting targets for NPL reduction, and monitoring and enforcing implementation; (ii) legal, judicial and fiscal reforms to remove impediments to NPL resolution; and (iii) measures to improve management of NPLs and develop secondary markets for troubled loans. Staff welcomes the progress made so far in the implementation of the NPL resolution strategy, reflected in the significant reduction of the NPL stock, and encourages the authorities to maintain this momentum, and to press banks to strengthen their risk management and corporate governance.

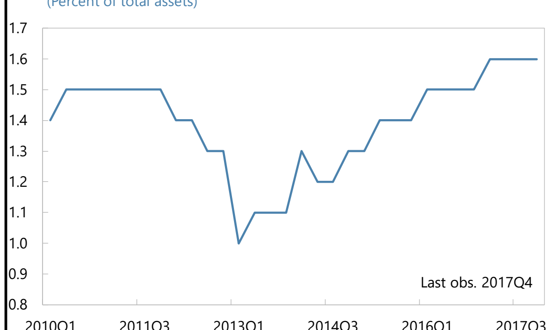
Box 1. Macroprudential Measures on New Mortgage and Consumer Loans

The Banco de Portugal announced in February 2018 macroprudential measures focused on new mortgage and consumer loans, which went into effect on July 1, 2018, under the principle of 'comply or explain'. The main provisions are:

- LTV ratio for new mortgages for primary residence cannot exceed 90 percent (80 percent for purposes other than primary residence).
- The DSTI ratio should not exceed 50 percent, with some limited exceptions. In the case of variable or mixed rate loans, banks are required to calculate DSTI ratios assuming interest rate increases of 100 basis points for loans with maturity below five years, 200 basis points for maturities between five and 10 years, and 300 basis points for maturities over 10 years. For these calculations, income is net of taxes and social security contributions.
- The maturity of mortgage and related loans is capped at 40 years, and the average maturity of new credit agreements should gradually converge to 30 years by 2022. For consumer credit agreements, the maturity of new loans should not exceed 10 years.
- New loans should be granted with regular payments of interest and capital.

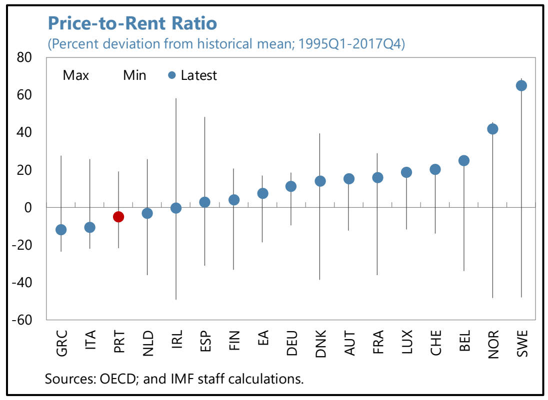
15. Despite the improved economic outlook, generating strong and sustained bank profitability will be challenging. Net interest income, the main source of Portuguese banks' profits, remains moderate, and may come under renewed pressure as deposit rates bottom out, funding costs increase due to MREL issuances, and competition from Fintech and nonbank financial institutions intensifies. High nonperforming assets are still a drag on profitability, and the updating of business models can involve upfront costs, as when closing brick-and-mortar branches.

Net Interest Income
(Percent of total assets)



Sources: Haver Analytics.

16. Housing prices continue to increase, but there is no significant overvaluation yet. Following a decline of 18 percent in real terms over 2010–13, housing prices have since increased by about 20 percent in real terms (7.9 percent in 2017), especially in Lisbon, Porto and the Algarve region.[7] While the increases have been driven largely by transactions on existing dwellings by non-residents, the share of housing transactions financed by Portuguese mortgages has been growing since 2015 (reaching 41 percent in the last quarter of 2017). Estimates in the ECB's May 2018 *Financial Stability Review* suggest that there are incipient signs of overvaluation in the residential real estate market. The authorities should continue to improve the quality of real estate data and related analytical tools, and to monitor mortgage markets and the evolution of risks to banks from developments in real estate markets.



Authorities' Views

17. While acknowledging remaining challenges in the financial sector, the European and Portuguese authorities pointed to progress achieved so far and reforms underway to address them:

- **Deleveraging in the non-financial private sector.** The Portuguese authorities noted that the nonfinancial private sector's debt-to-GDP had fallen by 47 percentage points since 2012, but recognized that continuing the deleveraging process is key to making the economy more resilient to future shocks. They observed that the positive net flow of loans to households in 2017 was driven by consumer loans, with newcomers to the credit market accounting for the largest contribution. The non-resident sector was the main contributor to the positive net flow of total credit (loans plus securities) to corporations with access to international securities markets. This financing was partially channeled to their domestic affiliates via intra-group loans.

- **Addressing NPLs.** The European and Portuguese authorities highlighted the NPL reduction over the last two years as an indication that all stakeholders, including at the EU level, are determined to address this issue. They pointed to several measures that have been recently finalized or are underway. At the EU level, the implementation of the *Action Plan to Tackle Non-Performing Loans in Europe* is underway.[8] At the national level, the measures include: (i) the continuous

[7] For example, in 2017:Q4, the median value of residential real estate transactions per square meter increased by 18 percent y-o-y in Lisbon and Porto, compared to a national median value increase of eight percent.

[8] This Action Plan includes, *inter alia*, the following initiatives: guidelines on management of nonperforming exposures and forborne exposures (building up on existing SSM guidelines); a blueprint for asset management companies; measures to strengthen NPL data infrastructure; measures to develop secondary markets for NPLs and enhance the protection of secured creditors; guidelines for the monitoring of loan tapes; measures to enhance disclosure requirements on asset quality; and measures to address potential under-provision of newly originated loans.

improvement of the legal, judicial and tax framework, including the recent establishment of a common decision body between the tax authority and the social security administration to participate in restructuring negotiations; (ii) the enhancement of in-court restructuring and insolvency frameworks (including through digitalization of processes); (iii) the introduction of several measures to speed up out-of-court settlement procedures; and (iv) ongoing actions to put in place an early warning mechanism and the development of a simplified regime to facilitate the transfer of NPL portfolios. In addition, at the bank level, they noted the strong execution of the NPL reduction plans submitted by banks to the supervisor and the operationalization of the platform for integrated management of NPL cross-exposures. The authorities also indicated that strong economic growth would contribute to the reduction of NPLs.

- **Ensuring strong and sustained bank profitability.** Acknowledging the challenges ahead, the European and Portuguese authorities indicated that banks' determined implementation of their strategies to cut costs and diversify income sources, alongside the improved economic outlook, would help ease pressure on profitability from low interest rates and increased competition. They highlighted progress achieved over the last years in improving the cost-efficiency of the Portuguese banking system as evidence of such resolve.

- **Mispricing of risk and excessive-risk taking.** While noting that there are no signs of a systematic mispricing of risk and excessive risk-taking by banks at this juncture, the Portuguese authorities pointed to the macroprudential measures taken in February 2018 on new mortgage and consumer loans as an indication of their determination to prevent them from happening.

B. External Balance and Policies

18. Portugal's external position remained weaker than consistent with medium-term fundamentals and desirable policy settings in 2017 (Annex III). There has been a strong improvement in the current account since the crisis, reflecting in large part rising goods exports and tourism. Nevertheless, the Net International Investment Position (NIIP) is still in deeply negative territory, and substantially improving the position would require sustained current account surpluses over the medium term. EBA model-based estimates suggest there was no current account gap in 2017. However, staff projects the current account balance to turn into a moderate deficit over the next several years as domestic demand increases and the growth in tourism subsides. Staff thus see a current account shortfall of about 2–4 percent of GDP in the medium term. This is also consistent with EBA results on the REER suggesting an overvaluation of about 5–10 percent. Continued and sustained quality upgrades and innovation, supported by appropriate structural, fiscal, and financial policies, would contribute to stronger external balances, as would the maintenance or improvement in price competitiveness.

Authorities' Views

19. The authorities agreed that a stronger NIIP would be desirable and would require sustained current account surpluses. Accordingly, they anticipate the current account to remain in surplus, fostering a steady and significant improvement in the country's external position over the medium-term. They pointed to non-cost competitiveness gains as the driving factor behind the strong export growth and the rise in market shares in recent years. They expect Portugal's external position to continue strengthening based on increased innovation, continued movement up the quality ladder, a well-educated labor force, and other factors improving non-cost competitiveness.

C. Fiscal Issues and Policies

20. The authorities have adopted a more ambitious 2018 fiscal deficit target than was contained in the state budget. Controlling for the capitalization of CGD, the budget closed 2017 with an overall deficit (0.9 percent of GDP) that was already lower than the original 2018 budget deficit target approved in late 2017 (1.1 percent of GDP). Accordingly, a more ambitious 2018 target of -0.7 percent of GDP was included in the Stability Program 2018–2022 launched in April 2018. Staff expect that the authorities will meet this target, with the improvement relative to 2017 driven by smaller expected one-offs[9], the favorable effect of the cycle, and a declining interest bill. Staff projects the public debt to GDP ratio to decline to 103 percent of GDP by 2023 on the assumption of unchanged policies.[10]

Fiscal Balance

(Percent of GDP)

	2016	2017	Staff Forecast 2018	Staff Forecast 2019
Overall balance	-2.0	-3.0	-0.7	-0.3
One-offs	0.3	-2.0	-0.3	0.0
Adj. overall balance	-2.3	-0.9	-0.4	-0.3
Cyclical component	-1.1	-0.4	0.0	0.2
Ouput gap	-2.5	-0.9	0.1	0.5
Structural balance	-1.1	-0.5	-0.5	-0.5
effort in 2018		0.6	0.0	-0.1
Interest	4.2	3.9	3.5	3.4
S. primary balance	3.0	3.4	3.0	2.9
effort in 2018		0.4	-0.3	-0.2

Source: Staff calculations.

21. When temporary factors are removed, however, the structural primary balance would deteriorate by about 0.3 percent of GDP in 2018. Spending pressure will be acute for wages, where the authorities have committed to the unfreezing of career progression (estimated net cost of EUR 200 million in 2018, or 0.1 percent of GDP, but subject to upward risk) and to continue with the gradual transition to a 35-hour week in the public sector. Meanwhile, public investment, although rising, remains low by cross-country and historical standards.

22. The authorities should take advantage of the favorable economic environment and front-load their announced fiscal consolidation plans. The Stability Program envisages a significant 1.5 percent of GDP adjustment in the primary balance (minus one-offs) over the period 2018–22. However, with the structural primary balance loosening by a cumulative 0.5 percent of GDP in 2018–19, almost all the proposed adjustment would occur in 2020 and 2021, when staff expects that growth will be weaker. To avoid such a pro-cyclical fiscal stance, adjustment should be front loaded. Specifically, the authorities could consider a one percent of GDP tightening of the structural

[9] The Resolution Fund is expected to make a payment worth 0.4 percent of GDP to Novo Banco in compensation for some qualifying losses in 2017, as part of a contingent capital scheme (see Box A2 in the DSA), which is expected to be partially offset by other 'one-offs'.

[10] The authorities envisage a somewhat faster reduction in public indebtedness, as they project stronger GDP growth in the forecast period.

primary balance cumulatively over 2018–2019, including aiming for over-performing on their official overall balance target for 2018.

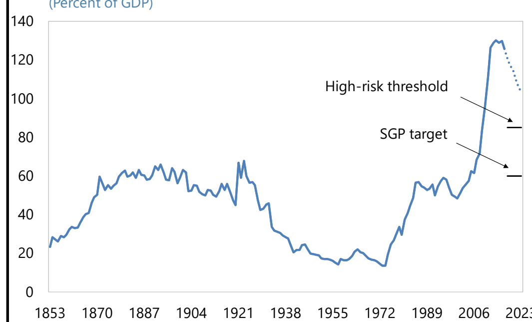
23. Frontloading would provide valuable policy space now and in the future. Rising uncertainty, including over external conditions, provides a further motive to adjust now when conditions are favorable, building policy space to deal with potential shocks. Near term, front-loading could allow contingent liabilities, such as Novo Banco support (Box A2), to be accommodated without disturbing the firm downward trajectory of debt. More fundamentally, a faster pace of consolidation now would shorten the time required to reduce public indebtedness to levels which are both safer and closer to regional averages. Portugal's debt to GDP ratio is 40 percentage points above the euro area average of 86.7 percent of GDP in 2017[11] (roughly the same as the 85 percent threshold viewed as high-risk by the IMF—see Annex I). Such high indebtedness limits the space Portugal would have to handle significant economic shocks. Depending on growth and interest rate assumptions, the proposed strengthening in the structural primary balance, starting now and sustained over time, could shorten the time required to reach the 85 percent of GDP mark by three or more years.

Years to reach public debt of 85 percent of GDP

Additional adjustment in 2018, percent of GDP	long-run (r-g)		
	0.4	-0.2*	-2.0
0*	16	12	9
0.5	13	10	8
1	12	9	7
1.5	10	8	7

* baseline assumption

Public Debt
(Percent of GDP)



Sources: IMF and staff calculations.

24. Continued structural fiscal consolidation should be based on durable expenditure reform. To preserve public capital, the consolidation should concentrate on the current balance. The ongoing expenditure review is a valuable tool, but it should be complemented with structural reforms to public employment and pensions to achieve lasting consolidation.

- The move to a 35-hour week that started in 2016, the difficulties in meeting small employment reduction goals in the past two years, and the ongoing unfreezing of career progressions (the extent of which is still under debate) suggest the need for a well-designed reform of the civil service, aimed at improving the level and composition of public employment. Previous staff analysis suggested that demographic trends should guide public employment reform, as they influence the demand for public services.[12] (For example, the pupil-teacher ratio in primary schools is below those of most European peers, and has declined in recent years, indicating room for consolidation.)

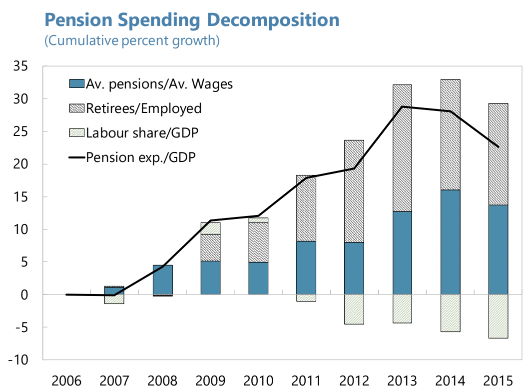
[11] IMF Country Report 18/223. The figure is a weighted average.

[12] IMF Country Report 17/279 (Portugal: Selected Issues).

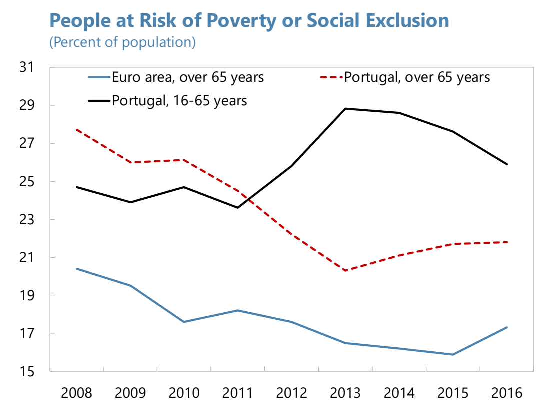
- On the pension system, measures are under consideration to reduce penalties for early retirement of employees with more than 40 years of contributions. While justifiable, they would risk increasing cash-flow needs in the social security system in the near term, albeit moderately, if qualifying individuals were to retire early, and should be accompanied with measures generating savings. In the medium-term, it is recommended that the 'grandfathering' of existing pensioners from the recent reforms be revisited, focusing on the highest pensions.

Figure 1. Portugal: Pension Indicators

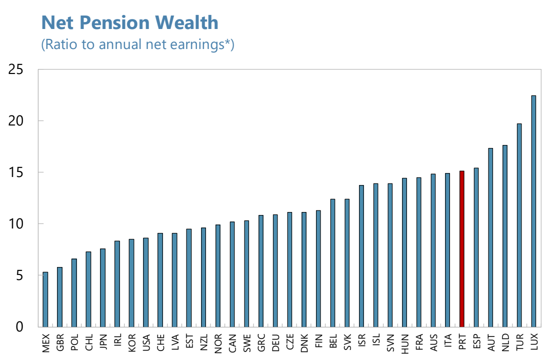
Pension spending as a share of GDP has risen by 23 percent since prior to the crisis. Only around half of this increase can be attributed to more retirees.



This has helped to reduce the risk of old-age poverty towards the euro area average, and pushed it below the levels for the working age population.

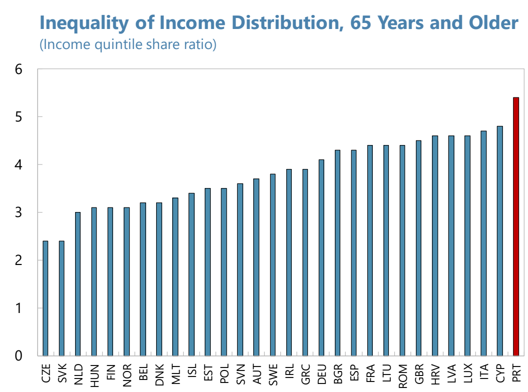


Yet Portugal has one of the most generous pension systems in the OECD, when compared to average earnings.



* Present value of the flow of pension benefits, taking account of the taxes and social security contributions, expressed as a multiple of annual net earnings.

And the income distribution of people over 65 is highly skewed, suggesting that savings could be made by targeting the most well off.



Sources: OECD and Eurostat.

25. Budget monitoring and control need to be improved. In the health sector, injecting public funds (about €1.4 billion in 2017–18) to clear arrears is unlikely to provide durable results without addressing the root causes of arrears, such as under-budgeting, as well as weaknesses in monitoring and enforcement practices. Recent initiatives to improve cost-effectiveness, such as the creation of a joint unit by the health and finance ministries, are important steps in the right direction; their effectiveness should be monitored, and if necessary, additional interventions should be directed at preventing the accumulation of new payment arrears. Finally, local governments should not delay the transition to an integrated accrual-based public accounting system.

Authorities' Views

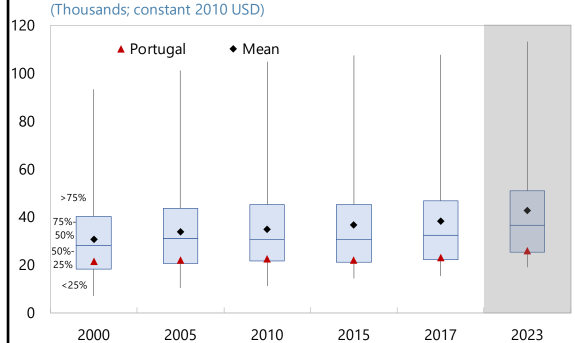
26. The authorities believe that the targets set out in the Stability Program 2018–2022 are realistic and appropriately paced. Their deficit reduction strategy is focused on: (i) continued restraint on public sector wages and employment, even as some necessary changes are phased in; (ii) efficiency savings from the ongoing spending review; and (iii) falling interest payments, which they expect to lead to a sustained decline of current expenditure of 2.4 percent of GDP by 2022. They view the pace of consolidation as appropriate, given their assessment that the economy is currently still in the recovery phase of the cycle and that growth will remain strong over the medium term. They project the fiscal deficit to decline to 0.7 percent of GDP in 2018 and turn to a surplus in 2020; they also expect that their fiscal strategy will reduce public debt to 102 percent of GDP by 2022, a downward trajectory that they consider robust to macroeconomic and financial shocks.

27. The authorities emphasized their commitment to advancing expenditure reforms with a view to enhance efficiency and improve inclusion of the most vulnerable groups. The authorities explained that they have bolstered the financing of pensions by phasing in the earmarking of a fraction of corporate income tax (reaching two percentage points by 2021) and improved the transparency of the system by launching an online pension benefit calculator. To improve the fairness of the system, the authorities are raising the value of the lowest pensions and analyzing the possibility of further reducing excessive penalties for early retirement, while keeping the legal retirement age indexed to life expectancy. In the health sector, the authorities explained that they are stepping up efforts to contain arrears accumulation by transferring additional resources to hospitals (about €500 million by end-2018) and strengthening budget planning and controls, which they expect to result in better services. They stressed that, in the context of the ongoing spending review, they are centralizing the procurement of drugs and medical devices, and renegotiating contracts with suppliers while tackling fraud. In March 2018, a task force of health experts was formed to collaborate with the Ministries of Health and Finance in identifying additional measures to improve the sustainability and efficiency of the health sector.

D. Structural Issues: Investment and Growth

28. Improving medium term growth prospects is necessary for Portugal to converge to euro area standards of living and reduce vulnerabilities. During the euro crisis, Portugal's average income fell further behind the euro area core, and in staff's projections convergence is not expected in the next five years, as growth of GDP per

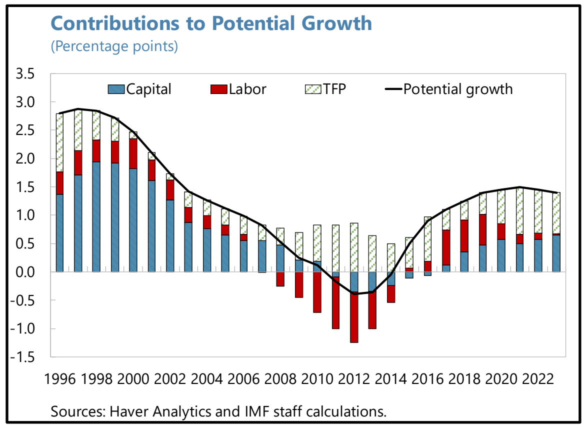
Real GDP per capita of EA Countries
(Thousands; constant 2010 USD)



Sources: WDI, WEO and IMF staff calculations.

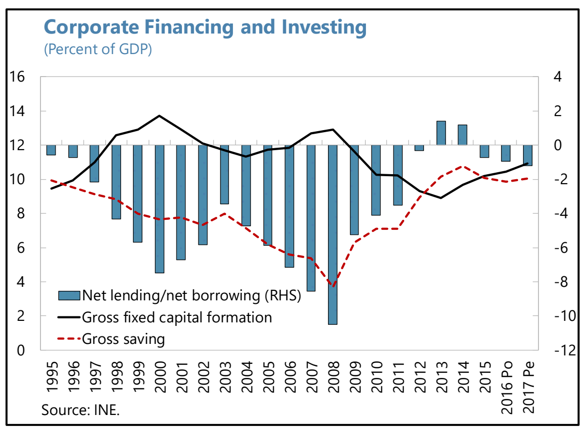
capita would be just above that in the euro area. And the still large stocks of public and private debt remain sources of vulnerability. Faster output growth would facilitate both income convergence and further deleveraging.

29. Potential growth in the medium term will remain moderate. The reforms implemented since the program era have improved labor market flexibility, product market competition, and the effectiveness of the judicial system, while the investment composition has shifted toward tradable sectors, reflecting the structural transformation of the economy. This laid the basis for a resumption of growth and employment. However, staff estimates potential growth at around 1.4 percent over the medium-term[13], considering remaining structural bottlenecks and unchanged policies. Near term, a decline in working age population (about 1 percent over five years) is expected to be offset by recovering labor force participation and moderating structural unemployment, but over the medium term a contracting labor force will weigh on growth (Annex IV). These estimates are subject to a large degree of uncertainty.



30. Increasing growth over the medium-term will require stronger domestic saving to finance additional private investment. Despite its ongoing recovery, investment remains relatively low as a ratio to GDP. Given Portugal's need to reduce its fiscal deficits further, public gross fixed capital formation is likely to remain constrained, although public investment efficiency can continue to improve from its strong level (see Selected Issues Paper). Private investment should thus be the driving force behind higher investment growth over the medium term, and will require larger saving to finance it—especially private.

- Gross corporate saving rose significantly during the adjustment period, but has remained broadly unchanged at 10 percent of GDP since 2015, and going forward there is even a risk of erosion if there were significant additional increases in labor costs. The authorities could build on recent tax changes to support firms that retain and reinvest earnings and owners who inject new equity into their companies.



- The household saving rate averaged 3.8 percent of GDP over the last three years, one of the lowest among advanced countries. The authorities should develop a medium-term strategy to

[13] The authorities in their Stability Program 2018–2022 estimate potential growth at around two percent, assuming a higher impact of skill-improvements on total factor productivity, and their Stability Program includes forecasts of real GDP growth slightly above two percent in the next four years.

strengthen saving, including by enacting regulations needed for the complementary professional pension regime as mandated in the pension law.

31. Portugal needs to overcome significant structural challenges to boost investment and raise productivity, building on past reforms. In particular:

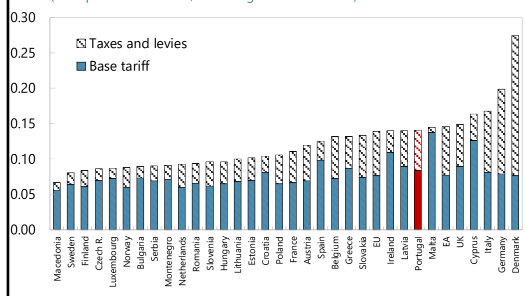
- **Uncertainty and regulation.** Ensuring a stable regulatory and tax environment would contribute to limit uncertainty, an important deterrent to investment.[14]

- **Energy prices.** Network industries such as energy and transport continue to be characterized by relatively high prices, affecting the competitiveness of firms in tradable sectors. Despite a decline in energy prices in recent years, they remain above the EU average. Ongoing work by the regulator to review existing tariff frameworks is thus welcome.

- **Wage growth and productivity.** Wage growth has continued to exceed productivity growth, reflecting a tightening labor market, especially in some segments, and significant minimum-wage increases. The minimum wage increased to €580 per month in 2018 from €557 in 2017 and €530 in 2016, and the minimum wage coverage of employees increased to 22 percent in 2017 (from 20.6 percent in 2016). Maintaining a similar trajectory in the future could increase rigidities and reduce competitiveness.

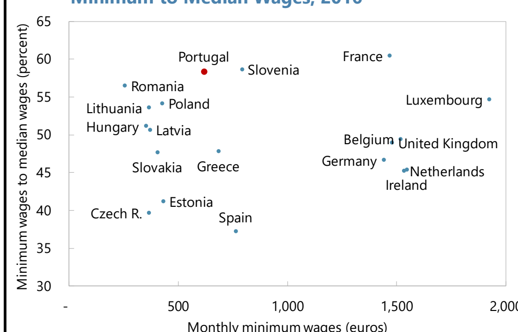
- **Human capital development.** Despite improvements in indicators of educational attainment, skill-shortages remain an obstacle to Portuguese firms, and the share of low-skilled workers (47 percent in 2017) is still much higher than the EU average (18 percent). Within its budget constraints, the government should continue to support on- and off-the job training, and linkages between public education institutions and industry.

Energy Prices for Industrial Consumers, 2017H2
(Euro per kilowatt-hour, including taxes and levies)



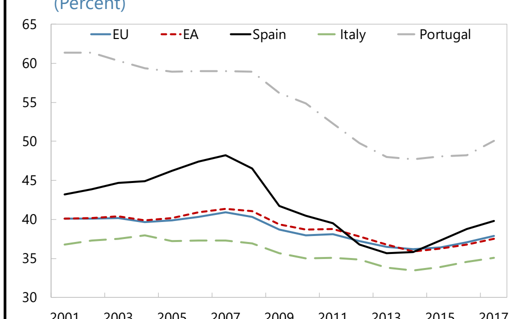
Source: Eurostat. 500 MWh < Consumption < 2 000 MWh. Prices are invoiced prices paid by end-users.

Minimum to Median Wages, 2016



Source: Eurostat.

Low-skilled Employment Rate
(Percent)

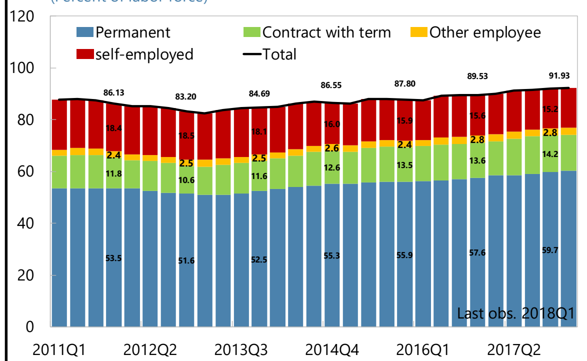


Sources: Eurostat; and IMF staff calculations.

[14] Uncertainty, high regulatory burdens and complex licensing procedures feature prominently in various surveys of businesses, such as the EIB's, and were issues raised during meetings between staff and private sector representatives.

- **Legal and institutional framework for debt enforcement and insolvency.** Official data indicate that reforms of the legal and institutional framework for debt enforcement and insolvency/debt restructuring have yielded positive results on resolution efficiency, debt recovery, and more recently in NPL resolution. Among other reforms, the authorities have introduced a new purely out-of-court collateral enforcement procedure, a debt-to-equity procedure that may override shareholder opposition by court approval, and further simplification and efficiency measures. The authorities have also established tax incentives for debt restructuring and debt-to-equity swaps. Staff welcomes these reforms and the continued refinement of the legal and institutional framework, and recommends further actions in two areas: (i) enable public creditors to participate more fully in debt restructuring, preferably on the same footing as other creditors, subject to clear and transparent guidelines; and (ii) prioritize addressing conditions allowing non-viable insolvent businesses to delay liquidation.

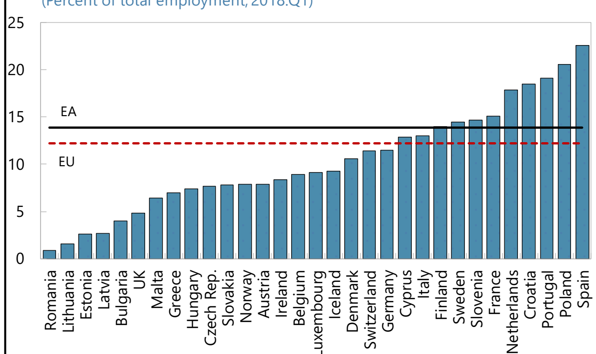
Employment by Type
(Percent of labor force)



Sources: INE and IMF staff calculations.

32. Preserving labor market flexibility is important for the economy to adapt to future shocks and to support productivity growth. Most jobs created in 2017 were permanent; however, temporary jobs in Portugal still represent a large fraction of employment by European standards. Against this background, the government coordinated tri-partite negotiations on labor regulations, aimed *inter alia* at increasing job security and reducing segmentation. The agreed reforms include measures that reduce firms' ability to flexibly manage their labor, such as new constraints in the use of "banks of hours" and a reduction in the maximum duration of temporary contracts; but they also permit an increase in the duration of probation periods in permanent contracts, and take into account industry-specific practices in the design of some regulations. Thus, the agreement's net effects on economic flexibility are hard to predict, as it both constrains temporary contracts and makes permanent contracts more flexible in some dimensions. These agreements are now in parliament. However, there are competing initiatives that would increase more markedly the restrictiveness of labor regulations. Such initiatives would be counterproductive, as flexible labor market institutions are key for Portugal, a member of a common currency area, to process adverse shocks.

Temporary Contracts
(Percent of total employment, 2018:Q1)



Sources: Eurostat and IMF staff calculations.

Authorities' Views

33. **The authorities in their Stability Program 2018–2022 see stronger potential growth of around two percent over the medium-term, grounded in structural improvements in skills, investment allocation, and export-orientation.** The ongoing improvement in education, both in attainment levels and quality, and the revitalization of the financial system are expected to support long-term potential growth and productivity, and are more relevant factors than the evolution of indicators such as labor cost indices, which can be misleading.[15] The authorities agreed with the need to boost investment and savings and to continue to improve the business environment, and noted that recent tax changes aimed to encourage firms to build equity. They also emphasized the need for better management skills and to foster innovation in small businesses, which rely on the ongoing education strategy and could be boosted through the return home of skilled Portuguese migrants. They explained that the proposed changes in labor market regulations are intended to address long-standing labor market segmentation issues, which have undesirable social effects but could not be addressed earlier owing to labor market weakness. Moreover, they stressed that the tripartite process used to draft the reform package, building on an extensive in-depth discussion between employers, unions, and government, ensured that the agreed set of measures was balanced. The authorities believe that tackling remaining structural challenges and building social capital will require both supply- and demand-side support as well as patience by all stakeholders, as reforms take time to materialize.

34. **The authorities stressed the importance of their multi-faceted strategy to boost investment and innovation.** Besides the continuing improvement of the legal, judicial, and tax framework, other measures are being implemented to improve funding and capital levels of SMEs and Mid-Caps. These include a new public post-restructuring financing instrument, co-investment initiatives with venture capital funds and business angels, renewed credit facilities with mutual guarantee, and the creation of a new type of listed companies (SIMFE[16]) holding shares in unlisted Portuguese firms.

STAFF APPRAISAL

35. **The Portuguese economy performed well in 2017.** Investment and exports were the key drivers of growth. The underlying fiscal balance posted a strong outturn allowing for 'one-off' payments. The improvement can be attributed to buoyant economic growth, disciplined budget execution, and falling interest costs, and has contributed to more favorable borrowing terms throughout the economy. Importantly, stability and confidence in the banking system increased following successful efforts to raise capital by banks and the sale of Novo Banco in 2017.

36. **Prospects remain positive, but downside risks have increased.** Portugal should continue to post strong, albeit moderating growth in the next few years. Continued fiscal restraint, together

[15] The projected reduction of low-skilled employment from 53 to 42 percent of the labor force is expected to improve the level of potential GDP by seven percent in 10 years (Gouveia and Coelho, 2018).

[16] *Sociedades de Investimento Mobiliário para Fomento da Economia*.

with the favorable economic context, bode well for the attainment of the 2018 fiscal target and for continued public debt reduction over the medium term. Nevertheless, policies need to remain strong in the face of heightened external risks and of pressures to erode past reforms. Weakening them may seem manageable in the present favorable circumstances, but it would impair the economy's ability to handle shocks down the road.

37. Staff sees a good case for frontloading the fiscal adjustment envisaged in the Stability Program 2018–2022. The stability program appropriately aims at a continued reduction in public indebtedness, which remains very high. Frontloading fiscal consolidation would take advantage of current favorable cyclical conditions and avoid postponing the fiscal effort till a time when activity is likely to be moderating and create space to absorb contingent spending pressures that could materialize in the next few years. Moreover, frontloading would also help further differentiate Portugal at a time of potential bond market volatility.

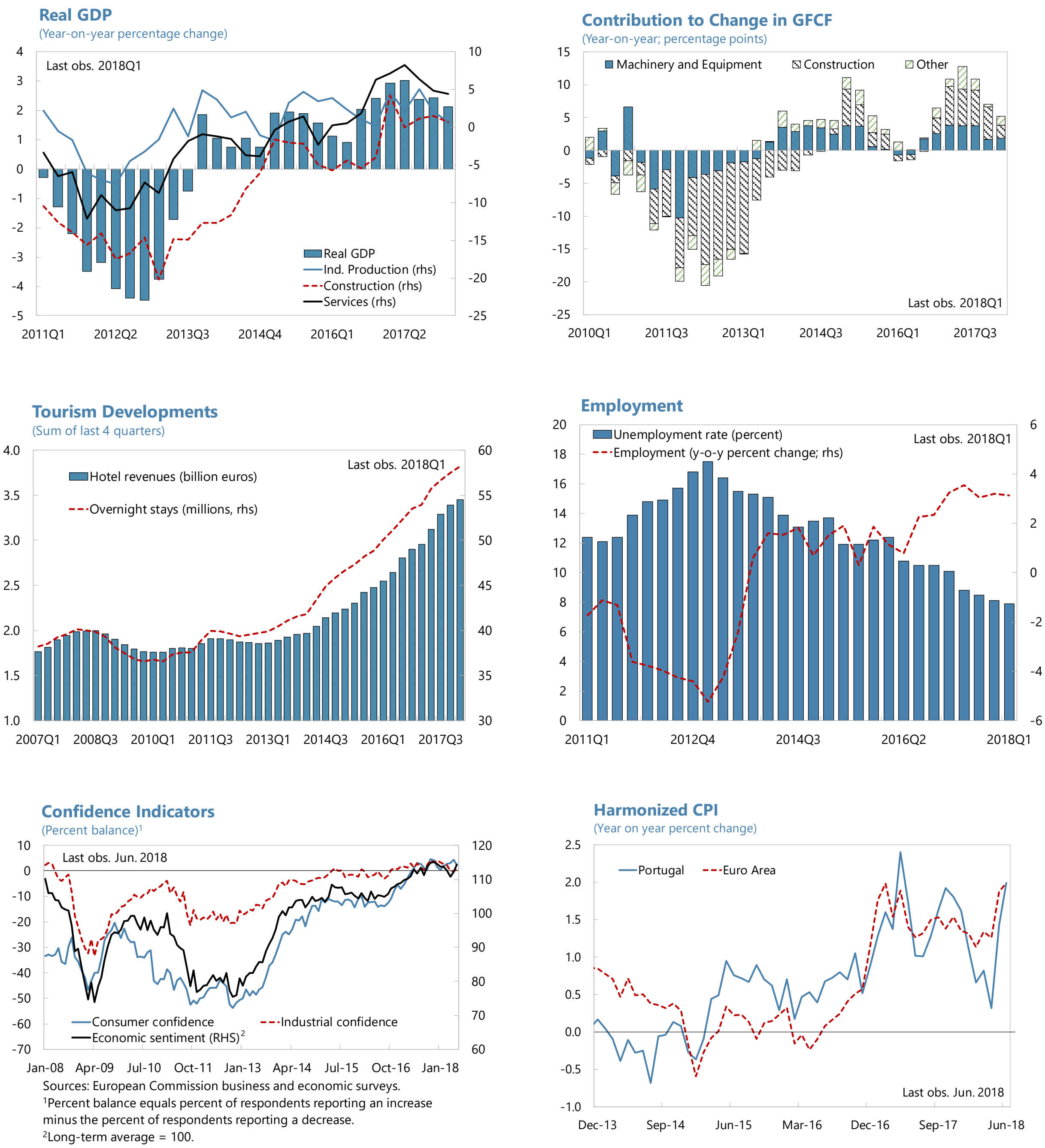
38. While systemic risks appear to be contained, the still-elevated stock of NPLs and low bank profitability remain concerns. Addressing these lingering vulnerabilities will require perseverance in implementing the NPL-resolution strategy. To avoid future NPL build-up, supervisors should continue to press banks to strengthen their risk management and corporate governance. The authorities should also continue to pay close attention to credit standards, as the low-interest rate environment could lead to excessive risk-taking and be ready to adjust the macroprudential measures if needed to bolster the resilience of the financial system and households.

39. Portugal's external position remains weaker than that consistent with medium-term fundamentals and desirable policy settings. The strengthening in the current account since the crisis helped change the trajectory of the country's net international investor position. Significantly improving the country's external position in the future requires larger-than-forecast current account surpluses over the medium term, which calls for policies geared at boosting domestic saving.

40. Stronger growth in the medium term will be essential to continue to reduce vulnerabilities and converge towards the average levels of productivity and income of the EU. Strengthening growth will require fostering soundly financed investment and continuing improvements in productivity and skills. Investment can be spurred by enhancing business conditions, streamlining regulations, and increasing the flexibility and responsiveness of institutions and markets. Sustainable financing of investment requires continuing efforts to strengthen domestic saving and the financial intermediation system.

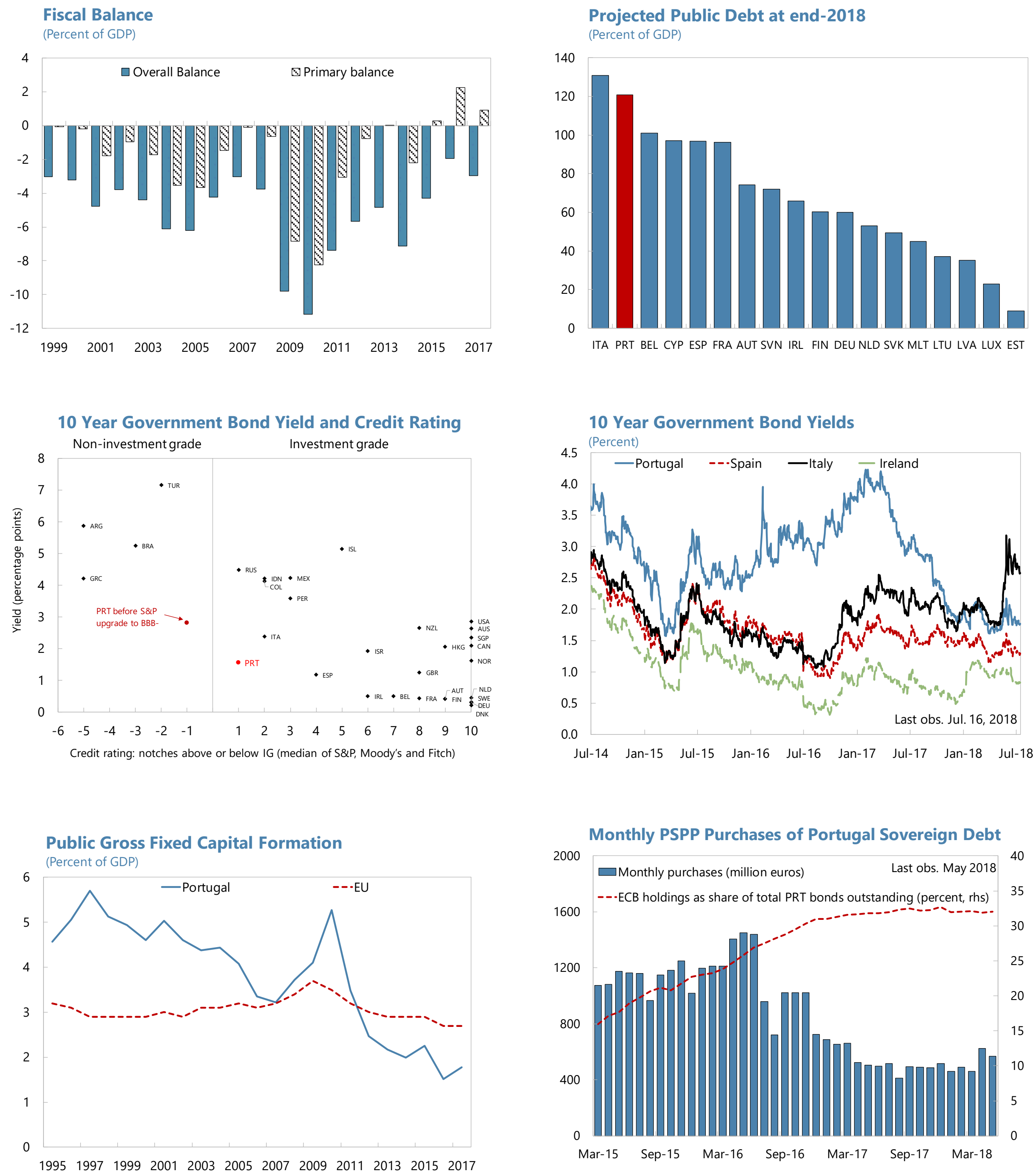
41. Staff recommends that the next Article IV consultation be held on the standard 12- month cycle.

Figure 2. Portugal: Real Sector Indicators



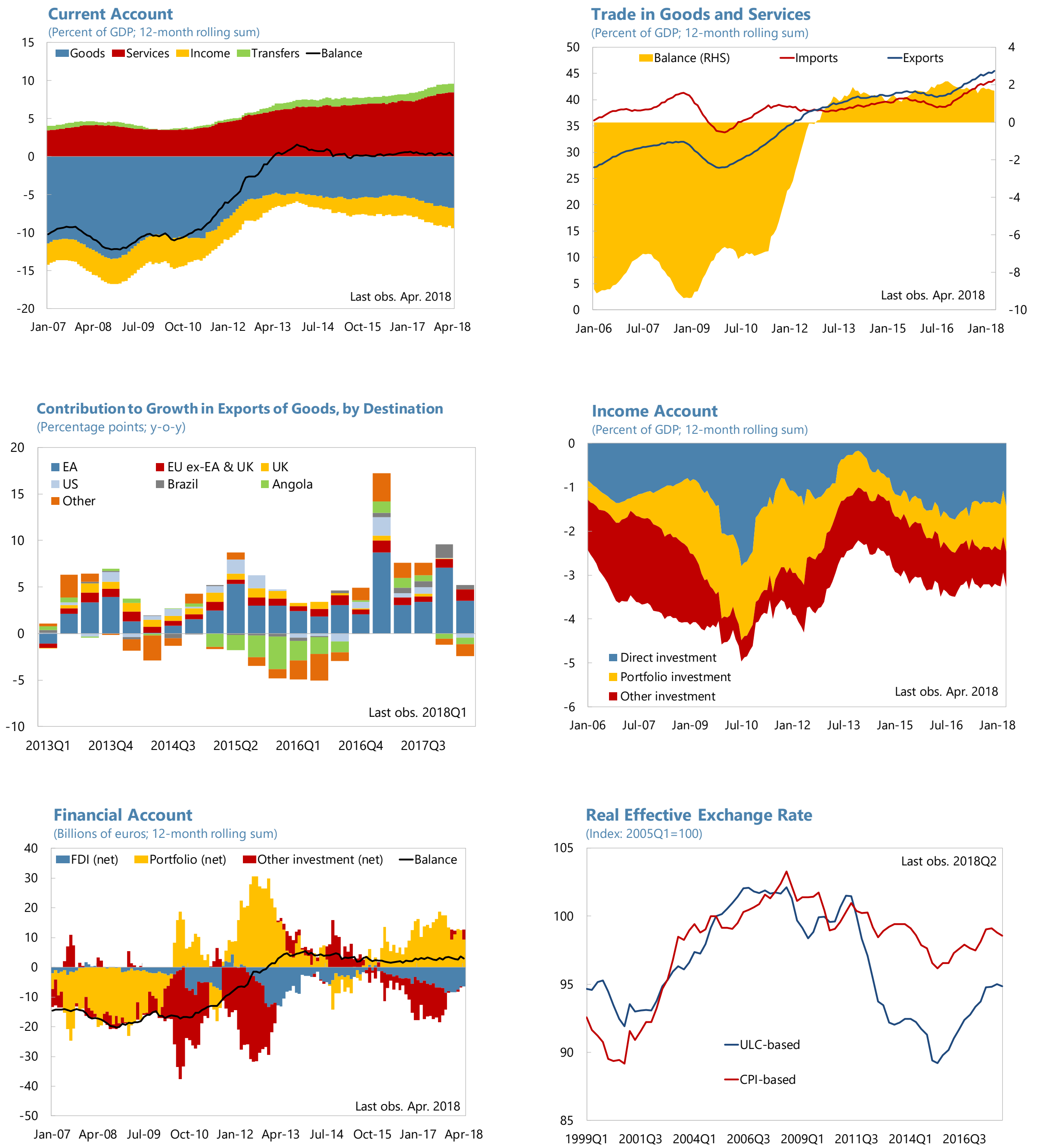
Sources: INE; Haver Analytics; and IMF staff calculations.

Figure 3. Portugal: Fiscal Sector Indicators



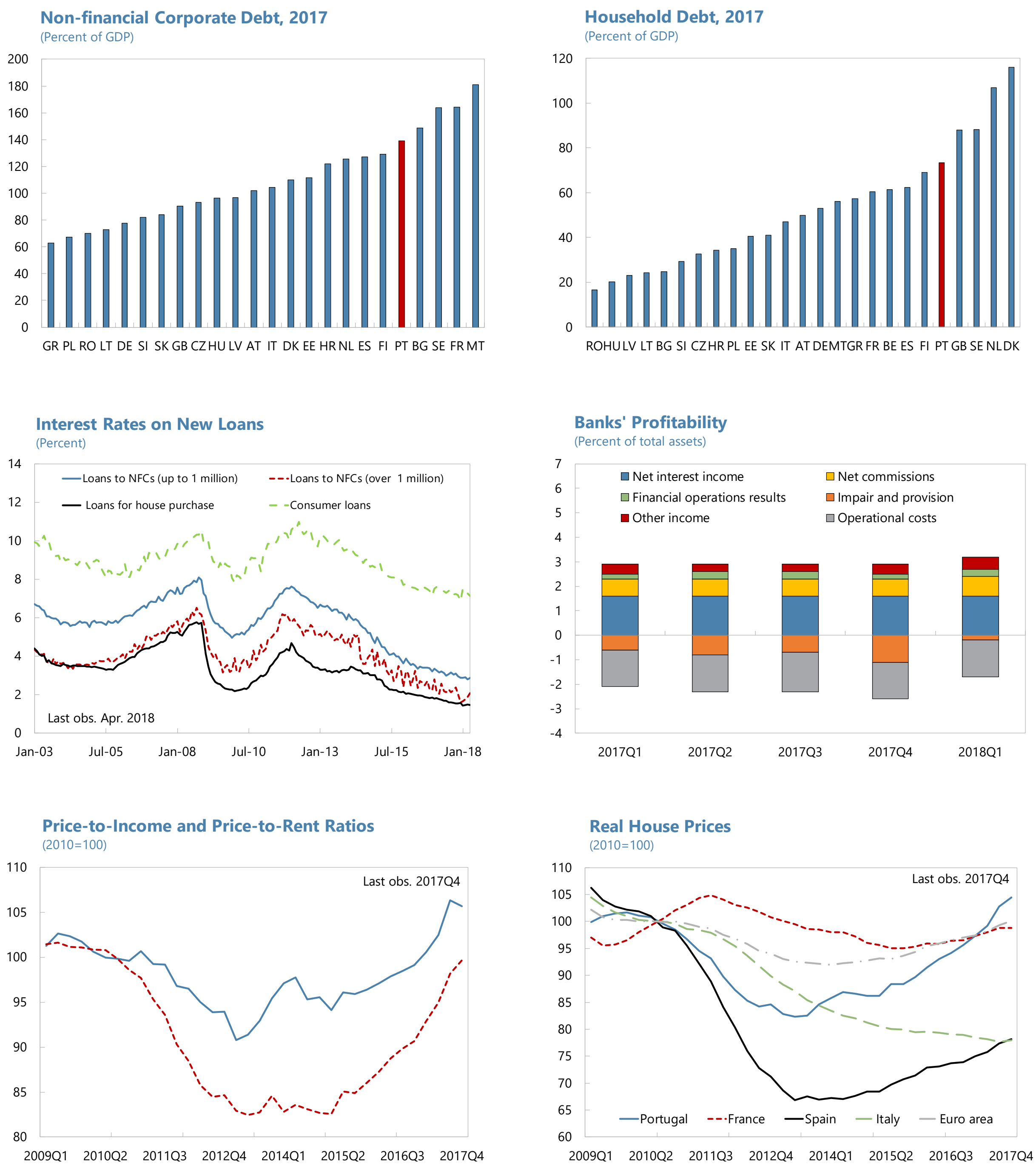
Sources: Haver Analytics; IGCP; ECB; and IMF staff calculations.

Figure 4. Portugal: External Sector Indicators



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

Figure 5. Portugal: Financial Stability Indicators



Sources: Banco de Portugal; Haver Analytics; and IMF staff calculations.

Table 1. Portugal: Selected Economic Indicators
(Year-on-year percent change, unless otherwise indicated)

					Projections					
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Real GDP	0.9	1.8	1.6	2.7	2.3	1.8	1.5	1.4	1.4	1.3
Total domestic demand	2.2	2.7	1.6	2.8	2.8	2.3	2.0	1.7	1.6	1.6
Private consumption	2.3	2.3	2.1	2.3	1.9	1.6	1.3	1.2	1.2	1.2
Public consumption	-0.5	1.3	0.6	-0.2	1.9	1.0	1.1	0.7	1.3	1.0
Gross fixed investment	2.3	5.8	1.5	9.2	7.6	6.3	5.0	4.2	3.4	3.3
Private	4.1	4.3	6.9	7.9	6.1	6.6	5.2	4.3	3.4	3.3
Government	-7.9	15.9	-30.9	21.2	19.6	4.2	3.8	3.6	3.4	3.2
Exports	4.3	6.1	4.4	7.9	6.2	4.7	4.2	4.1	4.1	4.1
Imports	7.8	8.5	4.2	7.9	6.8	5.5	4.9	4.4	4.3	4.3
Contribution to Growth										
Total domestic demand	2.2	2.8	1.6	2.9	2.9	2.4	2.0	1.7	1.7	1.6
Private consumption	1.5	1.5	1.4	1.5	1.2	1.0	0.9	0.8	0.8	0.8
Public consumption	-0.1	0.3	0.1	0.0	0.4	0.2	0.2	0.1	0.2	0.2
Gross fixed investment	0.4	0.9	0.2	1.5	1.3	1.1	1.0	0.8	0.7	0.7
Foreign balance	-1.4	-1.1	0.0	-0.2	-0.4	-0.5	-0.5	-0.3	-0.3	-0.3
Savings-investment balance (Percent of GDP)										
Gross national savings	15.4	15.9	16.1	16.8	17.2	18.0	18.4	18.9	19.6	20.6
Private	17.4	16.9	16.6	15.8	15.9	16.2	16.4	16.7	17.2	18.1
Public	-2.0	-0.9	-0.5	1.0	1.4	1.8	2.0	2.2	2.5	2.5
Gross domestic investment	15.3	15.8	15.5	16.3	17.0	18.1	18.9	19.7	20.9	22.1
Private	13.3	13.5	13.9	14.5	14.9	15.9	16.7	17.5	18.7	19.8
Public	2.0	2.3	1.5	1.8	2.1	2.1	2.2	2.2	2.3	2.3
Resource utilization										
Potential GDP	-0.1	0.5	0.9	1.1	1.3	1.4	1.5	1.5	1.4	1.4
Output Gap (Percent of potential)	-4.4	-3.1	-2.5	-0.9	0.1	0.5	0.5	0.4	0.4	0.3
Employment	1.4	1.4	1.6	3.3	1.9	1.2	0.7	0.5	0.4	0.3
Unemployment rate (Percent; average)	13.9	12.4	11.1	8.9	7.3	6.7	6.5	6.3	6.1	6.0
Prices										
GDP deflator	0.8	2.0	1.5	1.4	1.6	1.6	1.7	1.7	1.7	1.7
Consumer prices (Harmonized index)	-0.2	0.5	0.6	1.6	1.7	1.6	1.8	1.9	2.1	2.1
Compensation per worker (Whole economy)	-1.8	0.4	2.1	1.1	2.1	2.3	2.9	2.9	3.1	3.1
Money and credit (End of period, percent change)										
Private sector credit	-8.0	-4.1	-3.7	-3.1	0.1	0.8	1.6	1.6	1.6	1.6
Broad money	-0.4	4.1	9.0	7.5	3.4	2.9	2.8	2.7	2.6	2.5
Interest rates (Percent)										
Short-term deposit rate	1.6	0.8	0.4	0.3	...	...	...	...	...	...
Government bond rate, 10-year	3.8	2.4	3.2	3.1	...	...	...	...	...	...
Fiscal indicators (Percent of GDP)										
General government balance	-7.1	-4.3	-2.0	-3.0	-0.7	-0.3	-0.2	0.0	0.2	0.2
Revenues	44.6	43.8	43.0	42.9	43.2	43.3	43.3	43.2	43.2	43.2
Expenditures	51.7	48.1	44.9	45.9	43.9	43.6	43.5	43.3	43.0	43.0
Primary government balance	-2.2	0.3	2.2	0.9	2.8	3.1	3.1	3.1	3.1	3.1
General government debt	130.6	128.8	129.9	125.7	120.8	117.2	115.1	109.6	105.8	102.8
External sector (Percent of GDP)										
Trade balance (Goods)	-5.5	-5.3	-5.2	-6.3	-7.2	-7.7	-8.1	-8.4	-8.9	-9.2
Trade balance (Goods and Services)	1.1	1.7	2.1	1.8	1.4	1.2	1.0	0.9	0.6	0.5
Current account balance	0.1	0.1	0.6	0.5	0.2	-0.1	-0.5	-0.9	-1.3	-1.5
Net international investment position	-118.6	-113.2	-106.1	-105.7	-99.8	-94.6	-90.0	-86.5	-83.9	-81.8
REER based on ULC (2010=100)	91.9	89.6	91.9	93.7	91.3	90.9	91.9	92.3	92.9	93.3
(Rate of growth)	-0.3	-2.5	2.5	2.0	-2.5	-0.5	1.2	0.4	0.6	0.4
REER based on CPI (2010=100)	98.7	96.2	98.1	97.9	98.0	97.8	97.8	97.8	97.8	97.9
(Rate of growth)	-1.1	-2.5	2.0	-0.2	0.0	-0.1	0.0	-0.1	0.1	0.1
Nominal GDP (Billions of euros)	173.1	179.8	185.5	193.1	200.6	207.5	214.2	221.0	228.0	234.9

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

Table 2a. Portugal: General Government Accounts [1/]

(Billions of euros)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
					Projections					
Revenue	77.2	78.8	79.7	82.8	86.7	89.8	92.8	95.6	98.6	101.5
Taxes	43.6	45.6	46.4	48.7	50.4	52.0	53.6	55.0	56.6	58.2
Taxes on production and imports	24.6	26.1	27.3	29.0	30.3	31.2	32.0	32.7	33.5	34.2
Current taxes on income, wealth, etc. and capital taxes	19.0	19.5	19.1	19.7	20.1	20.8	21.6	22.3	23.1	24.0
Current taxes on income, wealth, etc.	19.0	19.5	19.1	19.7	20.1	20.8	21.6	22.3	23.1	24.0
Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	20.5	20.8	21.6	22.7	23.7	24.7	25.7	26.5	27.5	28.4
Grants and other revenue	13.2	12.4	11.7	11.4	12.6	13.2	13.6	14.0	14.5	14.9
Property income	1.7	1.3	1.2	1.2	1.2	1.3	1.3	1.4	1.4	1.5
Sales of goods and services	6.3	6.4	6.6	6.8	7.0	7.3	7.5	7.7	8.0	8.2
Other current revenue	3.4	3.3	3.0	2.7	2.8	2.9	3.0	3.1	3.2	3.3
Capital transfers and investment grants	1.7	1.4	0.8	0.7	1.5	1.7	1.8	1.8	1.9	1.9
Expenditure	89.5	86.5	83.4	88.6	88.1	90.5	93.1	95.7	98.1	101.1
Expense	91.2	87.7	85.8	90.8	89.9	92.2	94.8	97.3	99.7	102.6
Compensation of employees	20.5	20.3	20.9	21.3	22.1	22.8	23.5	24.1	24.8	25.4
Use of goods and services	9.8	10.0	10.4	10.5	10.9	10.9	11.3	11.7	12.0	12.4
Consumption of fixed capital	5.1	5.2	5.3	5.7	5.9	6.1	6.3	6.5	6.7	6.9
Interest	8.5	8.2	7.8	7.5	7.0	7.0	6.9	6.9	6.6	6.9
Subsidies	1.2	1.1	1.0	0.9	0.8	0.8	0.9	0.9	0.9	0.9
Social benefits	34.1	34.7	35.1	35.6	36.8	37.9	39.0	40.2	41.4	42.6
Grants and other expense	11.9	8.1	5.4	9.4	6.4	6.6	6.8	7.1	7.3	7.5
Other current expense	4.7	4.6	4.7	4.5	4.7	4.8	5.0	5.1	5.3	5.4
Capital transfers	7.2	3.4	0.8	4.9	1.8	1.8	1.9	1.9	2.0	2.1
Net acquisition of nonfinancial assets	-1.6	-1.2	-2.5	-2.2	-1.7	-1.7	-1.7	-1.6	-1.6	-1.5
Gross fixed capital formation	3.4	4.0	2.7	3.4	4.1	4.4	4.6	4.9	5.1	5.4
(-) Consumption of fixed capital	-5.1	-5.2	-5.3	-5.7	-5.9	-6.1	-6.3	-6.5	-6.7	-6.9
Acquisitions less disposals of other nonfinancial assets	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-8.9	-3.7	-0.9	-2.3	2.7	3.8	4.3	4.8	5.6	5.8
Net lending (+)/borrowing (–)	-12.3	-7.7	-3.7	-5.7	-1.4	-0.6	-0.3	-0.1	0.5	0.4
Net acquisition of financial assets	-6.5	-4.0	5.2	-2.9	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	0.0	-3.1	4.5	-2.6	...	...	...	...	...	...
Debt securities	-4.7	-1.0	0.0	-0.6	...	...	...	...	...	...
Loans	-0.1	0.1	-0.1	-0.1	...	...	...	...	...	...
Equity and investment fund shares	-2.1	-0.2	-0.1	0.3	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.1	-0.3	-0.5	-0.2	...	...	...	...	...	...
Other accounts receivable	0.4	0.5	1.4	0.2	...	...	...	...	...	...
Net incurrence of liabilities	5.9	3.9	8.9	2.8	...	...	...	...	...	...
SDRs	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	4.9	4.0	4.0	2.7	...	...	...	...	...	...
Debt securities	-1.9	11.2	11.3	10.3	...	...	...	...	...	...
Loans	3.6	-9.4	-6.0	-10.6	...	...	...	...	...	...
Equity and investment fund shares	0.0	-0.2	0.0	0.5	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	0.0	-0.2	...	...	...	...	...	...
Other accounts payable	-0.2	-1.1	-0.7	-0.2	...	...	...	...	...	...
Memorandum items:										
Primary balance	-3.8	0.5	4.1	1.8	5.6	6.4	6.6	6.8	7.1	7.3
Debt at face value (EDP notification)	226.0	231.5	241.0	242.7	242.4	243.3	246.7	242.3	241.3	241.4
Nominal GDP	173.1	179.8	185.5	193.1	200.6	207.5	214.2	221.0	228.0	234.9

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

[1/] GFSM 2001 presentation.

Table 2b. Portugal: General Government Accounts [1/]

(Percent of GDP, unless otherwise noted)

	2014	2015	2016	2017	Projections 2018	2019	2020	2021	2022	2023
Revenue	44.6	43.8	43.0	42.9	43.2	43.3	43.3	43.2	43.2	43.2
Taxes	25.2	25.4	25.0	25.2	25.1	25.1	25.0	24.9	24.8	24.8
Taxes on production and imports	14.2	14.5	14.7	15.0	15.1	15.0	14.9	14.8	14.7	14.6
Current taxes on income, wealth, etc. and capital taxes	11.0	10.9	10.3	10.2	10.0	10.0	10.1	10.1	10.2	10.2
Social contributions	11.8	11.6	11.6	11.8	11.8	11.9	12.0	12.0	12.1	12.1
Grants and other revenue	7.6	6.9	6.3	5.9	6.3	6.3	6.3	6.3	6.3	6.3
Property income	1.0	0.7	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Sales of goods and services	3.6	3.5	3.6	3.5	3.5	3.5	3.5	3.5	3.5	3.5
Other current revenue	2.0	1.8	1.6	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Capital transfers and investment grants	1.0	0.8	0.4	0.4	0.8	0.8	0.8	0.8	0.8	0.8
Expenditure	51.7	48.1	44.9	45.9	43.9	43.6	43.5	43.3	43.0	43.0
Expense	52.7	48.8	46.3	47.0	44.8	44.4	44.2	44.0	43.7	43.7
Compensation of employees	11.9	11.3	11.3	11.0	11.0	11.0	11.0	10.9	10.9	10.8
Use of goods and services	5.7	5.6	5.6	5.4	5.4	5.3	5.3	5.3	5.3	5.3
Consumption of fixed capital	2.9	2.9	2.8	2.9	2.9	2.9	2.9	2.9	2.9	2.9
Interest	4.9	4.6	4.2	3.9	3.5	3.4	3.2	3.1	2.9	2.9
Subsidies	0.7	0.6	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Social benefits	19.7	19.3	18.9	18.4	18.3	18.2	18.2	18.2	18.1	18.1
Grants and other expense	6.9	4.5	2.9	4.9	3.2	3.2	3.2	3.2	3.2	3.2
Other current expense	2.7	2.6	2.5	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Capital transfers	4.2	1.9	0.4	2.6	0.9	0.9	0.9	0.9	0.9	0.9
Net acquisition of nonfinancial assets	-0.9	-0.7	-1.3	-1.2	-0.9	-0.8	-0.8	-0.7	-0.7	-0.6
Gross fixed capital formation	2.0	2.2	1.5	1.8	2.1	2.1	2.2	2.2	2.3	2.3
(-) Consumption of fixed capital	-2.9	-2.9	-2.8	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9
Acquisitions less disposals of other nonfinancial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-5.1	-2.1	-0.5	-1.2	1.4	1.8	2.0	2.2	2.5	2.5
Net lending (+)/borrowing (–)	-7.1	-4.3	-2.0	-3.0	-0.7	-0.3	-0.2	0.0	0.2	0.2
Net acquisition of financial assets	-3.8	-2.2	2.8	-1.5	…	…	…	…	…	…
Monetary gold and SDRs	0.0	0.0	0.0	0.0	…	…	…	…	…	…
Currency and deposits	0.0	-1.7	2.4	-1.3	…	…	…	…	…	…
Debt securities	-2.7	-0.5	0.0	-0.3	…	…	…	…	…	…
Loans	-0.1	0.1	-0.1	0.0	…	…	…	…	…	…
Equity and investment fund shares	-1.2	-0.1	-0.1	0.1	…	…	…	…	…	…
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	…	…	…	…	…	…
Financial derivatives and employee stock options	0.1	-0.2	-0.3	-0.1	…	…	…	…	…	…
Other accounts receivable	0.2	0.3	0.8	0.1	…	…	…	…	…	…
Net incurrence of liabilities	3.4	2.2	4.8	1.5	…	…	…	…	…	…
SDRs	0.0	0.0	0.0	0.0	…	…	…	…	…	…
Currency and deposits	2.8	2.2	2.1	1.4	…	…	…	…	…	…
Debt securities	-1.1	6.2	6.1	5.3	…	…	…	…	…	…
Loans	2.1	-5.3	-3.2	-5.5	…	…	…	…	…	…
Equity and investment fund shares	0.0	-0.1	0.0	0.3	…	…	…	…	…	…
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	…	…	…	…	…	…
Financial derivatives and employee stock options	0.0	0.0	0.0	-0.1	…	…	…	…	…	…
Other accounts payable	-0.1	-0.6	-0.4	-0.1	…	…	…	…	…	…
Memorandum items:										
Primary balance	-2.2	0.3	2.2	0.9	2.8	3.1	3.1	3.1	3.1	3.1
Structural balance (Percent of potential GDP)	-0.9	-1.5	-1.1	-0.5	-0.5	-0.5	-0.4	-0.2	0.0	0.0
Structural primary balance (Percent of potential GDP)	3.7	2.9	3.0	3.4	3.0	2.9	2.8	2.9	2.9	3.0
Debt at face value (EDP notification)	130.6	128.8	129.9	125.7	120.8	117.2	115.1	109.6	105.8	102.8
Nominal GDP (Billions of euros)	173.1	179.8	185.5	193.1	200.6	207.5	214.2	221.0	228.0	234.9

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

1/ GFSM 2001 presentation.

Table 3. Portugal: Monetary Survey, 2014–2023

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

					Projections					
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
					Aggregated Balance Sheet of Monetary Financial Institutions (MFIs)[1/]					
Assets	404,575	386,337	368,146	366,438	371,536	374,623	380,813	386,035	391,786	395,359
Claims on Bank of Portugal	5,093	9,353	7,235	15,510	15,975	16,455	16,948	17,457	17,980	18,520
Claims on non-residents	71,467	63,875	55,396	50,390	50,894	51,403	51,917	52,436	52,960	53,490
Claims on non-monetary resident sector	307,488	296,203	285,502	282,294	286,279	288,450	293,632	297,803	302,522	305,023
General government	41,504	39,948	40,488	44,640	46,743	48,147	50,088	50,684	52,244	51,314
Central government	34,990	33,634	34,085	38,503	40,362	41,737	43,677	44,110	45,670	44,740
Loans	3,092	2,547	2,569	4,802	7,076	11,529	14,677	17,950	20,232	20,450
Securities	30,072	29,087	29,336	31,202	30,787	27,709	26,501	23,660	22,939	21,791
General government, excluding central government	6,514	6,314	6,403	6,137	6,380	6,410	6,410	6,575	6,575	6,575
Private sector	224,396	215,174	207,316	200,789	200,990	202,598	205,839	209,133	212,479	215,878
Non-financial corporations	100,711	96,630	91,508	86,100	88,193	90,047	91,636	93,063	94,335	95,573
Private individuals[2/]	123,685	118,544	115,808	114,689	112,797	112,551	114,203	116,070	118,144	120,305
Non-monetary financial institutions	43,414	41,081	37,697	36,863	38,547	37,705	37,705	37,986	37,799	37,830
Other assets	20,526	16,906	20,013	18,244	18,388	18,316	18,316	18,340	18,324	18,326
Liabilities	404,575	386,337	368,146	366,438	371,536	374,623	380,813	386,035	391,786	395,359
Liabilities to Bank of Portugal	32,503	29,616	25,450	25,604	24,836	24,091	23,368	22,667	21,987	21,327
Liabilities to non-residents	68,369	59,750	57,061	48,557	47,586	46,634	45,701	44,787	43,892	43,014
Liabilities to non-monetary resident sector	216,942	216,963	216,328	220,568	225,311	228,495	233,187	238,510	244,623	251,380
General government	12,741	11,545	9,475	10,247	8,647	7,447	6,647	5,847	5,847	5,847
Central government	9,120	6,667	4,151	5,182	3,788	3,263	2,912	2,562	2,562	2,562
General government, excluding central government	3,621	4,878	5,324	5,065	4,859	4,184	3,735	3,285	3,285	3,285
Private sector[2/]	163,138	168,061	172,185	177,083	181,906	187,050	192,542	198,412	204,694	211,423
Non-monetary financial institutions	41,062	37,358	34,668	33,239	34,757	33,998	33,998	34,251	34,083	34,111
Securities other than capital	27,577	20,792	12,946	12,895	13,282	13,680	14,091	14,513	14,949	15,397
Capital and reserves	59,184	59,216	56,362	58,814	60,522	61,723	64,466	65,557	66,335	64,240
					Money and Credit					
Broad money (M3)	147,174	153,193	167,000	179,603	185,694	191,121	196,377	201,588	206,924	212,159
Intermediate money (M2)	144,449	150,413	165,089	179,337	185,419	190,838	196,086	201,289	206,617	211,844
Narrow money (M1)	54,988	66,400	76,981	89,042	92,062	94,752	97,358	99,941	102,587	105,182
Private sector credit	224,396	215,174	207,316	200,789	200,990	202,598	205,839	209,133	212,479	215,878
Public sector credit	41,504	39,948	40,488	44,640	46,743	48,147	50,088	50,684	52,244	51,314
					(Percent of GDP)					
Broad money	85.0	85.2	90.0	93.0	92.6	92.1	91.7	91.2	90.8	90.3
Private sector credit	129.6	119.7	111.8	104.0	100.2	97.6	96.1	94.6	93.2	91.9
Public sector credit	24.0	22.2	21.8	23.1	23.3	23.2	23.4	22.9	22.9	21.8
					(Percentage change)					
Broad money	-0.4	4.1	9.0	7.5	3.4	2.9	2.8	2.7	2.6	2.5
Private sector credit	-8.0	-4.1	-3.7	-3.1	0.1	0.8	1.6	1.6	1.6	1.6
Public sector credit	7.3	-3.7	1.4	10.3	4.7	3.0	4.0	1.2	3.1	-1.8
Memorandum items:										
ECB access (Percent of assets)	8.0	7.7	6.9	7.0	6.7	6.4	6.1	5.9	5.6	5.4
Credit to deposits (Percent)	122.6	117.6	114.6	111.3	110.0	109.7	109.8	108.9	108.2	106.3
Loan to deposits (Percent)	105.4	100.6	96.7	93.5	92.7	94.0	94.9	95.5	95.4	94.3
Wholesale market funding (Percent of assets)[3/]	19.3	15.8	13.4	10.9	11.1	11.4	11.5	11.7	11.9	12.1

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, 2014–2023

(Billions of euros)

					Projections					
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Current and Capital account	2.5	2.3	3.0	2.7	3.8	3.9	3.5	1.7	0.0	-0.9
Current account	0.1	0.2	1.1	0.9	0.5	-0.1	-1.0	-1.9	-3.0	-3.4
Balance of goods and services	1.9	3.0	3.8	3.5	2.8	2.5	2.2	1.9	1.3	1.2
Trade balance	-9.5	-9.5	-9.6	-12.1	-14.5	-16.0	-17.3	-18.7	-20.4	-21.7
Exports fob	47.3	48.9	49.1	54.0	57.3	60.6	63.2	65.7	68.0	70.6
Imports fob	56.8	58.5	58.8	66.2	71.8	76.6	80.5	84.4	88.4	92.3
Services, net	11.4	12.5	13.5	15.6	17.3	18.4	19.5	20.6	21.7	22.8
Exports	23.4	25.2	26.7	30.3	33.2	35.3	37.3	39.4	41.6	43.9
Imports	12.0	12.6	13.3	14.7	15.8	16.8	17.9	18.9	20.0	21.0
Of which:										
Tourism	7.1	7.8	8.8	10.9	12.0	13.4	14.4	15.5	16.4	17.2
Exports	10.4	11.5	12.7	15.2	16.6	18.4	19.9	21.4	22.6	23.8
Imports	3.3	3.6	3.8	4.3	4.6	5.0	5.5	5.9	6.2	6.6
Primary income, net	-3.4	-4.3	-4.4	-4.9	-4.8	-5.4	-6.0	-6.3	-6.7	-6.9
Secondary income, net	1.6	1.6	1.6	2.2	2.4	2.8	2.8	2.6	2.4	2.3
Private remittances, net	3.0	3.2	3.3	3.8	3.9	3.9	4.0	4.1	4.1	4.2
Official transfers, net	-1.4	-1.6	-1.6	-1.6	-1.4	-1.2	-1.2	-1.5	-1.7	-1.9
Capital account	2.3	2.1	1.9	1.8	3.3	4.0	4.5	3.5	3.0	2.6
Financial account	2.7	2.3	3.0	3.1	3.8	3.9	3.5	1.7	0.0	-0.9
Direct investment	-2.7	-1.2	-3.2	-8.3	-6.9	-6.7	-6.2	-6.1	-5.9	-6.0
Direct investment assets	7.2	1.1	5.3	0.6	0.8	0.9	0.9	0.9	1.0	1.0
Direct investment liabilities	9.9	2.3	8.5	8.9	7.7	7.6	7.1	7.1	6.9	7.0
Portfolio investment, net	-1.4	0.1	15.5	9.3	4.7	4.0	3.3	0.2	-0.3	2.6
Financial derivatives	1.9	0.4	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment, net	3.1	1.5	-14.5	3.4	5.3	5.8	5.5	6.8	5.2	1.3
Reserve assets	1.7	1.5	4.7	-1.2	0.8	0.9	0.9	0.9	1.1	1.2
Errors and omissions	0.3	0.0	0.0	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:					(Percent GDP)					
Current and capital account	1.4	1.3	1.6	1.4	1.9	1.9	1.6	0.8	0.0	-0.4
Current account	0.1	0.1	0.6	0.5	0.2	-0.1	-0.5	-0.9	-1.3	-1.5
Of which: Balance of goods and services	1.1	1.7	2.1	1.8	1.4	1.2	1.0	0.9	0.6	0.5
Net international investment position[1]	-118.6	-113.2	-106.1	-105.7	-99.8	-94.6	-90.0	-86.5	-83.9	-81.8
Direct investment, net	-31.1	-31.2	-31.0	-35.7	-37.8	-39.8	-41.4	-42.9	-44.2	-45.5
Portfolio investment, net	-11.5	-10.4	0.2	2.2	4.4	6.2	7.5	7.4	7.0	7.9
Financial derivatives	-1.0	0.1	-0.1	-0.8	-0.8	-0.8	-0.8	-0.8	-0.7	-0.7
Other investment, net	-84.3	-81.6	-88.0	-82.6	-76.9	-71.5	-66.7	-61.6	-57.4	-55.2
Reserve assets	9.3	9.9	12.9	11.3	11.2	11.3	11.3	11.4	11.5	11.6

Sources: Bank of Portugal; and IMF staff projections.

1/ End-of-period data.

Table 5. Portugal: Selected Financial Indicators of the Banking System, 2013:Q1–2017:Q4 1/

(Percent)

	2013				2014				2015				2016				2017			
	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.
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	14.4	14.7	15.2
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	13.2	13.5	13.9
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	13.8	14.0	14.5
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	7.3	7.4	7.7
Asset composition and quality																				
Non-performing loans to total gross loans												17.5	17.9	17.9	17.6	17.2	16.4	15.5	14.6	13.3
Credit at risk 3/	10.4	10.5	11.1	10.6	10.8	11.2	11.9	11.9	12.3	12.7	12.9	12.0	12.2	12.7	12.6	11.8				
Sectoral distribution of loans																				
Residents	83.2	83.9	86.7	86.8	86.1	85.8	84.8	85.5	85.5	85.8	87.5	87.8	88.3	88.3	88.6	89.1	88.3	89.3	89.8	90.8
Nonresidents	16.8	16.1	13.3	13.2	13.9	14.2	15.2	14.5	14.5	14.2	12.5	12.2	11.7	11.7	11.4	10.9	11.7	10.7	10.2	9.2
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	0.3	0.4	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	3.9	4.7	3.4
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	50.4	50.5	47.3
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	62.2	70.4	64.5	64.4	57.6
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	10.9	10.7	10.5	10.2	10.7	11.5	12.8	12.9	14.0
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	15.7	15.4	15.4	14.9	15.5	17.2	19.0	19.0	28.3
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	95.3	94.4	93.6	94.0	92.6
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	3.6	3.3	3.3

Source: Bank of Portugal.

1/ The banking system data present a break in time series in 2014:Q3 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 June 30, 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 July 31 2014, was considered when determining the aggregate results of the banking system for 2014:Q3. 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 2015:Q3, which was adapted to be comparable with the latter data from ITS reporting framework (from 2015:Q4 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 2015:Q3). From 2015:Q4, 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, 2015–2023

(Percent of GDP, unless indicated)

	2015	2016	2017	Projections 2018	2019	2020	2021	2022	2023	Debt-stabilizing non-interest current account[6/]
Baseline: External debt	222.0	215.3	211.1	203.2	197.5	192.6	188.8	185.4	181.8	-0.9
Change in external debt	-13.9	-6.7	-4.2	-7.9	-5.7	-4.8	-3.8	-3.4	-3.6	
Identified external debt-creating flows (4+8+9)	-11.5	-7.1	-6.5	-3.3	-2.0	-1.3	-0.8	-0.5	-0.3	
Current account deficit, excluding interest payments	-5.0	-4.9	-4.4	-3.9	-3.5	-2.9	-2.9	-2.4	-2.3	
Deficit in balance of goods and services	-1.7	-2.1	-1.8	-1.4	-1.2	-1.0	-0.9	-0.6	-0.5	
Exports	41.2	40.9	43.7	45.1	46.2	46.9	47.6	48.1	48.7	
Imports	39.5	38.8	41.9	43.7	45.0	45.9	46.7	47.5	48.3	
Net non-debt creating capital inflows (negative)	-2.5	0.3	2.4	1.6	1.4	1.1	0.9	0.8	0.7	
Automatic debt dynamics[1/]	-4.0	-2.5	-4.5	-1.1	0.1	0.6	1.1	1.1	1.4	
Contribution from nominal interest rate	4.9	4.3	3.9	3.6	3.6	3.4	3.7	3.7	3.8	
Contribution from real GDP growth	-4.1	-3.5	-5.5	-4.7	-3.5	-2.9	-2.6	-2.6	-2.4	
Contribution from price and exchange rate changes[2/]	-4.7	-3.3	-2.9	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3)[3/]	-2.4	0.4	2.2	-4.5	-3.7	-3.5	-3.0	-2.9	-3.3	
External debt-to-exports ratio (Percent)	538.9	526.6	483.3	450.4	427.4	410.4	396.9	385.3	373.0	
Gross external financing need (Billions of Euros)[4/]	165.2	163.4	177.4	187.9	189.3	192.2	197.9	200.3	186.2	
Percent of GDP	91.9	88.1	91.9	93.6	91.2	89.7	89.5	87.9	79.3	
Scenario with key variables at their historical averages[5/]				203.2	202.2	201.6	201.4	201.2	200.3	4.2
Key Macroeconomic Assumptions Underlying Baseline										
Real GDP growth (Percent)	1.8	1.6	2.7	2.3	1.8	1.5	1.4	1.4	1.3	
GDP deflator in Euros (Percent)	2.0	1.5	1.4	1.6	1.6	1.7	1.7	1.7	1.7	
Nominal external interest rate (Percent)	2.1	2.0	1.9	1.8	1.8	1.8	2.0	2.0	2.1	
Growth of exports (Euros, percent)	4.7	2.4	11.2	7.4	5.9	4.9	4.5	4.4	4.4	
Growth of imports (Euros, percent)	3.3	1.3	12.2	8.5	6.5	5.3	4.9	5.0	4.6	
Current account balance, excluding interest payments	5.0	4.9	4.4	3.9	3.5	2.9	2.9	2.4	2.3	
Net non-debt creating capital inflows	2.5	-0.3	-2.4	-1.6	-1.4	-1.1	-0.9	-0.8	-0.7	

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, 2014–2023 [1/]

(Millions of SDR, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Disbursements	1,563	...	...	...	...	...	...	...	...	...
(Percent of quota)	152	...	...	...	...	...	...	...	...	...
(Projected debt service to the Fund, based on existing and prospective drawings)										
Total	716	7,263	4,065	8,608	797	79	79	1,624	1,574	661
Interest and charges	716	684	505	376	89	79	79	76	38	13
Repayments	0	6,579	3,560	8,232	708	0	0	1,548	1,536	649
Total debt service, in percent of										
Exports of goods and services	1.2	12.4	6.7	12.5	1.1	0.1	0.1	1.9	1.7	0.7
GDP	0.5	5.1	2.8	5.5	0.5	0.0	0.0	0.9	0.8	0.3
(Projected level of credit outstanding based on existing and prospective drawings)										
Outstanding stock	22,942	16,363	12,803	4,571	3,863	3,863	3,863	2,315	779	130
Percent of quota [2/]	2,228.0	1,589.1	621.5	221.9	187.5	187.5	187.5	112.4	37.8	6.3
Percent of GDP	15.7	11.6	8.8	2.8	2.3	2.2	2.1	1.2	0.4	0.1
Memorandum Items (Billions of SDR)										
Exports of goods and services	62	58	60	69	75	79	84	88	91	95
GDP	151	142	148	157	168	173	180	185	193	200

Source: IMF staff estimates.

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

[2/] Quota Increase in 2016.

Table 8. Portugal: General Government Financing Requirements and Sources 1/

(Billions of euros)

	2015	2016	2017	2018	2019	2020	2021	2022	2023
Gross borrowing need	58.9	40.0	39.5	27.0	29.7	28.8	37.5	32.3	29.0
Overall balance	7.7	3.7	5.7	1.4	0.6	0.3	0.1	-0.5	-0.4
Amortization	49.4	35.8	35.2	25.1	28.6	28.0	36.9	32.3	28.9
Medium- and long-term	28.3	20.7	10.1	8.8	13.7	13.0	20.2	15.5	13.2
Residents	18.7	12.0	0.6	2.2	7.6	7.0	13.9	11.7	7.7
Non-residents	9.6	8.7	9.5	6.6	6.1	6.0	6.3	3.8	5.5
Short-term1/	12.7	10.5	15.0	15.4	15.0	15.0	15.0	15.0	15.0
Residents	9.6	6.8	10.2	10.3	10.0	10.0	10.0	10.0	10.0
Non-residents	3.1	3.7	4.8	5.1	5.0	5.0	5.0	5.0	5.0
EU and IMF2/	8.4	4.5	10.1	0.8	0.0	0.0	1.8	1.8	0.8
Other (Net)3/	1.8	0.6	-1.4	0.5	0.5	0.5	0.5	0.5	0.5
Gross financing sources	58.9	39.9	39.7	27.0	29.7	28.8	37.5	32.3	29.0
Privatization receipts	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Market access	55.8	44.4	37.1	24.9	29.4	31.4	32.5	31.3	29.0
Medium- and long-term	45.3	29.5	22.2	9.9	14.5	16.4	17.6	16.3	14.0
Residents	15.7	9.5	8.6	4.1	7.2	6.7	9.4	7.9	5.9
Non-residents	29.6	19.9	13.6	5.8	7.3	9.8	8.1	8.4	8.2
Short-term1/	10.5	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0
Residents	6.8	10.2	10.3	10.0	10.0	10.0	10.0	10.0	10.0
Non-residents	3.7	4.8	4.7	5.0	5.0	5.0	5.0	5.0	5.0
Use of deposits	3.1	-4.5	2.6	2.1	0.3	-2.6	5.0	1.0	0.0
Net placement (Market access-amortization)	6.4	8.6	2.0	-0.2	0.8	3.4	-4.4	-1.0	0.1
Residents	-10.0	-1.5	3.0	1.2	-0.4	-0.3	-4.9	-4.3	-2.0
Medium- and long-term	-7.3	-4.8	2.9	1.5	-0.4	-0.3	-4.9	-4.3	-2.0
Short-term (Net increase)	-2.7	3.3	0.1	-0.3	0.0	0.0	0.0	0.0	0.0
Non-residents	16.4	10.1	-1.0	-1.3	1.2	3.8	0.5	3.3	2.1
Medium- and long-term	15.8	9.0	-0.9	-1.2	1.2	3.8	0.5	3.3	2.1
Short-term (Net increase)	0.6	1.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0

Source: Portuguese authorities and IMF staff estimates.

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

2/ For EFSF loans, outstanding loans are assumed to be rolled over for an additional seven years, as agreed with the EU.

3/ 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.

Table 9. Portugal: External Financing Requirements and Sources

(Billions of euros, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
					Projections					
Gross financing requirements	174.4	168.0	169.1	192.7	188.7	188.9	191.7	197.6	200.2	186.3
Current account deficit	-0.1	-0.2	-1.1	-0.9	-0.5	0.1	1.0	1.9	3.0	3.4
Medium- and long-term debt amortization	42.2	24.7	24.8	27.3	31.3	32.2	34.5	38.0	39.6	26.3
Public sector	23.4	9.6	8.7	9.5	6.2	5.7	5.6	5.9	3.4	5.2
Banks	16.9	13.2	14.1	15.6	19.7	19.9	20.2	20.5	20.8	21.0
Other private	1.9	1.9	2.0	2.2	5.4	6.5	8.7	11.6	15.4	0.0
Short-term debt amortization	132.4	135.2	140.9	156.2	157.0	156.6	156.2	155.9	155.8	155.8
Public sector	78.9	79.2	88.3	103.1	111.4	110.9	110.2	109.5	108.8	108.1
Central Bank	77.0	74.1	82.3	95.8	106.7	105.9	105.2	104.5	103.8	103.1
General government and SOEs	1.9	5.1	6.0	7.3	4.7	5.0	5.0	5.0	5.0	5.0
Banks	39.8	40.1	35.9	36.9	28.8	30.6	32.4	34.2	36.0	37.8
Other private	13.7	15.9	16.7	16.3	16.8	15.1	13.6	12.2	11.0	9.9
EU and IMF[1/]	0.0	8.3	4.5	10.1	0.8	0.0	0.0	1.8	1.8	0.8
Sources of financing	169.2	168.0	169.1	192.7	188.7	188.9	191.7	197.6	200.2	186.3
Capital account (Net)	2.3	2.1	1.9	1.8	3.3	4.0	4.5	3.5	3.0	2.6
Foreign direct investment (Net)	-2.7	-1.2	-3.2	-8.3	-6.9	-6.7	-6.2	-6.1	-5.9	-6.0
Inward	9.9	2.3	8.5	8.9	7.7	7.6	7.1	7.1	6.9	7.0
New borrowing and debt rollover	168.4	173.2	183.4	187.9	189.4	190.9	193.7	200.2	202.6	192.1
Medium and long-term borrowing	33.2	34.6	29.7	30.9	32.8	34.7	37.8	44.5	46.7	35.6
General government	19.7	29.6	19.5	10.6	6.3	6.9	7.5	11.0	9.2	8.2
Banks	12.8	3.5	7.4	19.0	21.0	21.3	21.6	21.9	22.1	27.4
Other private	0.8	1.6	2.8	1.3	5.4	6.5	8.7	11.6	15.4	0.0
Short-term borrowing	135.2	138.6	153.7	157.0	156.6	156.2	155.9	155.8	155.8	156.5
Public sector	79.2	86.0	100.6	111.4	110.9	110.2	109.5	108.8	108.1	108.1
Central bank	74.1	82.3	95.8	106.7	105.9	105.2	104.5	103.8	103.1	103.1
Of which: ECB access	31.2	26.2	22.4	22.1	21.4	20.6	19.9	19.2	18.5	17.9
General government	5.1	3.7	4.8	4.7	5.0	5.0	5.0	5.0	5.0	5.0
Banks	40.1	35.9	36.9	28.8	30.6	32.4	34.2	36.0	37.8	39.5
Other private	15.9	16.7	16.3	16.8	15.1	13.6	12.2	11.0	9.9	8.9
Other (Includes asset operations)	1.1	-6.1	-12.9	11.3	2.8	0.8	-0.3	-0.1	0.6	-2.4
Of which: Net errors and omissions	0.3	0.0	0.0	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Rollover rates										
General government	98.1	226.9	165.4	91.2	103.3	111.0	117.8	147.1	167.9	128.5
Private	96.3	81.1	92.2	92.9	102.0	102.3	102.4	102.5	102.5	110.3
Banks	93.2	74.0	88.5	91.1	106.4	106.2	106.0	105.8	105.6	113.7
Other private	107.3	102.2	102.1	97.9	92.4	93.0	93.9	94.9	95.8	90.0

Sources: Bank of Portugal and IMF staff estimates.

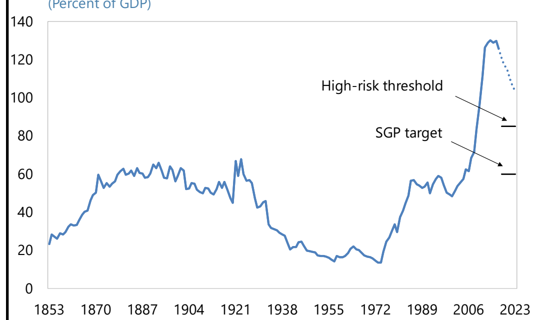
[1/] For EFSF loans, outstanding loans are assumed to be rolled over for an additional seven years, as agreed with the EU.

Annex I. Public Debt Sustainability Analysis (DSA)

Portugal's debt remains high and vulnerable to a range of macroeconomic and financial shocks. Nevertheless, a return to growth, an improvement in the structural balance and a reduction in risks from the banking sector have led to an improvement in market sentiment. The marginal cost of borrowing has fallen significantly in recent years and S&P and Fitch have upgraded Portugal to investment status. In the baseline scenario, public debt is projected to decline from 126 percent of GDP in 2017 to 103 percent in 2023. However, while debt appears to be on a downward trajectory, risks will remain high over the medium term until levels normalize. In this regard, further effort to gradually raise the structural primary balance is required to build resilience and create policy space if adverse shocks materialize.

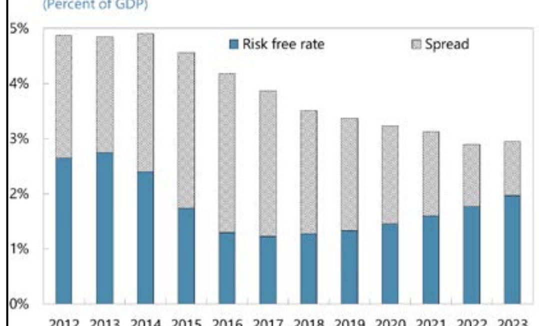
A. Baseline Scenario

1. **Debt in 2017 remains elevated at 126 percent of GDP, but has continued its downward trajectory and is now below its 2012 level.** Debt fell by 4.2 percentage points of GDP in 2017. The primary driver of this fall was real GDP growth, which reached its highest level since 2000, at 2.7 percent. The primary balance, at 0.9 percent of GDP, was smaller than the previous year, reflecting the impact of the recapitalization of CGD, which masked an underlying improvement. A decline in the interest rate bill and the use of cash deposits also contributed to the fall in debt. Despite these positive dynamics, the stock of debt remains very high, and well above the 85 percent of GDP high-risk threshold for the market access (MAC) DSA and the 60 percent of GDP target mandated in the Stability and Growth Pact.



Sources: IMF and staff calculations.

2. **Debt is expected to decline by 22 percent of GDP over the next six years, reaching 103 percent by 2023.** The primary driver of this reduction is expected to be from the primary balance — reducing debt by a cumulative 19 percentage points of GDP, under the assumption that the structural primary balance will remain broadly constant at its 2018 level over the forecast horizon. Real GDP growth is expected to reduce debt ratios by a cumulative 11 percentage points of GDP. The interest bill will put upward pressure on debt, but the size of this effect is expected to decline from 3.9 percent of GDP in 2017 to 2.9 percent in 2023. While the 'risk-free' rate is expected to rise as monetary conditions normalize, the fall in Portugal's spread and its declining debt stock will dominate, leading to an overall decline in interest payments (Box A1).

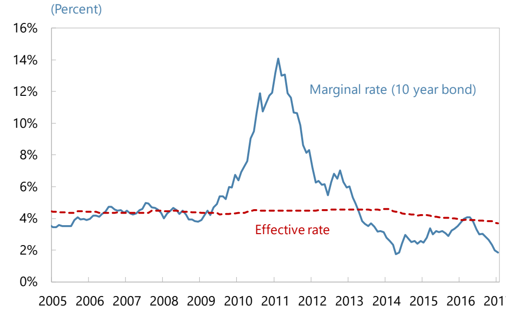


Source: Ministry of Finance, Dealogic, and staff calacULATIONS.

Box A1: Projecting the Structural and Cyclical Component of the Interest Bill

At the peak of the crisis, the yield on 10-year debt reached over 17 percent. Since then, borrowing costs have fallen dramatically. This decline can be attributed to strong policy action, including fiscal consolidation and pro-growth structural reforms, as well as support from the official sector. However, despite this spike in the marginal cost of borrowing, the effective interest rate on the stock of medium-to-long term (MLT) bonds remained relatively stable, largely due to the program support provided by the official sector. More recently, there has also been a steady decline in borrowing costs across Europe, with 10-year German Bunds around zero since 2015. This combination of a lower 'risk-free' rate and a declining spread, has led to a steady reduction in Portugal's effective interest rate since the 2015.

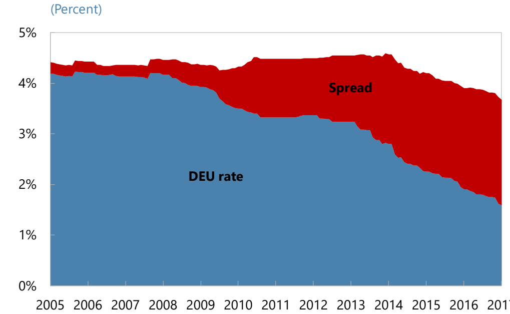
Interest Rate on MLT Bonds
(Percent)



Sources: Bloomberg, Dealogic and staff caclulations.

Using bond-level data, the effective interest rate can be separated into the 'risk-free' component and the spread. The former can be viewed as being largely driven by cyclical factors, in particular monetary policy; while the latter can be viewed as the structural component, driven primarily by credit risk. This shows that the cyclical component has fallen significantly over the last 10-years and is the primary driver of the recent decline of the effective interest rate. Improvements in the marginal cost of borrowing arising from declines in spreads will take some time to influence the effective interest rate.

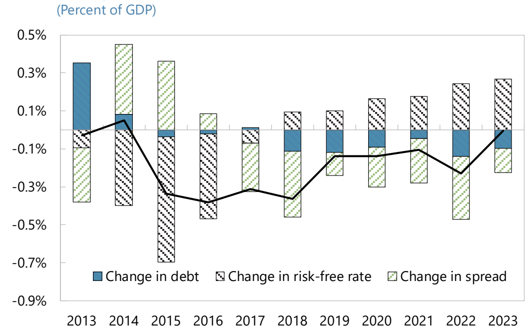
Effective Interest Rate on MLT Bonds
(Percent)



Sources: Dealogic and staff caclulations.

Looking ahead, the marginal cost of borrowing is likely to increase as monetary conditions normalize, with both the 'risk-free' rate and the spread increasing. Nevertheless, a falling debt stock, the early repayment of IMF credit and the steady amortization of previously accumulated high-yield debt will put downward pressure on the interest rate bill. The net effect will be a sustained decline in interest payments, from 3.9 percent of GDP in 2017 to 2.9 percent in 2023. This decline can be attributed to the dominance of structural drivers – the pass-through of lower spreads in new debt issuances and the steady decline in the debt stock.

Change in the Interest Bill
(Percent of GDP)



Sources: Ministry of Finance, Dealogic, and staff calculations.

B. Risk Assessment

3. Portugal's elevated debt burden leaves it highly vulnerable to a range of macroeconomic and financial sector shocks. Debt will exceed the high-risk threshold for market access countries (85 percent of GDP) throughout the forecast horizon (Figure 1). Government gross financing needs (GFN) are expected to remain below the equivalent high-risk threshold of 20 percent of GDP; although in 2021, the current amortization profile implies a spike to 17 percent. Market perception of debt vulnerabilities is favorable, and the risks from short-term debt and the stock of debt held by non-residents is assessed to be low. Nevertheless, a total economy external financing requirement of 50 percent of GDP leaves Portugal vulnerable to external conditions.

4. Risks are skewed to higher debt. At such high debt levels, relatively minor negative shocks to the main drivers of debt, or a deterioration in global risk sentiment, can lead to a loss of confidence and adverse equilibria. This can be seen from the asymmetric fan-chart in Figure 1. This suggests that further effort to gradually raise the structural primary balance would build resilience and create policy space, if adverse shocks materialize.

C. Realism of Baseline Assumptions and Alternative Scenarios

5. The baseline assumes a largely unchanged fiscal stance after 2018. Following a minor expected loosening in 2018, the structural primary balance is expected to remain essentially constant at around three percent of GDP for the rest of the forecast, significantly above the level needed to stabilize debt (-0.2 percent). While maintaining this fiscal stance is achievable when compared against historical experience (Figure 2), the authorities should resist pressure to roll-back past efforts, now that the crisis period has ended. Continued growth, converging to potential (1.4 percent), is an important driver of the declining debt trajectory. If growth were to disappoint, perhaps due to a reversal of structural reforms or weaker external conditions, then this could stall the debt reduction process (Figures 4 and 5).

6. The authorities' medium-term fiscal strategy under the Stability Program 2018– 2022 envisages a reduction in public debt to 102 percent of GDP by 2022. This compares to 107 percent of GDP in the staff baseline. However, the authorities' projection is based on an ambitious fiscal adjustment, which has yet to be linked to specific policy measures. The Stability Program assumes average real GDP growth of 2.2 percent in 2018–22, as opposed to staff's baseline projection of 1.6 percent over the same period.

D. Stress Test

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

i. A *growth shock* of -2.3 percent (one-standard deviation of historical growth) applied in 2019 and 2020, would increase debt to 124 percent of GDP, 11 percent of GDP above the baseline.

ii. A *primary balance shock* of -1.7 percent of GDP (1/2 standard deviation of historical changes) applied in 2019 and 2020, would increase debt to 117 percent of GDP in 2020, 4 percent of GDP above the baseline.

iii. An *interest rate shock* of 350bps over 2018-23 would lead to a gradual deterioration of the debt position, leaving it 3 percent of GDP higher than the baseline by 2023.

iv. A standard *contingent liability shock*, equal to 10 percent of GDP, would raise debt by an equivalent amount across the forecast period. Such a shock also has the potential destabilize interest rates, which could have second round effects on growth and debt, although these factors are not modelled here.

v. A *severe combined shock* that incorporates the macro-fiscal and contingent liabilities adverse scenarios mentioned above would significantly affect the country's debt dynamics, raising debt above 130 percent of GDP, where it would remain largely unchanged.

vi. An *upside shock*, where the authorities achieve the overall balance envisaged under the Stability Program (but with all other assumptions unchanged), would lead to debt of 99 percent of GDP by 2023, 4 percent of GDP below the baseline.

Box A2: Contingent Liabilities Associated with the Novo Banco Sale

While the sale of Novo Banco to Lone Star in October 2017 prevented its resolution, the terms of the sale included a Contingent Capital Agreement that is expected to impact the public finances.

After the completion of the sale, the Portuguese Resolution Fund retained control of 25 percent of Novo Banco's shares, but remained exposed to a large portfolio of specific troubled assets in the bank's balance sheet. Under the terms of sale, the Resolution Fund would have to compensate Novo Banco for recognized losses in this portfolio of assets, to the extent that such losses may cause Novo Banco's capital ratios to decline below predefined thresholds. The cumulative limit to such compensation payments was set at €3.89 billion (2 percent of 2017 GDP), over a period of eight years. Separately, the government agreed to give the Resolution Fund access to loans from the Portuguese Treasury to help finance such payments (the Resolution Fund was expected to finance at least a fraction of the payments with resources of its own). The payments themselves (not the loans) are classified as government spending, given the sectorization of the Resolution Fund.

The results for 2017 presented by Novo Banco in March shows a loss of nearly €1.4 billion, driven by impairments of €2 billion, most of which are related to the assets covered by the contingent capital agreement. In view of the effect on capital of those losses, the Resolution Fund made a payment to Novo Banco for €792 million (0.4 percent of GDP) to restore the bank's capital ratio to the predefined level. The Resolution Fund borrowed about €430 million from the government to finance part of this payment.

The fact that Novo Banco moved aggressively with this first wave of impairments already in the last quarter of 2017 has convinced analysts that further payments arising from qualifying capital losses related to additional impairments should be expected in the future.

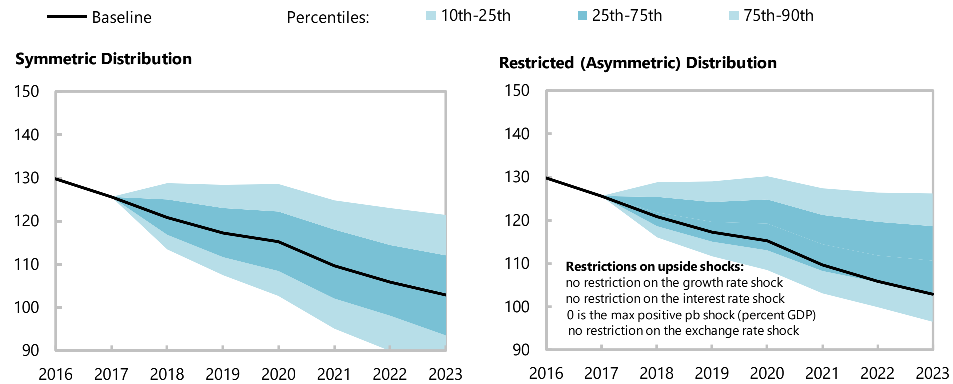
Figure 1. Portugal Public DSA Risk Assessment, 2016–2023

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

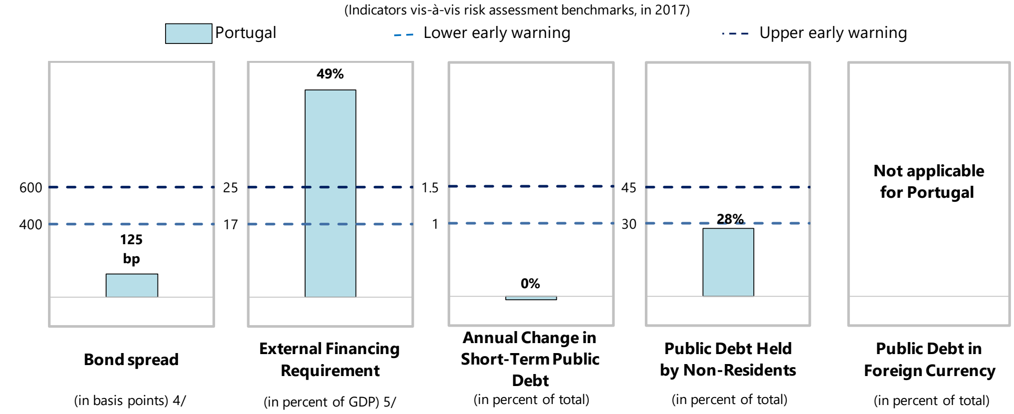
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2017)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85 percent 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, and white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20 percent 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, and white if stress test is not relevant.

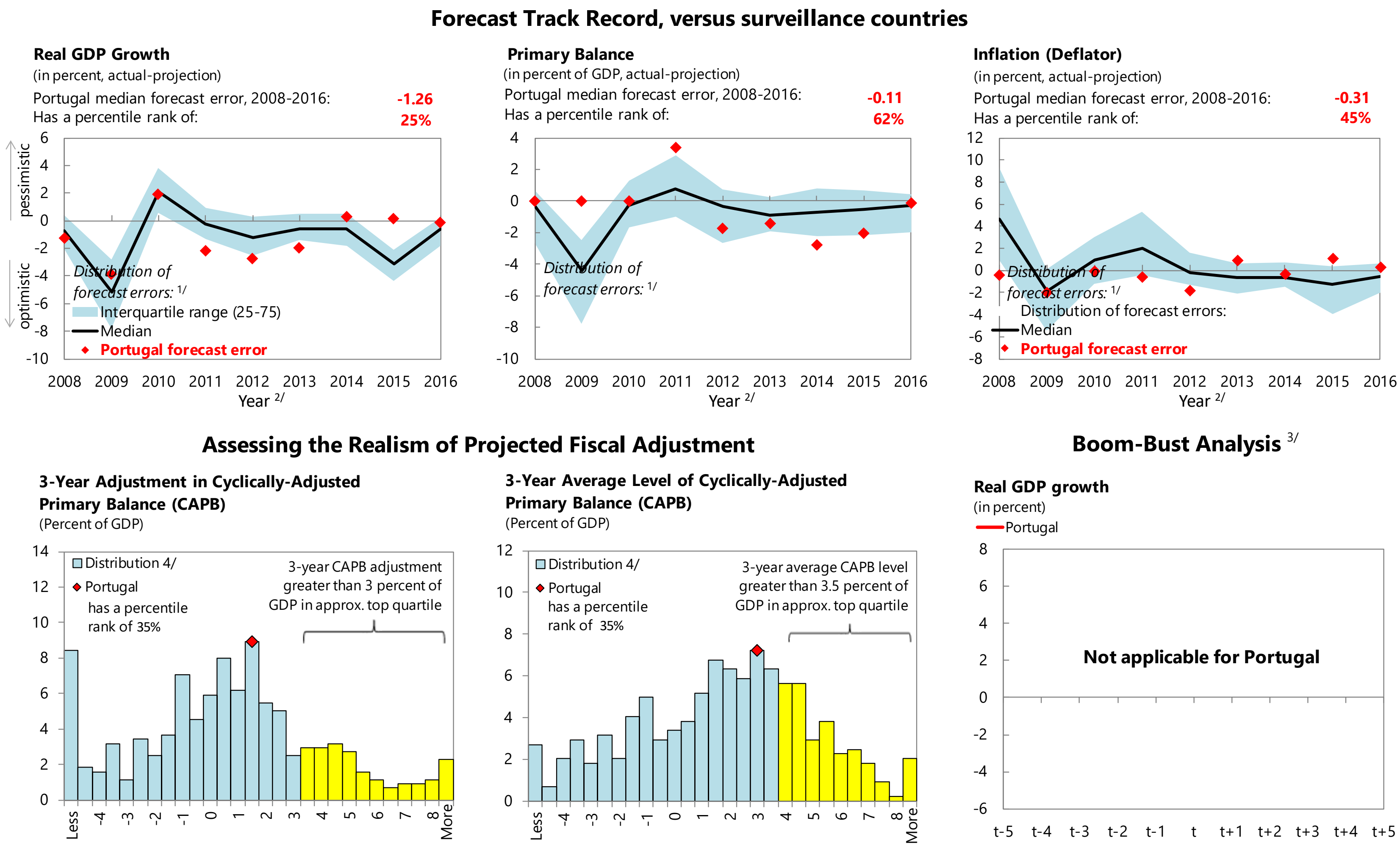
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, 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 three months, January 11, 2018 through April 11, 2018.

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



Source : IMF Staff.

1/ Plotted distribution includes surveillance 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 obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 3. Portugal Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario, 2007–2023

(in percent of GDP unless otherwise indicated)

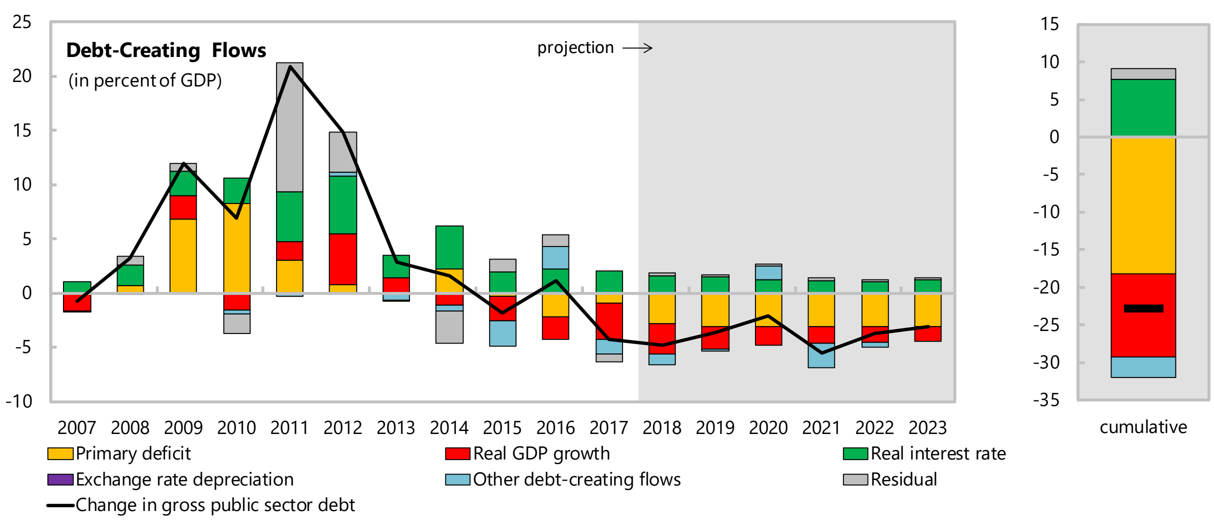
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2007-2015 [2/]	2016	2017	2018	2019	2020	2021	2022	2023
Nominal gross public debt	104.5	129.9	125.7	120.9	117.3	115.2	109.6	105.9	102.8
Public gross financing needs	25.1	21.3	21.2	13.0	13.9	13.0	16.6	13.8	11.5
Real GDP growth (in percent)	-0.3	1.6	2.7	2.3	1.8	1.5	1.4	1.4	1.4
Inflation (GDP deflator, in percent)	1.2	1.5	1.4	1.6	1.6	1.7	1.7	1.7	1.6
Nominal GDP growth (in percent)	0.9	3.2	4.1	3.9	3.4	3.3	3.2	3.1	3.0
Effective interest rate (in percent) [4/]	4.1	3.4	3.1	2.9	2.9	2.8	2.8	2.7	2.8

As of April 11, 2018		
Sovereign Spreads		
EMBIG (bp) 3/		119
5Y CDS (bp)		73
Ratings	Foreign	Local
Moody's	Ba1	Ba1
S&Ps	BBB-	BBB-
Fitch	BBB	BBB

Contribution to Changes in Public Debt

	Actual			Projections							
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	6.6	1.1	4.2	-4.8	-3.6	-2.1	-5.5	-3.8	-3.1	-22.8	
Identified debt-creating flows	5.1	0.1	-3.5	-5.0	-3.8	-2.3	-5.7	-4.0	-3.3	-24.2	
Primary deficit	2.4	-2.2	-0.9	-2.8	-3.1	-3.1	-3.1	-3.1	-3.1	-18.2	-0.2
Primary (noninterest) revenue and grants	42.6	43.0	42.9	43.2	43.3	43.3	43.2	43.2	43.2	259.5	
Primary (noninterest) expenditure	45.0	40.8	42.0	40.4	40.2	40.2	40.2	40.1	40.1	241.3	
Automatic debt dynamics [5/]	3.2	0.2	-1.3	-1.2	-0.6	-0.5	-0.4	-0.5	-0.2	-3.3	
Interest rate/growth differential [6/]	3.2	0.2	-1.3	-1.2	-0.6	-0.5	-0.4	-0.5	-0.2	-3.3	
Of which: real interest rate	2.8	2.3	2.1	1.6	1.5	1.2	1.2	1.0	1.2	7.7	
Of which: real GDP growth	0.4	-2.0	-3.3	-2.8	-2.1	-1.7	-1.6	-1.5	-1.4	-11.0	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.4	2.1	-1.3	-1.0	-0.1	1.2	-2.3	-0.4	0.0	-2.7	
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	-0.1	2.1	-1.3	-1.0	-0.1	1.2	-2.3	-0.4	0.0	-2.7	
Residual, including asset changes [8/]	1.5	1.0	-0.7	0.2	0.2	0.2	0.2	0.2	0.2	1.4	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = 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 numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

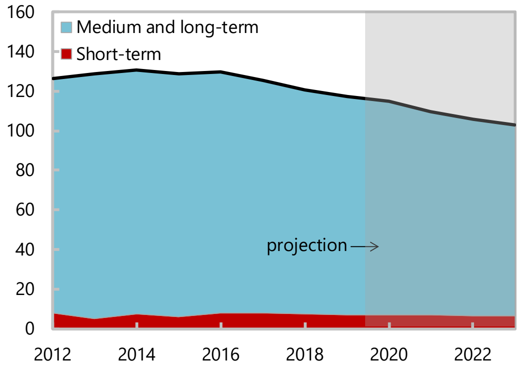
8/ Includes asset changes and interest revenues (if any). In 2017, includes the recapitalization of CGD. For projections, includes exchange rate changes during the projection period.

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.

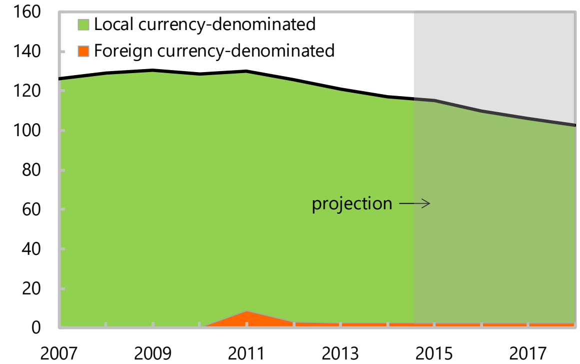
Figure 4. Portugal Public DSA - Composition of Public Debt and Alternative Scenarios, 2012–2023

Composition of Public Debt

By Maturity
(in percent of GDP)



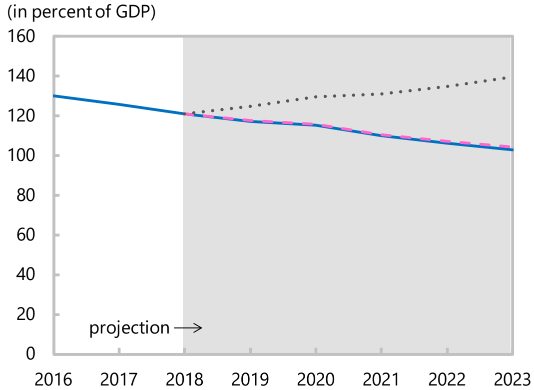
By Currency
(in percent of GDP)



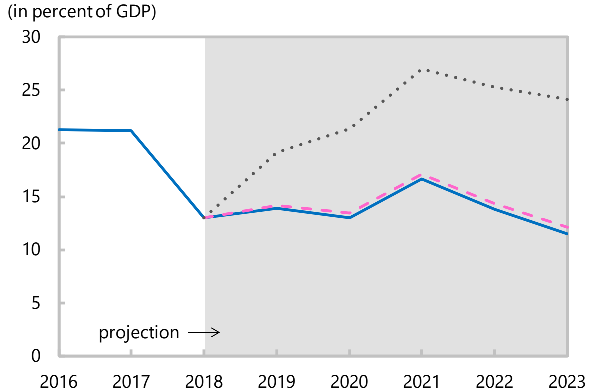
Alternative Scenarios

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)

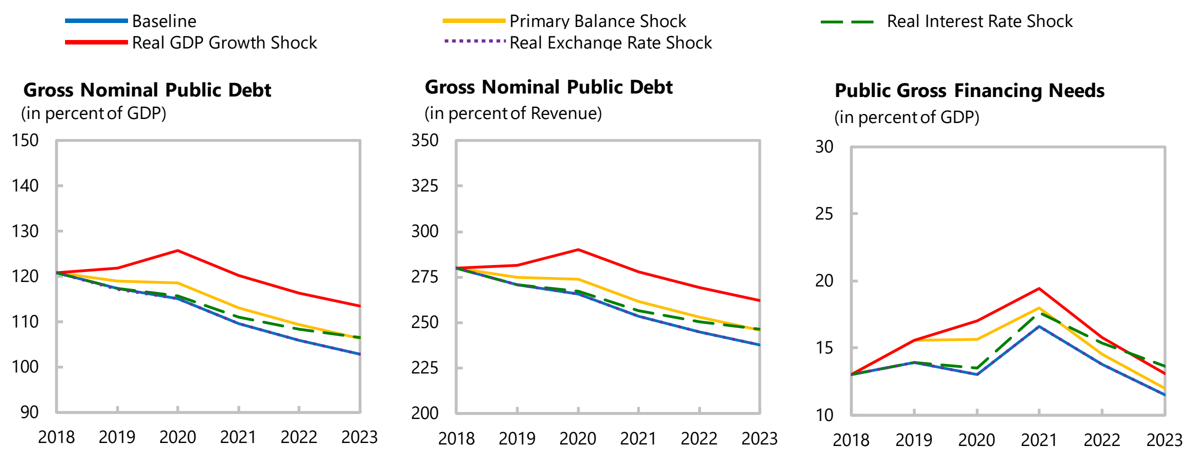
Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	2.3	1.8	1.5	1.4	1.4	1.4
Inflation	1.6	1.6	1.7	1.7	1.7	1.6
Primary Balance	2.8	3.1	3.1	3.1	3.1	3.1
Effective interest rate	2.9	2.9	2.8	2.8	2.7	2.8
Constant Primary Balance Scenario						
Real GDP growth	2.3	1.8	1.5	1.4	1.4	1.4
Inflation	1.6	1.6	1.7	1.7	1.7	1.6
Primary Balance	2.8	2.8	2.8	2.8	2.8	2.8
Effective interest rate	2.9	2.9	2.8	2.8	2.7	2.8

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	2.3	-0.1	-0.1	-0.1	-0.1	-0.1
Inflation	1.6	1.6	1.7	1.7	1.7	1.6
Primary Balance	2.8	-1.8	-1.8	-1.8	-1.8	-1.8
Effective interest rate	2.9	2.9	3.0	3.1	3.2	3.5

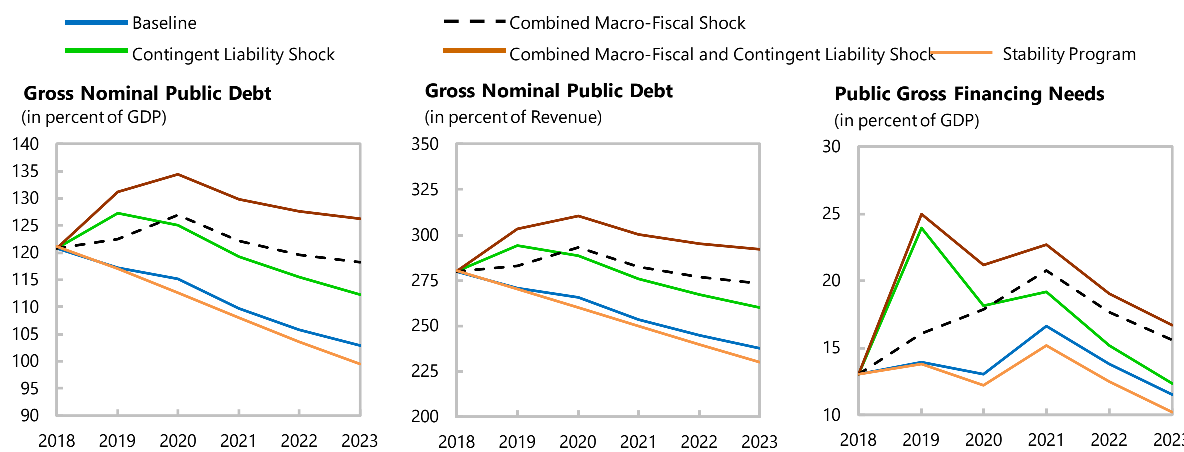
Source: IMF staff.

Figure 5. Portugal Public DSA - Stress Tests, 2018–2023

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2018	2019	2020	2021	2022	2023
Real GDP growth	2.3	1.8	1.5	1.4	1.4	1.4
Inflation	1.6	1.6	1.7	1.7	1.7	1.6
Primary balance	2.8	1.4	1.4	3.1	3.1	3.1
Effective interest rate	2.9	2.9	2.9	2.9	2.8	2.9
Real Interest Rate Shock						
Real GDP growth	2.3	1.8	1.5	1.4	1.4	1.4
Inflation	1.6	1.6	1.7	1.7	1.7	1.6
Primary balance	2.8	3.1	3.1	3.1	3.1	3.1
Effective interest rate	2.9	2.9	3.3	3.5	3.7	4.1
Combined Shock						
Real GDP growth	2.3	-0.5	-0.8	1.4	1.4	1.4
Inflation	1.6	1.0	1.2	1.7	1.7	1.6
Primary balance	2.8	1.4	0.7	3.1	3.1	3.1
Effective interest rate	2.9	2.9	3.3	3.6	3.8	4.2
Contingent Liability Shock						
Real GDP growth	2.3	1.8	1.5	1.4	1.4	1.4
Inflation	1.6	1.6	1.7	1.7	1.7	1.6
Primary balance	2.8	-6.9	3.1	3.1	3.1	3.1
Effective interest rate	2.9	2.9	2.7	2.7	2.7	2.8

Real GDP Growth Shock	2018	2019	2020	2021	2022	2023
Real GDP growth	2.3	-0.5	-0.8	1.4	1.4	1.4
Inflation	1.6	1.0	1.2	1.7	1.7	1.6
Primary balance	2.8	1.9	0.7	3.1	3.1	3.1
Effective interest rate	2.9	2.9	2.9	2.9	2.8	2.9
Real Exchange Rate Shock						
Real GDP growth	2.3	1.8	1.5	1.4	1.4	1.4
Inflation	1.6	1.7	1.7	1.7	1.7	1.6
Primary balance	2.8	3.1	3.1	3.1	3.1	3.1
Effective interest rate	2.9	2.9	2.8	2.8	2.7	2.8
Combined Macro-Fiscal and Contingent Liability Shock						
Real GDP growth	2.3	-0.5	-0.8	1.4	1.4	1.4
Inflation	1.6	1.0	1.2	1.7	1.7	1.6
Primary balance	2.8	-7.5	2.4	3.1	3.1	3.1
Effective interest rate	2.9	2.9	3.4	3.7	3.9	4.3

Source: IMF staff.

Annex II. Risk Assessment Matrix [1/]

Source of Risks	Relative Likelihood	Impact	Policy response
Loss of investor confidence. Weaker structural and fiscal policy efforts, and reform reversals, or other negative surprises, potentially including difficulties in the banking system.	Low	**High** Increase in sovereign bonds yields and reduction in foreign direct investment. Significant funding distress, higher public and private borrowing costs.	Strengthen policy buffers and avoid backtracking on reforms. Continue to implement policies that support growth, lasting fiscal adjustment, and a strong banking system, to foster investor confidence, and favorable financing conditions.
Rising protectionism and retreat from multilateralism. Global imbalances and fraying consensus about the benefits of globalization lead to escalating and sustained trade actions and spreading isolationism. This threatens the global trade system, regional integration, labor mobility, as well as global and regional policy and regulatory collaboration. In the short term, increased uncertainty about growth triggered by escalating trade tensions leads to increased financial market volatility. Negative consequences for growth are, in turn, exacerbated by adverse changes in market sentiment and investment.	High	**High** Weaker economic environment and expectations would have broad negative effects for a small open economy like Portugal, both for the near-term upswing, and for medium-term growth prospects.	Stronger macro-financial and structural policies to support investment, sentiment, growth, and resilience of the economy.
Weaker-than-expected global growth. Euro Area: Progress on fiscal adjustment, on addressing legacy banking-sector problems, and on other structural reforms slows or reverses, raising debt sustainability concerns, steadily pushing up borrowing costs, and undermining medium-term growth prospects.	Medium	**High** Lower growth and investment would imperil debt dynamics in all sectors. With the euro area accounting for 60 percent of total exports, the current account balance and IIP would be at risk	Step up structural reforms to improve competitiveness and reduce indebtedness. Step up efforts to clean up corporate and bank balance sheets, to minimize drag on investment and growth.
Policy and geopolitical uncertainties: **Intensification of the risks of fragmentation/security dislocation** in parts of the Middle East, Africa, Asia, and Europe, leading to socio-economic and political disruptions.	Medium	**High** Escalation of euro skepticism, leading to less cooperation and a reversal of integration.	Accelerate structural reforms to support investment and growth.

Unsustainable macroeconomic policies. Policies in systemically important countries to boost near-term activity beyond sustainable levels (due to domestic political pressures or in response to external policy spillovers) exacerbate underlying vulnerabilities and, in some cases, backfire by hurting confidence and global growth.	Medium	High As a result of spillovers from developments abroad, an abrupt rise in sovereign yields in Portugal could jeopardize growth prospects and impact the fiscal accounts and the banking system negatively.	Step up efforts to clean up corporate and bank balance sheets. Strengthen policy buffers and avoid backtracking on reforms to prevent contagion and decouple Portuguese yields from movements in other European yields.
Sharp tightening of global financial conditions causes higher debt service and refinancing risks; stress on leveraged firms, households, and vulnerable sovereigns; capital account pressures; and a broad-based downturn. Tighter financial conditions could be triggered by a sharper-than-expected increase in U.S. interest rates (prompted by higher-than-expected inflation) or the materialization of other risks.	High	High Less favorable financial conditions and potentially wider spreads as global conditions tighten would affect highly leveraged firms and households as short-term and variable-rate loans are repriced, and could weaken banks' balance sheets.	Step up efforts to implement policies that support growth, lasting fiscal adjustment, continued balance sheet clean-up, and a strong banking system, which would contribute to shoring up investor confidence, and ease financing conditions and restraints.

1/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).

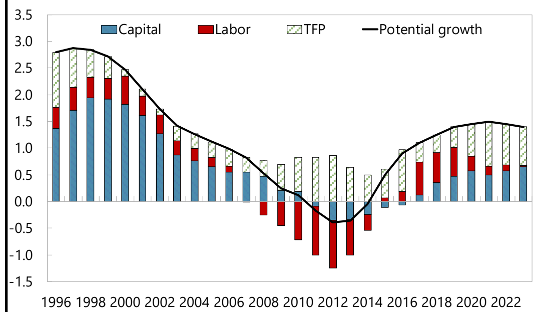
Annex III. External Sector Assessment

		Overall Assessment
Foreign asset and liability position and trajectory	**Background.** The negative net international investment position (NIIP) declined from its peak in 2014 of 118 percent of GDP to about 106 percent of GDP at the end of 2017. This improvement has been driven by positive current account balances following the large adjustment during the crisis, but offset by improving external debt valuations. Gross external debt remains high at 211 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, but Portugal remains exposed to a loss in confidence by external investors.	**Overall Assessment:** The external position in Portugal in 2017 was weaker than that consistent with medium-term fundamentals and desirable policy settings. Despite the large adjustment in the current account since the crisis, a strong improvement to a more sustainable NIIP position would require sustained current account surpluses for a long period. In 2018 the CA is projected to deteriorate somewhat with rising import demand. **Potential policy responses:** Sustained fiscal consolidation and structural reforms to improve Portugal's competitiveness and potential growth are needed. Investment can be spurred by enhancing business conditions, streamlining regulations, and increasing the flexibility and responsiveness of institutions and markets. The stock of NPLs remains a concern and continued fast reduction, while keeping adequate capital buffers, is necessary.
Current account	**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 very strong growth in tourism. The current account registered a surplus of 0.5 percent of GDP in 2017, which is expected to moderate and shift to a deficit as import growth outstrips export growth. **Assessment.** EBA model-based estimates suggest a cyclically adjusted current account balance at 0.0 percent of GDP, compared to a norm of -0.1 percent of GDP, implying there is no current account gap. Nevertheless, staff assesses the small actual current account surplus of 0.5 percent to be insufficient in view of the still large negative NIIP, which needs to be put on a firm and sustained downward trajectory. Assuming continued capital account surpluses, staff assesses a current account short-fall of about 2–4 percent of GDP to bring about a strong medium-term improvement in the NIIP. 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.	
Real exchange rate	**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 4½ percent below, and ULC-based REER 7½ percent below. Both REER measures have been on an appreciating trend since the post crisis low points in early 2015, and although the appreciation since then is limited, the trade balance has started to deteriorate. Cost competitiveness will be challenged if the trend continues. **Assessment.** The EBA's *index* regression model suggest an overvaluation of 4.9 percent for 2017, while the *level* REER model suggest the REER is fairly valued with a marginal estimated 0.4 percent undervaluation. Even the index model metric is at the lower end of what is implied by the current account gap, given current policies, to put the NIIP deficit on a decisive downward trajectory, which suggest an overvaluation of the REER in the range of 5 to 10 percent applying the model elasticity. It should be noted that the adjustment could be less through price competitiveness and more through continued and sustained quality upgrades and innovation to improve non-price competitiveness.	
Capital and financial accounts: flows and policy measures	**Background.** Financing conditions have eased dramatically since the resumption of sovereign market access in 2014. Sovereign spreads are now down to a little above 100 basis points, after being above 300 as recently as early 2017, and credit ratings have been upgraded. This reflects, among other things stronger GDP growth, improved fiscal, progress in addressing weaknesses in the banking sector, and support from ECB purchases. **Assessment.** A current account surplus and improved macro conditions have helped support external financing rollover needs for the near-term. Further policy action will be needed over the medium term to secure investor confidence and rule out negative equilibria.	
FX inter-vention and reserves level	**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.	

Annex IV. Labor Market Developments and Productivity

1. Labor factor growth is expected to support potential growth in the short term. In the near term adverse demographic trends are temporarily offset by declining structural unemployment and recovering labor force participation. In the longer term, when ageing and decreasing population will weigh more notably on labor factor growth, potential growth is estimated to be around 1¼ percent, or 1.5 percent in per capita terms.

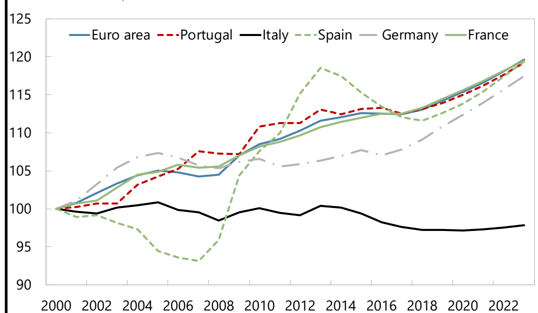
Contributions to Potential Growth
(Percentage points)



Sources: Haver Analytics and IMF staff calculations.

2. Continuing improvements in educational attainment and a reduction of self-employment underpin the medium-term projections for labor productivity and total factor productivity. Labor productivity outperformed the EU average in late 2000s-early 2010s, benefiting from rapid improvement of labor skills, as well as from labor shedding during the crisis. Average skills are expected to continue improving going forward, including as lower-skilled self-employed decline as a share of labor.

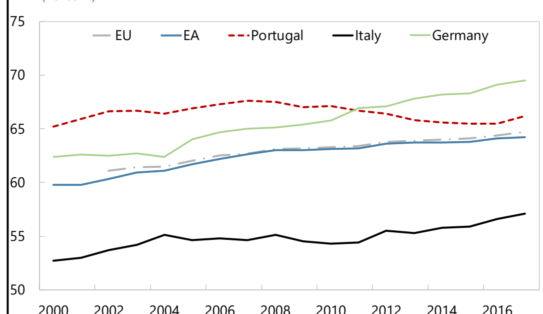
Labor Productivity
(2000=100; per worker)



Sources: WEO, Eurostat, and IMF staff calculations.

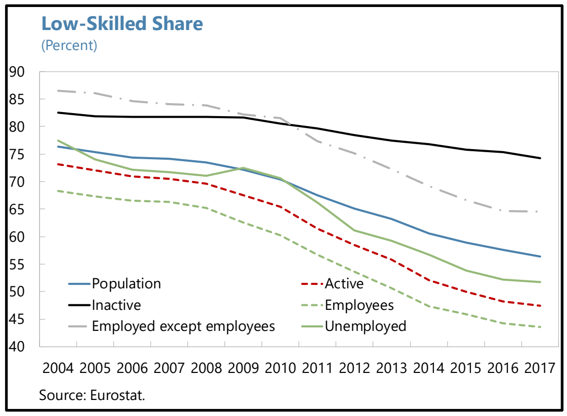
3. Labor force participation started to recover in 2017, increasing by 0.8 percent. The activity rate stands at 66.2 percent, above the EU and EA averages of 64.7 and 64.2, respectively. It is projected to recover further towards pre-crisis levels, increasing on average by about 0.2 percent per year. An increasing share of full-time employment, including a reduction of involuntary part-time work, would also positively affect labor's contribution to growth.

Labor Force Participation Rate
(Percent)

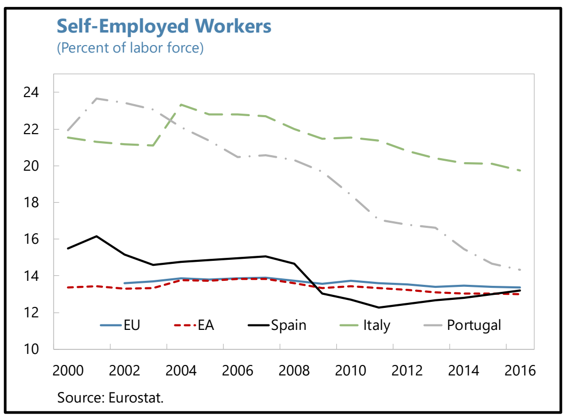


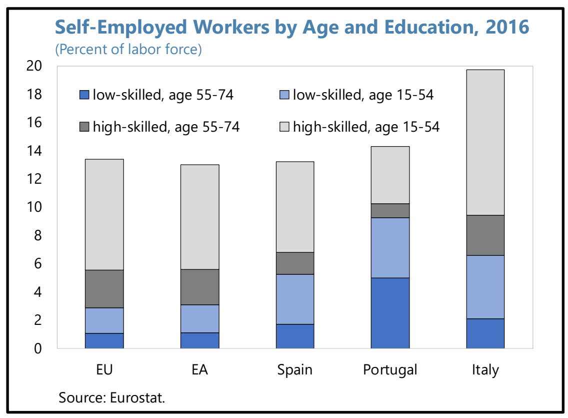
Source: Eurostat.

4. Although the share of low-skilled workers in Portugal (47 percent in 2017) remains significantly higher than the EU average (18 percent), it has declined markedly since the mid-2000's. The decline is broad-based and is more pronounced for employees and for the unemployed. There was a cyclical uptick during the crisis, especially for the unemployed, but not strong enough to offset the overall negative trend.



5. Another notable development is the continuous reduction of self-employment. It declined from 24 percent in the late 1990s to 14.3 percent in 2017, approaching the EU average of 13.4. The reduction of self-employment in Portugal appears to be strongly connected to improvements in educational attainment and demographic cohort replacement. So as elder cohorts age and general educational attainment continues to rise, self-employment will continue to fall.





6. Labor market reforms and human capital development would help to address demographic pressures going forward. The declining ratio of workers to the population will intensify pressures on social programs, pensions, and health care. Addressing labor market segmentation and fostering skill formation will promote more inclusive growth.

Annex V. Past Recommendations

Recommendations	Progress
Labor markets	
Labor market flexibility. Safeguard program-era policy changes to make: (i) hiring and collective bargaining more flexible; and (ii) permanent contracts more flexible rather than restricting temporary contracts.	**Partially implemented.** Measures under consideration emerged from a tripartite negotiation, preventing significant reversals. Agreed measures would mostly discourage temporary contracts, and constrain flexibility afforded by "banks of hours;" however, allowances would be made for sectoral differences, and longer probation periods would improve permanent contracts.
Financial sector	
Boosting internal capital generation.	**Partially Implemented.** Progress has been made in cutting costs, with the continued reduction in the number of branches and employees per habitant, the sale of BPI's holding in Angola and various restructurings. On the earnings side, no tangible progress has been made, with income from services and commissions remaining practically unchanged.
Removing the impediments to NPL resolution.	**Implemented.** Several initiatives taken in 2017 to improve the legal framework include the setting-up of a platform by three banks with common exposures to large nonfinancial corporates to expedite NPL sales, the development of a simplified regime to facilitate the transfer of NPL portfolios, the establishment of a legal regime for debt-equity swaps and the creation of a new legal framework for voluntary out-of-court debt restructurings.
Addressing the forthcoming regulatory challenges.	**Implemented.** The impact of the introduction of IFRS9 and the implementation of the Minimum Requirement for Own Funds and Eligible liabilities (MREL) on financial stability appears to be manageable. This is due to the positive macroeconomic outlook, increase in impairment recognition over the last years following asset quality review exercises, improvement in market perception about Portuguese banks and the envisaged four-year transition period for MREL.
Fiscal sector	
Public sector payments discipline. Implement a more forceful strategy to prevent new arrears in the hospital sector by reviewing budgeting policy, addressing inefficiencies, and further strengthening commitment controls.	**Partially implemented.** In the context of the ongoing spending review, the initiatives in the healthcare sector to increase central control of budgetary execution, decrease arrears, strengthen the joint performance monitoring and control from the MoF and MoH have been insufficient to prevent hospitals from accumulating new arrears, which the EC (2018 European Semester) reports to have increased by €300 million in 2017.
Structural primary adjustment. For 2018, implement a structural primary adjustment of 0.5 percent of GDP, in line with Portugal's commitments under the Stability and Growth Pact.	**Not implemented**. According to staff estimates, there is a slight loosening of 0.2 percent of GDP implicit in the 2018 target for the overall balance under the April 2018 Stability Program.
Wage bill. Implement a stronger wage bill planning and a public sector restructuring to adjust the level and composition of public employment to generate the planned fiscal savings while improving service delivery.	**Partially implemented**. The wage bill grew only by 0.3 percent in real terms, and declined as a share of GDP, generating a saving of around 0.3 percent of GDP. However, these savings might be eroded under pressures related to the unfreezing of career progressions and gradual restoration of the 35 hour week. There has been no meaningful adjustment to the level and composition of public employment.
Pension reforms. Revisit recent pension reforms to reduce grandfathering.	**Not implemented**. No major reforms of the pension system have been implemented.
Corporate debt overhang. Reduce the tax debt bias to offset the distortion of the deductibility of debt interest.	**Implemented.** The 2018 budget contain provisions to extend the deductibility of equity to SMEs.

INTERNATIONAL MONETARY FUND

PORTUGAL

August 21, 2018

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By
European Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of June 30, 2018)

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	5,457.02	264.89
Reserve position in Fund	465.77	22.61

SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	806.48	100.00
Holdings	536.74	66.55

Outstanding Purchase and Loans:	**SDR Million**	**Percent Quota**
Extended Arrangements	3,862.69	187.50

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]				
	2018	**2019**	**2020**	**2021**	**2022**
Principal	0	0	0	1,547.69	1,536.25
Charges/Interest	39.71	79.33	79.37	76.26	37.55
Total	**39.71**	**79.33**	**79.37**	**1,623.94**	**1,573.80**

[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 19-29, 2017, and the staff report (Country Report No. 17/278) was discussed on September 11, 2017.

Post-Program Monitoring Discussions:
The Sixth Post-Program Monitoring Discussions were held in Lisbon during November 28 – December 6, 2017, and the staff report (Country Report No. 18/52) was considered on a lapse of time basis on February 21, 2018.

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 June 30, 2018

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 June 30, 2018)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	06/30/18	06/30/18	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	5/18	6/18	M	M	M
Reserve/Base Money	4/18	6/18	M	M	M
Broad Money	4/18	6/18	M	M	M
Central Bank Balance Sheet	5/18	6/18	M	M	M
Consolidated Balance Sheet of the Banking System	4/18	6/18	M	M	M
Interest Rates[2]	5/18	6/18	M	M	M
Consumer Price Index	5/18	6/18	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	4/18	6/18	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	4/18	6/18	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	4/18	6/18	M	M	M
External Current Account Balance	4/18	6/18	M	M	M
Exports and Imports of Goods and Services	4/18	6/18	M	M	M
GDP/GNP	2018:Q1	6/18	Q	Q	Q
Gross External Debt	2018:Q1	5/18	Q	Q	Q
International Investment Position	2018:Q1	5/18	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 and domestic banks 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. Alessandro Leipold, Executive Director for Portugal and Ms. Ines Lopes, Advisor to the Executive Director
September 7, 2018

Overview

The Portuguese authorities commend IMF staff for the constructive overview of the Portuguese economy and fruitful discussions during the Article IV Consultation. They take note of the conclusions and reiterate their commitment to sound economic and fiscal policies, focused on fostering competitiveness, growth, social cohesion, and sustainable public finances.

The authorities welcome the acknowledgement of the strong performance of the Portuguese economy in 2017 and positive outlook for 2018, while noting downside risks related to recent global and euro area developments.

They share the staff's positive assessment of Portugal's macroeconomic policies, stressing their continued engagement in structural fiscal consolidation and the implementation of structural reforms designed to improve productivity and the resilience of the Portuguese economy to adverse shocks.

Economic Activity

Recent economic developments remain positive, with GDP growing by 0.5 percent in the second quarter of 2018 (2.3 percent year-on-year), in line with the Government's target of 2.3 percent for the year as a whole. Growth continues to be backed by significant increases in investment and exports (6.4 percent and 6.8 percent, respectively). Portuguese firms continue gaining market share in both goods and services. In July, the economic climate indicator reached its highest level since May 2002.

The Stability Programme 2018–2022, in line with the National Reform Programme, reaffirms a predictable and sustainable economic path that has been fundamental to promote economic confidence and, in particular, investment.

Main price developments point to an acceleration of consumer price inflation in July 2018, with HICP rising by around 2.2 percent, mainly due to the evolution of energy, restaurant and hotel prices. The CPI annual rate for the same month registered a lower value of around 1.6 percent, but still increasing from 1.5 percent registered in June. Ultimately, core inflation maintained its value at one percent.

The labor market continues to exceed expectations. The unemployment rate in the second quarter of 2018 stood at 6.7 percent, down 1.2 percentage points from the previous quarter and 2.1 percentage points from the previous year. It is now below the authorities' forecasts in the Stability Programme and IMF forecasts for 2019. Employment increased by 2.1 percent year-on-year in the second quarter of 2018, while salaried employment grew by 2.9 percent. The employment rate is now around 55.1 percent - the highest since the first quarter of 2011.

These results are framed by a continuous constructive engagement with the Social Partners. In particular, a Tripartite Agreement was reached in May which foresees a comprehensive set of policies aimed at reducing labor market segmentation.

Fiscal Policy

Portugal is firmly committed to continuing on a path of structural fiscal consolidation. The fiscal deficit in 2017 (0.9 percent of GDP, excluding the one-off factor of the recapitalization of Caixa Geral de Depósitos) was lower than the forecast in the 2017 State Budget (1.6 percent), due to stronger-than-expected growth, favorable interest cost dynamics and successful public expenditure control, supported by an expanding spending review.

Budget execution through July indicates that the deficit target of 0.7 percent of GDP for 2018 is well within reach. Revenue is up by 5.3 percent and expenditure is down by 2.5 percent when compared to 2017. The fiscal deficit, measured on a cash basis, improved by 1,109.7 million euros compared to the same period in 2017. The primary surplus increased by 1,417.1 million euros. Portugal has been recording primary surpluses of over 2 percent of GDP for some time, being amongst the EU Member States with higher primary surpluses.

The ongoing expenditure review should help generate additional efficiency savings as it expands to new areas. It is currently covering education, healthcare, state-owned enterprises, public procurement, real estate management, internal administration, justice, and public employment.

In the health sector, for example, a new joint unit overseen by the Ministries of Finance and Health is working on an array of measures to tackle the generation of arrears in Portuguese hospitals, sharpen the accountability of hospital management, and find efficiency savings through centralized procurement. This structure will contribute to promote the sustainability of the Portuguese health system.

The Portuguese Government is also fully committed to using revenue windfalls to continue reducing the public debt, bringing it back to more sustainable levels. The public debt is expected to reach 122.2 percent of GDP in 2018, down from 125.7 percent in 2017. The amortization profile has been smoothed, and the financing costs of outstanding debt have declined. This has helped reduce refinancing risks and improve investors' perception of Portugal's credit risk.

With regards to the IMF loan, from a total amount of 26 billion euros (23 billion SDR) drawn, Portugal has already repaid 23.79 billion euros corresponding to over 80 percent of the total loan.

Structural Reforms

The Portuguese Government has been pursuing an ambitious set of structural reforms, namely through the implementation of the National Reform Programme, focused on improving potential growth.

This includes a broad range of policy areas, from education, healthcare, and social security, to the judicial system, business environment and energy sector.

Using education and skills as an example, the National Reform Programme is effectively addressing school failure and early departure from education. Training is focused on increasing skills and employability of young people and adults. In the area of vocational education and training, the National Catalogue of Qualifications is being revised, establishing a system for Anticipation of Labor Market Needs, and implementing the European Quality Assurance Reference Framework. Efforts are also ongoing to improve the average digital skills of the Portuguese population.

In the judicial system, the recent progress in the review of insolvency proceedings is noteworthy. The Insolvency and Companies' Recovery Code was revised, including changes to the special revitalization proceedings, with the aim of making them more agile and, thus, improve the overall efficiency of the judiciary. There is mounting evidence that these reforms are yielding successful results on resolution efficiency, debt recovery, and in NPL resolution.

Moreover, recent progress in the judiciary is closely linked to a major initiative designed to improve the business climate and support SMEs. A new regime for the out-of-court restructuring of companies has been created, whereby it is possible to reach an agreement between the debtor and the creditor, with specialized support in company recovery. In parallel, an Early Warning Mechanism was developed to inform companies on an annual basis on their global financial situations, providing relevant recommendations on their sustainability. These initiatives are expected to decrease courts' workload and support viable companies to remain competitive. Moreover, within the context of the *Capitalizar* program, new credit lines were set up to foster SMEs and start-ups activity.

Finally, in the energy sector, the tariff debt declined by seven percent in both 2016 and 2017 and is projected to decline by a further 17 percent in 2018. Under the baseline scenario, the current debt is expected to be fully repaid by the end of 2021, which would reduce the overall burden on the final price for consumers. Moreover, the Portuguese Government is working to foster investment in new renewable capacity without feeding-in tariffs that could impact the demand side.

Financial Sector Policies

The Portuguese economy has been strengthening its resilience to unfavorable shocks to financial stability. Notably, non-financial corporations and households' indebtedness has declined, and the banking sector is now more robust.

Concerning the former, the clear improvement of non-financial corporations' financial indicators (including those related to capitalization) should be emphasized, especially for SMEs. This improvement occurred alongside an upswing of business investment, associated to companies with lower indebtedness ratios.

As for households, consumer credit has been accelerating and new loans for house purchases have been increasing at robust growth rates - despite the still declining stock. At the same time, credit standards were being eased. Hence, Banco de Portugal, as macroprudential authority, issued a Recommendation designed to mitigate excessive risk-taking by the banking sector and other financial corporations in granting new credit to households, thus contributing to the resilience of the banking sector and promoting households' access to sustainable financing, reducing default risk.

The adjustment of the non-financial private sector has been occurring against the background of particularly favorable economic and financial conditions. In addition, developments in real estate markets have been shaped by robust demand from non-residents and tourism, with upward pressures on prices, mostly, since the second half of 2017, and in particular in the residential segment of the real estate market.

In the banking sector, recent developments have been contributing to increased robustness, notably via: (i) the stabilization of the shareholder base of the major banking groups; (ii) the increase of banks' capital ratios; (iii) the increase in operational efficiency; and (iv) the increase of banks' capacity to significantly reduce their stock of NPLs. In this regard, in the period from June 2016 to March 2018, NPLs declined by 15.8 billion euros (approximately 30 percent), representing a decrease of 5.2 percentage points in the NPL ratio, alongside an increase in the impairment coverage ratio. These developments have been framed by a comprehensive European action plan to tackle NPLs, and a national strategy based on three pillars: (i) review of the legal, judicial and fiscal framework; (ii) microprudential supervisory activity, within the Single Supervisory Mechanism (SSM), in particular NPL reduction plans submitted by the institutions to Banco de Portugal and the ECB, and (iii) management of the NPL portfolios, which includes the creation of a platform for the integrated management of non-performing bank loans, currently in operation. The Portuguese authorities remain committed to continuing the reduction of non-performing loans.

Additionally, profitability in the Portuguese banking sector has been recovering: operating income has somewhat increased and efficiency has improved amidst the deepening of restructuring processes; however, profitability is still under pressure in a context of increased competitive pressures raised by new market players equipped with innovative technologies aimed at providing financial services digitally (FinTech) and increasing regulatory demands, most notably those associated with the Minimum Requirement for Own Funds and Eligible Liabilities (MREL).

Conclusion

The Portuguese authorities reiterate their enduring commitment to meeting their obligations towards the Fund.

In line with the Stability Programme 2018–2022, the Portuguese Government will endeavor to ensure that the public finances continue on a firm path of fiscal consolidation and are resilient to external risks and vulnerabilities.

Furthermore, the authorities remain resolute with respect to their ambitious structural reform agenda set out in the National Reform Programme, which is key to supporting sustainable and shared economic growth.

The Portuguese authorities look forward to the next Article IV Consultation in 2019.