INTERNATIONAL MONETARY FUND

IMF Country Report No. 23/218

PORTUGAL

June 2023

2023 ARTICLE IV CONSULTATION—PRESS RELEASE AND STAFF REPORT

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 2023 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 June 15, 2023 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 a lapse of time basis, following discussions that ended on May 5, 2023, 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 June 1, 2023.
- An **Informational Annex** prepared by the IMF staff.

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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International Monetary Fund
Washington, D.C.

PRESS RELEASE

PR23/225

IMF Executive Board Concludes 2023 Article IV Consultation with Portugal

FOR IMMEDIATE RELEASE

Washington, DC – **June 22, 2023:** The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Portugal on June 13, 2023.

The economy sustained its dynamic recovery from the pandemic into 2022. GDP surpassed the pre-pandemic level in the first quarter and growth averaged 6.7 percent for the year—among the highest in the euro area. The momentum continued through early 2023 with growth at 2.5 percent (year-on-year) in Q1. While headline inflation peaked in late 2022, core inflation has been stickier amid limited economic slack, high profit margins and tight labor markets. Wage growth has accelerated, partly reflecting minimum wage hikes and labor shortages.

Growth is projected to soften for the rest of the year to average 2.6 percent in 2023 and 1.8 percent in 2024. Inflation is expected to continue to ease over 2023 but remain above 2 percent in the near term. The current account deficit is expected to narrow as terms-of-trade normalize and external demand strengthens.

Despite new fiscal support measures, the fiscal deficit narrowed significantly to reach 0.4 percent of GDP in 2022, mainly reflecting stronger tax revenues. Public debt fell below its pre-pandemic level to 113.9 percent of GDP. In 2023, the fiscal position is expected to be broadly similar to 2022. Public debt is set to remain on a downward path in 2023 and over the medium term.

The banking system and household and corporate sectors have been resilient to recent shocks so far. However, tighter financial conditions, amid a buoyant housing market, have increased financial risks.

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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]

Portugal's strong recovery continued till early 2023, but near-term growth is expected to soften. Domestic demand growth is projected to be dragged down by high cost of living and export growth to soften. After peaking in late 2022, inflation is expected to gradually ease over 2023 but remain above its target for some time, reflecting the broad-based nature of inflationary pressures.

Risks to the outlook are broadly balanced. Tighter financial conditions—potentially accompanied by a sharp correction in housing prices—or a deeper global or regional slowdown, and persistently higher energy prices would further hurt growth and increase risks. Conversely, continued strong tourism momentum and a resilient labor market are the main upside risks.

Maintaining a contractionary fiscal policy stance in 2023 is appropriate to build fiscal space and support monetary policy in reducing inflation pressures. If growth weakens appreciably, automatic stabilizers should be fully deployed; conversely fiscal overperformance must be saved. Further fiscal support should be reserved only for severe downside scenarios and designed to be temporary, non-price-distortionary, and targeted to the most vulnerable households.

A stronger medium-term fiscal effort relative to the baseline, comprising both revenue and expenditure measures, would build fiscal space and mitigate debt-related risks further and improve resilience to contingency risks. On the revenue side, simplifying the tax system and eliminating tax distortions, rolling back reduced VAT rates, reinstating carbon taxes and improving tax administration are key reforms. On the expenditure side, reforms to contain age-related spending pressures from pensions and health care are long-standing priorities. The spending composition should increase the share of public investment relative to current spending. Other important medium-term reforms include strengthening of the medium-term budgetary framework, strengthening the financial sustainability of SOEs, and further improving the social safety net.

Financial policies need to maintain focus on containing systemic risks, which have risen on the back of tighter financial conditions and rising housing market vulnerabilities. Banks and supervisors should continue to maintain vigilance on credit quality, market and interest rate risk, and liquidity management. Continuously improving capital headroom would serve as an important safeguard. Efforts to contain risks from transnational money laundering should continue.

To address the build-up of vulnerabilities in the residential real estate sector, the authorities could gradually phase in a sectoral systemic risk capital buffer. Such a measure would need to be holistically calibrated considering other macroprudential measures, the cost of complying

[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.

with resolvability requirements, and avoiding procyclical effects. Further supporting housing supply and affordability, without generating market distortions, would alleviate housing market strains.

Structural policies should continue focusing on boosting productivity growth. Timely implementation of the NRRP—which focuses on raising R&D, improving the education system, judicial system and business regulations, and scaling up green investment—is crucial. Reforms to improve labor market performance and dynamism, supported by active labor market policies and support for skilling and re-skilling workers would spur further private sector driven growth. Receding energy prices provides an opportunity to gradually increase carbon taxes, combined with targeted measures to protect the most vulnerable. Efficient planning, budgeting, implementation, and oversight will be key to maintain strong investment absorption capacity of EU funds in the economy.

Portugal: Selected Economic Indicators

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

			Projection
	2021	2022	2023
Real GDP	5.5	6.7	2.6
Private consumption	4.7	5.8	1.0
Public consumption	4.6	1.7	3.0
Gross fixed investment	8.7	3.0	4.3
Exports	13.4	16.7	4.4
Imports	13.2	11.1	2.8
Contribution to Growth (Percentage points)			
Total domestic demand	5.8	4.7	1.9
Foreign balance	-0.3	2.0	0.7
Resource utilization			
Employment	1.9	2.1	0.7
Unemployment rate (Percent)	6.6	6.0	6.6
Prices			
GDP deflator	1.5	4.4	4.0
Consumer prices (Harmonized index)	0.9	8.1	5.6
Fiscal indicators (Percent of GDP)			
General government balance	-2.9	-0.4	-0.4
Primary government balance	-0.6	1.4	1.8
Structural primary balance (percent of potential GDP)	0.6	0.7	1.2
General government debt	125.4	113.9	107.9
Current account balance	-0.8	-1.3	-0.4
Nominal GDP (Billions of euros)	214.7	239.3	255.3

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

INTERNATIONAL MONETARY FUND

PORTUGAL

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION

June 1, 2023

KEY ISSUES

Context: The Portuguese economy has sustained its dynamic recovery from the pandemic. Driven by private consumption and external demand, growth in 2022 was markedly higher than the euro area (6.7 percent versus 3.5 percent). Growth is projected to slow to 2.6 percent in 2023, with downdrafts from higher cost of living on domestic demand and a slower external demand growth. Headline inflation is expected to decline from 8.1 percent in 2022 to 5.6 percent in 2023, with core inflation declining more gradually. Near-term risks to the outlook are broadly balanced—key downside risks arise from tighter-than-projected financial conditions and weaker global growth, offset by upsides from tourism.

Policy Recommendations: A contractionary fiscal stance is appropriate to sustain debt reduction and support monetary policy in containing inflation. Efforts to further strengthen public and financial sector balance sheets and implement structural reforms to raise growth potential should continue.

- **Fiscal Policy:** Revenue windfalls from strong nominal GDP growth narrowed the deficit in 2022 despite additional policy support. The 2023 fiscal stance is expected to remain contractionary. Fiscal policy should be flexible to the outlook, while avoiding further untargeted fiscal support. Steady fiscal consolidation, focused on broad public expenditure reform, containing ageing-related spending, and improving revenue performance is needed to increase fiscal space, reduce public debt at a sustained pace, and contain risks from tighter financial conditions. Improving the financial sustainability, efficiency and monitoring of state-owned enterprises remains a priority.

- **Financial Policy**: Notwithstanding recent declines in leverage levels, households and firms are strained by higher borrowing costs and weaker income growth, calling for close monitoring of risks, including from a buoyant housing market. While the financial sector has been resilient, banks should maintain prudent levels of forward-looking provisions. Further fine-tuning the macroprudential policy mix, including through a sectoral capital buffer for real estate exposures, could help reduce systemic risk.

- **Structural Policies:** Improving productivity is key. The National Recovery and Resilience Plan contains ambitious investments in education, digitalization as well as regulatory reforms, which should be implemented in a timely manner, along with sustained labor market reform. Reinstating and increasing the carbon tax, supported by targeted relief for vulnerable households, would help meeting carbon neutrality targets sooner, as currently planned.

Approved By
Laura Papi (EUR) and Eugenio Cerutti (SPR)

The mission took place in Lisbon and Porto during April 26-May 5, 2023. The team comprised Ms. Rupa Duttagupta (head), Mr. Kamil Dybczak, Mr. Ippei Shibata, Ms. Laura Valderrama, Ms. Hannah Winterberg (all EUR), and Mr. Antonio Pancorbo (MCM). Mr. Paul Tershakovec, Mr. Shiqing Hua and Ms. Erika Paola Espinoza (all EUR) supported the mission from headquarters. Ms. Ana Rita Mateus (OED) joined the mission meetings, and Mr. Federico Giammusso (OED) joined the concluding meetings. The mission met with Mr. Mario Centeno (the Governor of Banco de Portugal, BdP), Mr. João Nuno Mendes (the Secretary of State for Finance), other key interlocutors in Portugal—government agencies, BdP, private sector, banking community, and civil society—and the European Central Bank.

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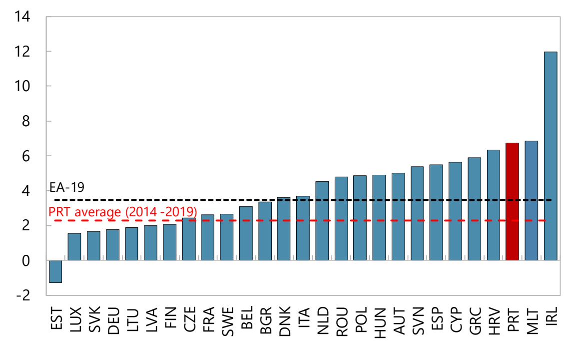
ANNEXES

CONTEXT AND RECENT DEVELOPMENTS

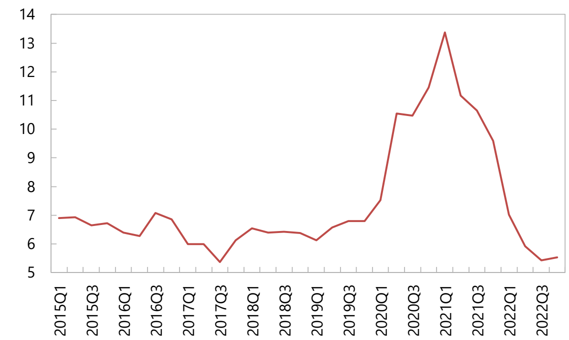
1. Portugal's dynamic economic recovery continued into 2022 and early 2023. GDP surpassed its pre-pandemic level in 2022:Q1 and growth averaged 6.7 percent (euro area, EA: 3.5 percent). Private consumption was the main driver of growth—reflecting policy support, a strong labor market, and the saving rate receding from its pandemic high—along with a sustained rebound in exports, including particularly tourism (Figure 1). The momentum continued through early 2023 with growth at 2.5 percent (year-on-year) in Q1.

Real GDP Growth, 2022
(Percent, year-over-year)



Source: IMF WEO database.

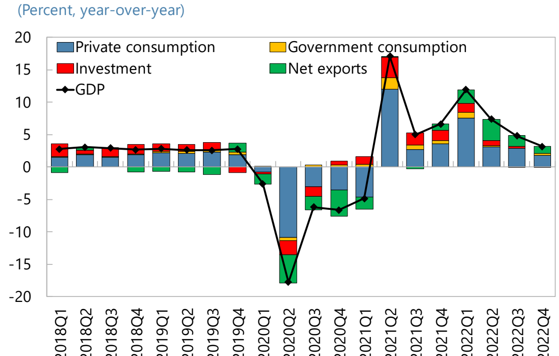
Household Savings
(Percent of disposable income, 4Q moving-average)



Sources: Haver Analytics and IMF staff calculations.

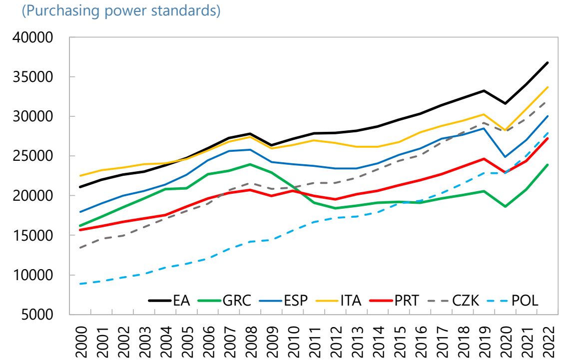
2. But investment growth has been subdued. Portugal is set to receive sizeable EU funds over 2021-26 from the Recovery and Resilience Facility (about 7 percent of 2022 GDP at €16.6 billion: €13.9 billion in grants, €2.7 billion in loans). The national recovery and resilience plan (NRRP) reforms are primarily focused on the labor market, digitalization, competitiveness, and climate change. While milestones and targets were met to receive the first two installments of EU disbursements (about 2.1 percent of 2022 GDP, including pre-financing), translating these milestones and targets into productive investments will be critical for strong medium-term growth, sustained improvements in living standards and income convergence.

Contribution to Real GDP Growth
(Percent, year-over-year)



Sources: Statistics Portugal, Haver Analytics, and IMF staff calculations.

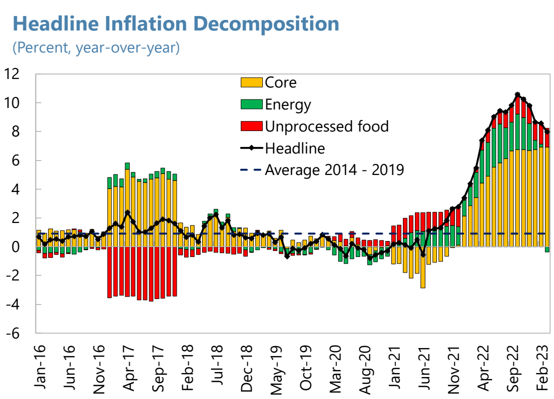
GDP per Capita
(Purchasing power standards)



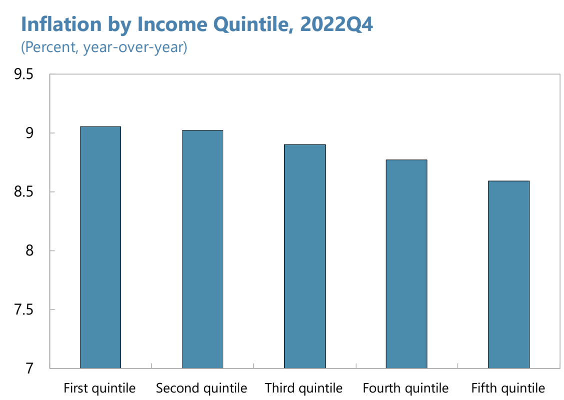
Sources: Eurostat and IMF staff calculations.

3. High inflation and tighter financial conditions are posing new headwinds for the economy.

- Initially driven by surging energy and food prices, inflation pressures have broadened. Headline inflation averaged 8.1 percent (EA: 8.4) in 2022, while core (HICP excluding energy and unprocessed food) averaged 6.2 percent (EA: 4.8 percent), reflecting, in part, tightness in the economy and firms passing through higher production costs to output prices (Figure 2). However, inflation expectations are broadly anchored. Poorer households felt a sharper hit on their purchasing powers, due to their higher spending share on food and energy.



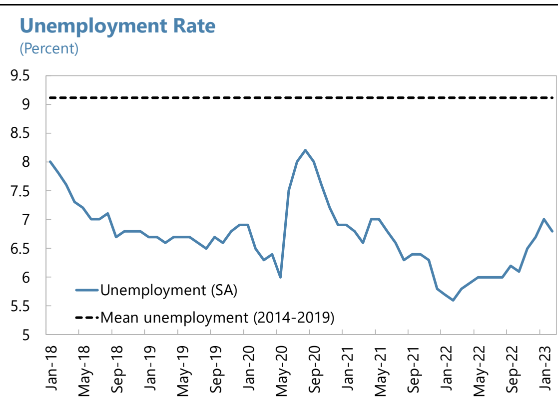
Sources: Eurostat, Haver Analytics, and IMF staff calculations.



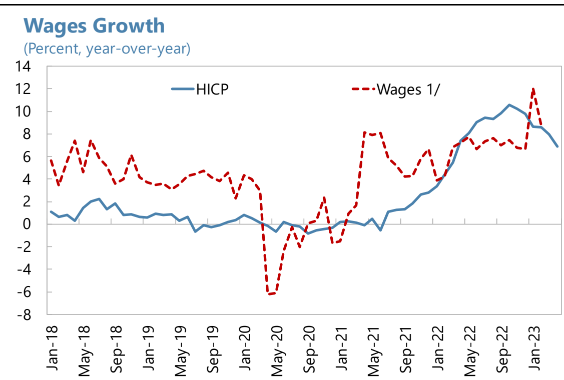
Sources: Eurostat and IMF staff calculations.

- Borrowing rates have risen by 250 to 300 basis points since early 2022—reaching, nearly 4 percent for mortgages in March 2023, and above 3 percent and 5 percent, respectively for yields on sovereign and corporate bonds.

4. The labor market is resilient, pointing to limited economic slack, and wage growth has accelerated. Participation and employment rates further improved in 2022, exceeding pre-pandemic levels, although not for hours worked. The unemployment rate averaged 6 percent, close to pre-pandemic lows, although rising since late 2022. Rising wages partly reflects minimum wage hikes (6 percent and 7.8 percent in 2022 and 2023 respectively) but also labor shortages (Figure 3).



Sources: Eurostat, Haver Analytics, and IMF staff calculations.



Sources: Statistics Portugal and Haver Analytics.
1/ Wage growth is proxied by the growth rate of nominal compensation per employee.

5. The government deployed a wide range of primarily broad-based support measures to address rising cost of living (2 percent of GDP in 2022). Expenditure measures comprised both, one-off income support and support to energy-intensive firms. Revenue measures comprised reduction in excises on petroleum products and energy (ISP) and suspension of the scheduled increase in the carbon tax. Liquidity support was granted to hard-hit sectors (transport, agriculture). Portugal and Spain were also granted an extension of the temporary Iberian cap on prices for natural gas used for electricity production from the original expiry of May 2023 to December 2023.[1]

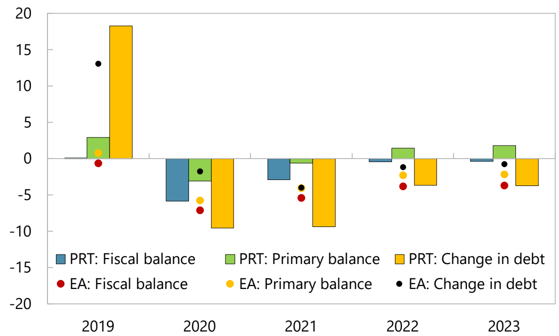
Measures in Response to High Energy Prices
(Percent of GDP)

	2022	2023
Total: revenue + expense	**2.0**	**2.0**
Revenue	**-0.6**	**-1.1**
Taxes on production and imports	*-0.6*	*-1.0*
VAT (e.g., reduction on essential food)	-0.2	-0.2
Other (excise taxes: e.g., ISP and carbon tax)	-0.5	-0.7
Current taxes on income and wealth	*-0.01*	*-0.1*
PIT (e.g., tax reduction to support housing charges)		-0.1
Corporate income tax (IRC, e.g., tax reduction on energy fertilizers etc)	-0.01	-0.02
Social contributions		*-0.01*
Expense	**1.3**	**0.9**
Compensation of employees (e.g., civil servant's additional increase in wages and meal allowance)	*0.3*	*0.2*
Social benefits (e.g., exceptional support to pensioners, vulnerable households)	*0.7*	*0.4*
Subsidies (e.g., subsidy for energy-intensive firms and agriculture)	*0.4*	*0.3*

Sources: Portuguese authorities and IMF staff calculations.

6. Despite new support, the fiscal deficit fell to 0.4 percent of GDP in 2022 from 2.9 percent of GDP in 2021, standing out favorably in the EA (Figure 4). Gains from revenue overperformance due to stronger-than-expected nominal GDP growth, the phasing out of some Covid-related measures, more than offset additional policy support. The primary balance improved to 1.4 percent of GDP in 2022 relative to -0.6 percent of GDP in 2021. The public debt-to-GDP ratio fell below its pre-pandemic level to 113.9 percent of GDP at end-2022.

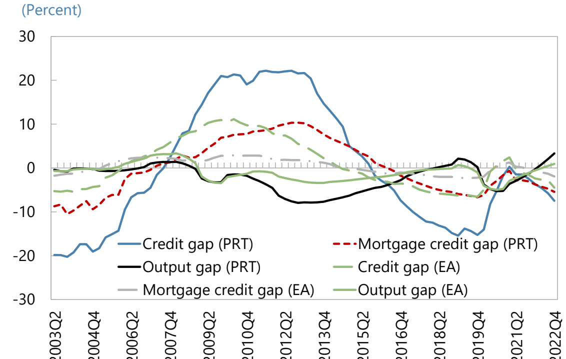
Fiscal Balance and Primary Balance
(Percent of GDP)



Source: IMF WEO database.

7. Credit growth has slowed, reflecting both demand and supply factors. Nominal private credit grew at 2.1 percent in 2022, down from 3.1 percent in 2021, while real credit contracted by 6 percent, pushing the credit-to-GDP gap deeper into negative territory (- 7.5 percent; EA: -4.5 percent). Lending standards tightened particularly for households and small companies. Households continued to de-risk their balance sheets with their debt declining to 64 percent of

Credit and Business Cycle in Portugal and the Euro Area
(Percent)



Sources: Haver Analytics, ECB, WEO, and IMF staff calculations.

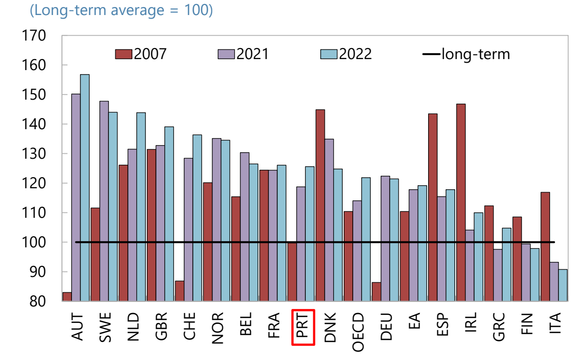
[1] The Iberian cap acts as a subsidy on gas prices paid by power stations and generates savings for consumers by limiting the price for infra-marginal energy producers. Electricity prices are assessed to be modestly lower (relative to a counterfactual without the cap), without generating fiscal costs (see the IMF's Staff Report for Spain 2022 Article IV Consultation).

GDP in 2022 from a 72 percent pandemic peak. Similarly, NFC's debt decreased by 18 percentage points (pp) to 125 percent of GDP in 2022.

8. But the housing market is still bouyant. Nominal residential real estate (RRE) prices rose by 11 percent (y/y) in 2022:Q4 (EA: 3 percent), while cumulatively real house prices have risen by about70 percent since 2015. Price-to-income has also risen by 25 percent relative to pre-pandemic levels. Non-residents are estimated to account for some 10-12 percent of housing sales, although these shares are typically higher in key metropolitan areas and for higher-end properties (Box 1 in the IMF's 2019 Staff Report). Around half of all RRE transactions is mortgage credit financed. Portuguese banks are relatively more exposed to the RRE market than EA peers, and nearly 90 percent of the mortgage stock is at variable interest rates.

Price-to-Income in European Countries

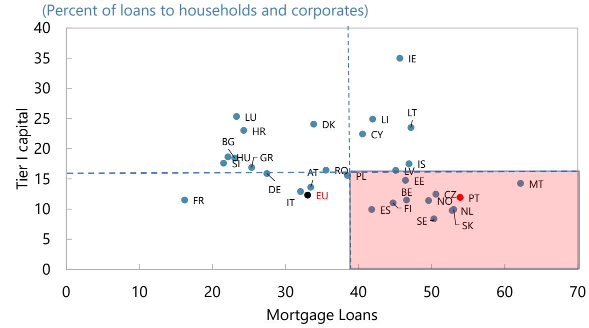
(Long-term average = 100)



Sources: OECD, Haver Analytics, and IMF staff calculations. The latest data is 2022Q4 except for Estonia, Netherlands, and Portugal (2022Q3).

Exposure to Residential Real Estate Sector, Dec 2022

(Percent of loans to households and corporates)



Source: EBA Risk Dashboard; and IMF staff calculations. The chart shows Tier 1 capital as a share of total loans, rather than risk-weighted assets (y-axis) and mortgage loans as a share of total loans (x-axis). The cut-off points of the dashed lines represent the average. The data is based on a sample of banks representing the largest EBA reporting institutions in each country.

9. Macroprudential measures have limited credit risks somewhat, but pockets of vulnerability still remain. Since 2018, when borrower-based measures were introduced and tightened, the share of high credit risk loans—DSTI (LTV) higher than 50 (90) percent—has fallen. Still, the share of new loans in 2022 with DSTI between 50 and 60 percent and LTV between 80 and 90 percent is sizeable, and the average maturity of housing loans is relatively long (31years).

Portugal: Macroprudential Policy Decisions (Borrower-based Measures)

Instrument	Date of Application: Decision	Date of Application: Effective	Parameter	Speed Limit (not subject to parameter)
LTV ratio	1/30/2018	7/1/2018	• 90% permanent residence • 80% other purposes • 100% financial leasing	N/A
DSTI ratio	1/30/2018	7/1/2018	• 50% • Includes all credit agreements • Considers impact of interest rate rise • 20% haircut on income for borrower ≥70y	• 20% on loans (DSTI ≤ 60%) • 5% (no DSTI limit)
	1/29/2020	4/1/2020	• 50% • Includes all credit agreements • Considers impact of interest rate rise • 20% haircut on income for borrower ≥70y	• 10% on loans (DSTI ≤ 60%) • 5% (no limit) • Not applicable to consumer credit with maturity < 2 years to alleviate liquidity shortages (until Sept. 2020)
Loan maturity	1/30/2018	7/1/2018	• 40 years (mortgages) • Gradual convergence to 30 years by 2022	N/A
	1/29/2020	4/1/2020	• 40 years (mortgages) • Gradual convergence to 30 years by 2022 • 10 years (consumer loans for education, health, renewables, and cars) • 7 years (other consumer loans)	N/A
	1/25/2022	2/1/2022	• 40 years for age ≤ 30 • 37 years for 30 < age ≤ 35 • 35 years for age > 35	N/A

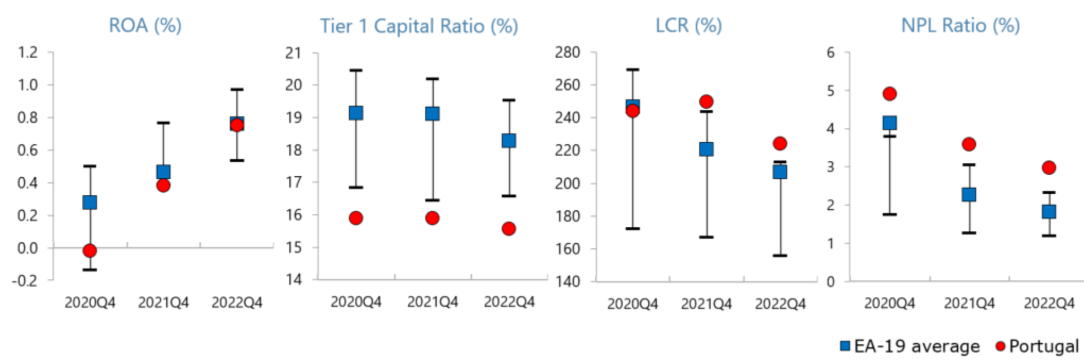
Sources: ESRB Macroprudential database and IMF staff calculations.

10. New measures were taken to address housing affordability. A temporary mortgage relief measure was introduced in late-2022 allowing eligible borrowers to renegotiate first-residence floating-rate mortgages with debt service ratio exceeding 50 percent or above 36 percent and increasing by more than

5pp. New measures were introduced in 2023 for interest burden relief and rental support to lower-income families and extension of some credit lines. Fiscal costs of these measures are expected to be contained given strict eligibility criteria. Other policies aim to increase housing supply through reforms related to land-use, zoning provisions, simplifying regulations and tax incentives (see OECD, 2021 and 2022).

11. The banking sector has held up well so far. However, tier 1 capital ratios (CET1) and non-performing loans are weaker than EA averages for EBA reporting banks. Banks have continued to reduce their NPL ratios, which fell to 3.0 percent at end-2022, although asset quality deterioration tends to materialize with a lag. Stage 2 loans declined to 11.5 percent of total credit, reducing the gap compared with peers (EU average 9.4 percent). Profitability rose on the back of declining pandemic-related provision flows and strong interest income. The CET1 ratio declined somewhat due to dividend distributions and valuation losses. Bank holdings of sovereign debt is estimated at 13.4 percent of total assets, exposing them to market risks, although three-quarters of this exposure is booked at amortized cost (with no capital impact in case of market valuation shocks). Liquidity buffers are high, helping offset potential refinancing needs associated with TLTRO borrowings. Nonetheless, banking system health remains heterogenous due to legacy issues. The non-bank financial sector, relatively small in EA comparison has so far remained resilient, though market risks

Banking Sector: Profitability, Capitalization, Liquidity and Nonperforming Loans



Sources: EBA Risk Dashboard and IMF staff calculations.
Note: The whiskers correspond to the 25th and 75th percentiles. Sample comprises EBA-reporting institutions.

warrant close attention as well.

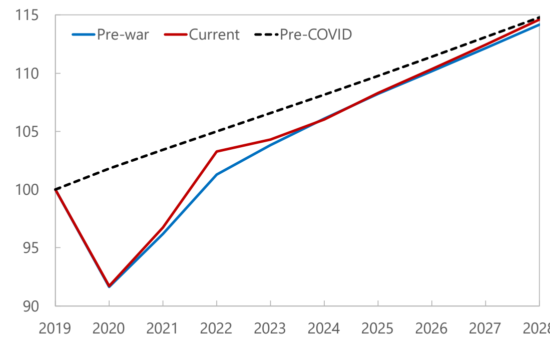
12. The 2022 external position is assessed to be in line with the level implied by medium-term fundamentals and desirable policies (Figure 5, Annex II)]. The current account deficit widened to 1.3 percent of GDP in 2022 from 0.8 percent of GDP in 2021. The deterioration in goods income and transfer balances—in part reflecting a 3 pp deterioration in the terms-of-trade—was only partly offset by revenue overperformance from tourism.

OUTLOOK AND RISKS

13. **The baseline projection is underpinned by the following assumptions.** We assume that the war and related sanctions do not escalate.[2] Commodity prices are expected to continue to ease in line with the April 2023 WEO projections. Global supply bottlenecks are expected to continue to gradually alleviate. The ECB is expected to raise the policy rate by some 150 bps between end-2022 and end-2023. The NRRP implementation rate for fiscal spending, about 1 pp of GDP in 2023 and thereafter, is expected to be sustained. The fiscal stance is projected to remain slightly contractionary in 2023 and the overall deficit broadly unchanged at the 2022 level. Over the medium term, the overall deficit is projected to remain at around -0.3 percent of GDP.

14. **Growth is projected to soften for the rest of the year to average 2.6 percent in 2023 and 1.8 percent in 2024.** The slowdown reflects lower external demand growth from main trading partners, and more subdued domestic demand given higher cost of living. Growth is expected to stabilize to its trend of about 2 percent in the medium term, supported by higher investment and reforms under the NRRP.

Portugal: Projected Real GDP
(2019=100)



Sources: IMF WEO database and IMF staff calculations.

15. **Inflation, which peaked in late 2022, is expected to ease over 2023 but remain above its target for some time.** Headline inflation is projected to average 5.6 percent in 2023 and 3.1 percent in 2024 and continue easing towards the 2 percent target over the medium term. Core inflation is expected to average 5.9 percent in 2023 and retreat to 2 percent more gradually, reflecting stickiness from the broad-based nature of inflationary pressures. Staff analysis suggests limited risks of second-round pressures amid negative real wage growth and anchored inflation expectations (Selected Issues Paper, SIP, I).

16. **The current account deficit is projected to narrow, as terms-of-trade normalize,** reaching -0.4 percent of GDP in 2023. As the current account and the fiscal balances improve over the medium term, the negative NIIP would continue its downward trend.

17. **Risks to the near-term outlook are broadly balanced (Annex III).** A greater-than-expected tightening of financial conditions, a sharper global or regional slowdown and persistently higher energy prices would drag growth further. As interest rates increase, banks could further tighten lending standards to contain risks from variable-rate exposures, which combined with a potential sharp correction in housing prices, could crimp domestic demand and increase systemic risk. Conversely, a faster tourism momentum and continued labor market resilience would strengthen growth. Over the medium-term, global fragmentation or slower use of NGEU funds

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[2] As a member of the EU, Portugal adheres to EU sanctions imposed on Russia and Belarus.

would hamper growth potential. For inflation, higher inflation risks from a greater passthrough from nominal wage growth are offset by negative inflation risks from weaker-than-projected demand.

Authorities' Views

18. The authorities broadly agreed with staff's assessment of the outlook and risks. They expected growth in 2023 to remain robust, driven by tourism and exports—the latter making steady gains in market share—resilient private consumption and accelerated absorption of NGEU and EU funds. They agreed that headline inflation would decline with receding energy prices, but core inflation would remain stickier amid tight labor and product markets. They noted that recent wage growth also reflected improved skill mix and productivity increases. The views on risks and the external sector assessment were broadly aligned.

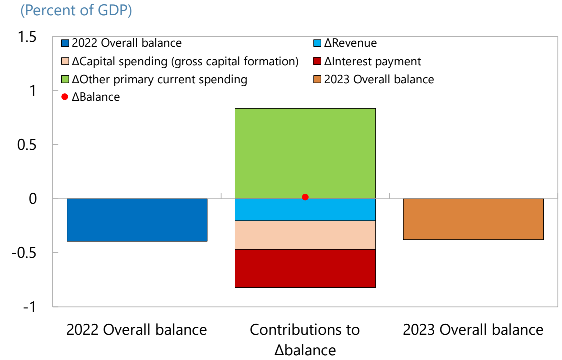
POLICY DISCUSSIONS

As elsewhere in Europe, policies need to navigate the headwinds from tighter financial conditions while growth slows and inflation remains high. This calls for fiscal policy to prioritize building buffers, keep public debt on a firmly downward path and raise resilience to contingency risks. Financial policies need to contain systemic risks and further strengthen financial sector balance sheets. Steady implementation of the NRRP with complementary structural reforms are key for sustained productivity growth.

A. Fiscal Policy

19. The fiscal position in 2023 is expected to be broadly similar to 2022. The overall balance is projected at -0.4 percent of GDP, in line with the authorities' 2023 Stability Program. Continued growth and the full withdrawal of remaining Covid-related measures would offset new support (2 percent of GDP). Public debt in 2023 is projected to decline to 107.9 percent of GDP as a lower fiscal deficit and nominal GDP growth offsets higher debt-financing costs.

Contributions to Changes in Overall Balance, 2022-23
(Percent of GDP)



Sources: WEO Live and IMF staff calculations.

20. The implied slightly contractionary fiscal stance for 2023 is appropriate under baseline assumptions of no additional fiscal support, to continue reducing public debt and supporting ECB's monetary policy. The overall cyclically adjusted balance is estimated to improve by 0.1 pp to -1.2 percent of potential GDP in 2023 even as the deficit remains flat. At the same time, growth is expected to be supported by scaled up public investment (2.8 percent of GDP versus 2.5 percent of GDP in 2022), largely financed by NGEU grants.

21. Fiscal policy could shift towards more targeted support. While energy support measures in 2022 cushioned incomes, they could have been better targeted and less costly (see Ari and others, 2022). Additional fiscal support for 2023 (around 2 percent of GDP) includes public wage and pension increases, temporary VAT exemption on essential items, and housing support measures. Receding energy prices provides an opportunity to phase out broad-based measures, shift to targeted support for vulnerable households, as well as lift the Iberian price cap. Relatedly, interest and rental relief measures—while fiscally small given strict eligibility criteria—could be shifted to targeted income relief to lower-income households.

22. Fiscal policy should remain flexible to downside risks, fully deploying automatic stabilizers while avoiding untargeted support. Under severe downside scenarios, automatic stabilizers should be fully deployed, and further fiscal support should be temporary, non-price-distortionary, and well targeted to the most vulnerable households. Broader business support should also be temporary, limited in size, and narrowly targeted to most-affected firms to enable continued activity. Support measures should avoid dampening energy price signals and be accompanied by strong governance safeguards and conditionalities (ideally to increase energy efficiency) where appropriate. NGEU-financed public investment for 2023 should be preserved even under downside scenarios. Conversely, fiscal overperformance must be saved.

23. Over the medium term, staff expects the fiscal deficit to average 0.3 percent of GDP and public debt to stay on a downward track. The projections for the deficit are slightly weaker than the authorities' projection under the 2023 Stability Program (of falling to zero by 2026). The differences primarily reflect staff's projection of somewhat higher spending, particularly pension and health-related spending from an aging population, and a slightly higher wage bill in GDP, which are partly offset by stronger tax revenues. The public debt-to-GDP ratio is expected to dip below 100 percent in 2025, resulting in moderate risk to debt sustainability despite the high level (Annex IV).

24. A sustained medium-term fiscal effort would bolster fiscal space and mitigate public debt risks further. While public debt would retreat significantly even under the baseline, recent successive adverse shocks since the Covid-19 have underscored the vulnerability of public finances. With fiscal space at risk and still high public debt, a sustained consolidation effort combined with strong medium-term growth is key for a steady public debt reduction (SIP II). Building fiscal space would ensure that public investment is not compromised even after the end of NGEU while also increase fiscal resilience to contingency risks, including from the financial sector. Relative to staff's baseline projections, staff proposes a discretionary effort—averaging annually ¼-⅓ percent of GDP during 2024–28 (this is aligned with past advice, see 2022 Article IV Staff Report)—to achieve a balanced budget. Sustaining this fiscal path beyond the medium term would bring debt to under 60 percent of GDP within two decades. Overall, fiscal policy should be flexible to respond to shocks, build more ambitious buffers when growth is stronger and avoid procyclicality.

25. Staff recommends a mix of revenue and expenditure measures to improve fiscal policy composition and efficiency of spending.

Potential Impact of Selected Recommmended Fiscal Measures
(Percent of GDP)

	Yield per year
1. Lowering tax expenditure policy gap to euro area average 1/	**0.6 - 1.5**
2. Reducing VAT compliance losses to EU average 2/	**0.1 - 0.3**
3. Bringing Property Tax to OECD Average 3/	**0.04 - 0.27**
4. Carbon Price Reform 4/	**0.23 - 0.27**
4. Controlling Wage Pressure 5/	**0.07**

Source: GTAP, European Commission, and IMF staff estimates.
1/ Direct cross-country comparisons of the value of tax expenditures need to be interpreted with caution. Tax expenditures are departures from country-specific benchmark tax systems and their aggregation can result in over- or underestimation.
2/ Revenue lost to VAT fraud and evasion, VAT avoidance and optimisation practices, bankruptcies and financial insolvencies, as well as miscalculations and administrative errors.
3/ Bringing property tax revenue to OECD average of 1.8 percent of GDP in 2021.
4/ Please see 2021 PRT Selected Issues Paper "Reducing Greenhouse Gas Emission in Portugal: the Road Ahead" for details.
5/ Measures to bring wage spending to pre-Pandemic period.

- *Revenue Measures*: There is scope to improve the efficiency of the tax administration, simplify and further modernize the tax system (including digitalization of tax administration). Rationalizing preferential regimes offered to taxpayers could deliver efficiency gains by eliminating compliance and administrative costs and reducing tax-induced misallocation of resources, while providing room to reduce the high labor tax wedge (OECD 2023). Tax reforms, supported by a centralized tax policy unit (recommended by the IMF's 2022 Technical Assistance mission on tax policy), should aim to eliminate distortions, roll back reduced VAT rates and rationalize tax expenditures. There is scope to improve property taxes over the medium term (OECD, 2021). The carbon tax should also be gradually raised over time (see the IMF's 2022 SIP).

- *Expenditure measures*:

  a. Containing age-related spending pressures, a long-standing priority. Key reforms should focus on pension reform, as discussed in the IMF's 2022 Article IV staff report and the OECD Pensions report (2021).[3]

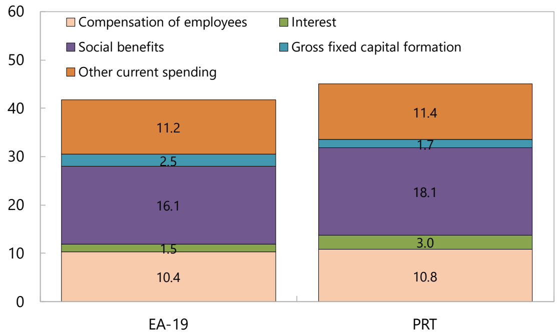
  b. Strengthening the financial position of the National Health Service (NHS), which further deteriorated during the pandemic. Steps to improve spending efficiency and strengthen spending rationalization of the NHS, which are expected in the NRRP, are priorities.

  c. Undertaking a comprehensive review of the public employment and compensation structure to contain the public sector wage bill.

- *Composition of Expenditure*: In recent years, fiscal spending composition has favored current over investment spending, which should be reversed. The NRRP envisages significant investment to accelerate green and digital transformation. For a timely and effective absorption of the EU funds, transparent planning and budgeting, implementation, and oversight will be key.

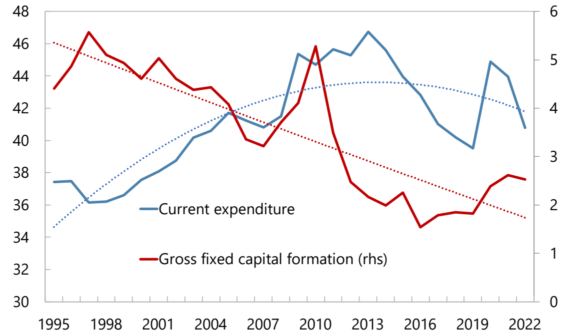
[3] These reforms include simplifying non-contributory benefits regimes, including eliminating duplication, strengthening contributory working period incentives of minimum pensions, additionally linking increases in life expectancy gains to the minimum age of early retirement on top of general retirement age, and abolishing special (early) retirement ages for specific subgroups (OECD Pensions Report 2021).

Expenditure Composition, 2019
(Percent of GDP)



Sources: WEO Live and IMF staff calculations.

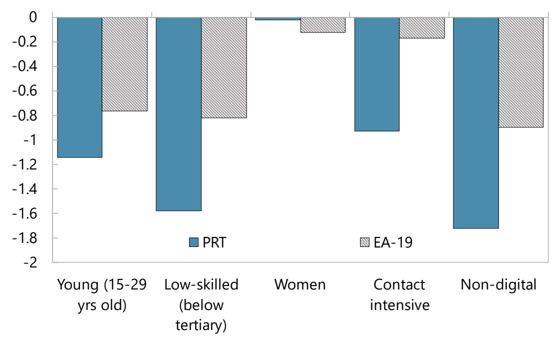
Current Spending and Gross Fixed Capital Formation
(Percent of GDP)



Sources: WEO Live and IMF staff calculations.

26. Addressing distributional challenges remains critical. During the Covid pandemic, vulnerable groups (such as, young, and low-skilled workers in contact-intensive non-digital jobs (SIP III)) were among the most impacted. Challenges in regional inequality of opportunity, poverty, social exclusion, and housing affordability also remain. Continuing to improve targeting of social assistance, alleviating labor market duality, improving job quality, and investing in education with an emphasis on digital literacy would be important (OECD, 2021), as would be the implementation of the National Strategy to Combat Poverty (ENCP).

Employment Impact during COVID19 by Worker and Job Types
(Percent change, share of employment)



Sources: Eurostat and IMF staff calculations.

27. Structural fiscal reforms—supported by public consultation—would improve public sector efficiency, governance, and fiscal sustainability. Recent efforts include measures aimed at strengthening public sector managers' performance, liquidations and mergers of state-owned enterprises (SOEs) in 2022, and the ongoing public expenditure review. A full implementation of the 2015 Budgetary Framework Law, including steps to strengthen the medium-term budgetary framework, reforms to improve financial sustainability of SOEs, including the NHS, remain imperative for medium-term fiscal sustainability and improved efficiency (OECD 2021, IMF Staff Report 2019).

Authorities' Views

28. The authorities were confident of maintaining a prudent near-term fiscal position. They noted that it was important to use the 2022 revenue windfalls to alleviate cost-of-living pressures, although in a targeted and time-consistent way. Sustained growth in 2023 and a complete withdrawal of Covid-19 measures would offset new fiscal support. Scaled-up investment through the RRP would continue to support growth while maintaining sound public finances.

29. The authorities reiterated their commitment to a steady fiscal consolidation over the medium term with the aim to reduce public debt to below 100 percent of GDP by 2025. In terms of specific measures: for revenues, modernizing the tax system and reducing the high tax wedge on labor is a priority. They also highlighted that recent efforts to expand social benefits for the vulnerable have helped lower the share of individuals at risk of poverty and social exclusion, despite the pandemic. For medium-term spending reforms, the government aims to draw on a working group's recommendations for pension system sustainability expected in late-2023. Regarding the Budgetary Framework Law, a multi-year expenditure ceiling has been submitted to Parliament. Strengthened governance, improved financial performance, and stronger efficiency of SOEs also remain key fiscal priorities for the government.

B. Financial Policies

30. The recent tightening in financial conditions combined with rising vulnerabilities in the housing market have increased systemic risk relative to 2021:

- **Households.** Staff analysis suggests that, under adverse scenarios (proxied by higher interest rates and a slower household gross income growth), almost half of households could be pushed to spend over 70 percent of their income on food, utilities, and debt repayments, with sharper effects on low-income households (SIP IV, Figure 5). This could also have broader macro-financial effects related to lower household consumption and credit losses. However, recent policy support and strength in the labor market are important mitigating factors.
- **Firms**. Some 20 (35) percent of large firms (SMEs) have interest coverage ratios less than 1, a share that could increase under adverse conditions (Figure 6).
- **Housing market**. House prices are estimated to be around 20 percent above long-term values (SIP IV, Figure 7). While the impact of terminating the Golden Visa program is expected to be modest (the program reportedly accounted for some 5 percent of transactions in new dwellings over the past decade), risks should be carefully monitored. A sharp house-price correction could weigh on banks.[4] However, there are some mitigating factors, including strong employment levels, sustained household deleveraging, stabilizing energy prices, and macroprudential policies that have helped reduce high-risk LTV and DSTI ratios on new mortgages.

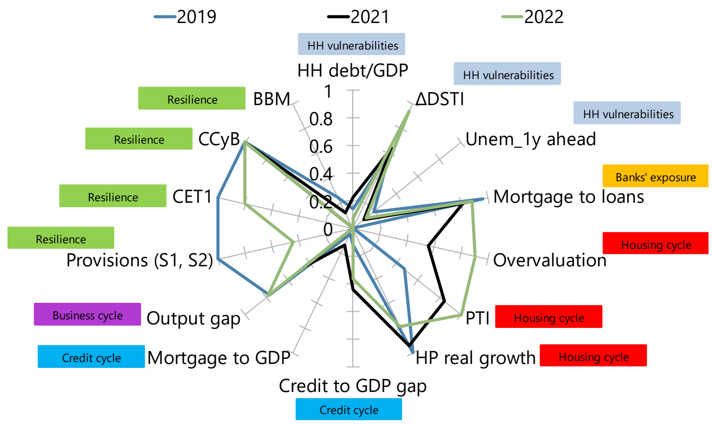
[4] The impact on bank capital could reach 100 basis points under an adverse scenario that combines shocks to household balance sheets with a 20 percent house price correction (SIP IV).

Systemic Risk in Portugal since the Pandemic

Systemic risk is estimated to have increased in 2022 compared to 2021 driven by a higher share of overstretched households and rising imbalances in the residential real estate market.

Heatmap of Systemic Risk in Portugal

(Indicator: 1 = high risk (low resilience); 0 = low risk (high resilience)



Sources: OECD, EBA risk dashboard, Haver Analytics, Statista, WEO, Hypostat, HFCS microdata, and IMF staff calculations. Note: The chart shows quantitative measures of each component of systemic risk (upper, right, bottom and bottom left), as well as resilience (left, upper left). Each relevant indicator has been bucketed from 2000 (or latest) to 2022 to allow for comparable weighting across indicators. This transformation normalizes the value of each indicator between 0 and 1, with low values signaling low risk (or high resilience) and high values showing high risk (or low resilience). BBM stands for borrower-based measures; CCyB stands for countercyclical capital measure; CET1 shows banks' common equity capital ratio, and provisions for S1 (stage 1) and S2 (stage 2) loans. ΔDSTI shows the increase in debt service payments in 2022 for outstanding borrowers with adjustable-rate loans.

31. **Continued emphasis on prudent risk management practices and close monitoring of financial sector vulnerabilities is needed to help reduce systemic risk.** With current heightened financial market uncertainty, enhanced vigilance is crucial—for banks and supervisors—on market risk, liquidity risks, credit impairments (which could materialize with a lag), while maintaining prudential policies related to capital levels, and strengthening contingency planning. Caution is needed in capital distributions, especially if buffers weaken under stressed conditions as well as to comply with final MREL targets. While the non-bank financial sector is relatively small and strains are currently limited, it is important to continue maintaining strong vigilance through regular discussions with financial supervisors, including on cross-entity exposures and related risks.

32. **Under the baseline, a further gradual macroprudential policy tightening would also build bank resilience against systemic risk in banks' mortgage portfolios.** Given the build-up of RRE vulnerabilities, the Portuguese authorities could consider introducing a sectoral Systemic Risk Buffer (SyRB) on banks' residential real estate exposures. Recent strengthening of banks' net interest income provides an opportunity to build such buffers. Tighter regulations should be phased-in gradually to avoid triggering procyclical credit tightening. While there are no signs of excessive credit build-up so far and overall credit growth has slowed, loan quality should continue to be monitored as higher rates may challenge the debt servicing capacity of borrowers. Conversely, borrower-based measures will need to be flexibly adjusted—for instance, easing the requirement of a higher interest rate in applying DSTI limits for new mortgage lending—if downside risks to the

financial cycle begin to materialize. Over the medium term, a positive neutral CCyB rate could be considered to build releasable capital buffers and further strengthen financial stability.

33. Policies to support housing supply and affordability would help ease housing market strains. Housing affordability has weakened in Portugal, particularly among low-income households and renters (Figure 6). Increasing the supply of residential and rental property–supplemented by scaled-up public investment for social housing, including under the NRRP–are key to reduce housing market imbalance and improve affordability.

34. Progress on strengthening the private debt resolution regime should continue. Portugal has already incorporated the EU Directive for insolvency and restructuring into national law. Measures to further streamline judiciary processes and strengthen out-of-court procedures have continued. The duty to file for bankruptcy—which was suspended during the Covid pandemic—should be restored to minimize risks of resource misallocation.

35. Efforts to contain risks from transnational money laundering should continue. As discussed in the IMF 2022 Article IV staff report, this requires keeping risk assessment studies updated, including through analyses of relevant data, to effectively manage and mitigate cross-border risks. These priorities are key given that Portugal has international foreign-direct investment incentives. The termination of the Golden Visa should alleviate additional money laundering risks from foreign investors (e.g., related to tax evasion and corruption proceeds). The effectiveness of the AML/CFT framework should continue to be enhanced, building on recent progress—including ensuring availability of relevant data (e.g., beneficial ownership information) to ensure risk-based supervision and compliance of banks and Virtual Asset Service Providers with AML/CFT preventative measures—to effectively manage transnational risks emanating from illicit financial flows.

Authorities' Views

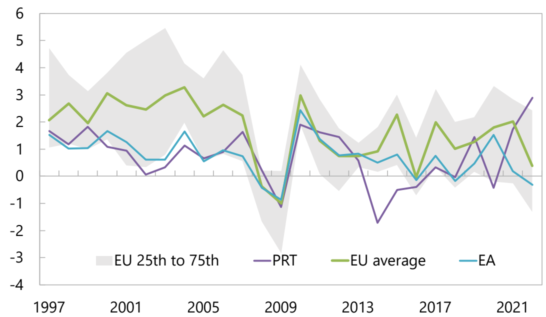
36. The authorities concurred with the need for continued prudent risk management practices and close monitoring of financial sector vulnerabilities to enhance bank resilience. They emphasized the importance of close vigilance on credit quality, market risk, and liquidity risks, while continuing to build CET1 capital levels and maintaining sound prudential policies towards dividend distributions, addressing legacy issues, and strengthening contingency planning. A bill is with the parliament (since November 2022) to revoke Covid-19's suspension of the duty to file for insolvency. They noted recent further strengthening of the AML/CTF framework including adoption of targeted supervisory actions such as thematic inspections of correspondent banking relationships and safeguards regarding the Golden Visa Program to ensure a healthy financial system.

37. The authorities highlighted the need for a balanced approach to macroprudential policy to address systemic risk while reducing procyclicality risks. They agreed that strong house price growth and tighter financial conditions could weigh on borrowers' debt servicing capacity. However, they noted that the macroprudential policy stance remains neutral, supported by effective borrowers-based measures in fostering bank resilience. They argued against additional capital buffers given procyclicality concerns and banks' need to comply with final MREL targets. Similarly, while the SyRB was a valid consideration under normal times and if RRE risks continued to intensify, introducing further capital requirements under uncertainty could constrain lending further. Conversely, the authorities also stand ready to adjust current borrower-based measures if these result in an excessive tightening of credit conditions.

C. Structural Reforms

38. Portugal's NRRP rightly focuses on structural reforms to boost productivity. Portugal's productivity growth has been lagging the average wage growth and the EA best performers, reflecting in part structural factors, e.g., educational and skill levels; innovation, investment, and digitalization gaps, adverse demographics, and low R&D spending. The NRRP aims to address these gaps, with reforms focused on education and skill building, digitalization, and improving the functioning of the judicial system and business regulations.

Labor Productivity Growth
(Percent, annual growth rate)

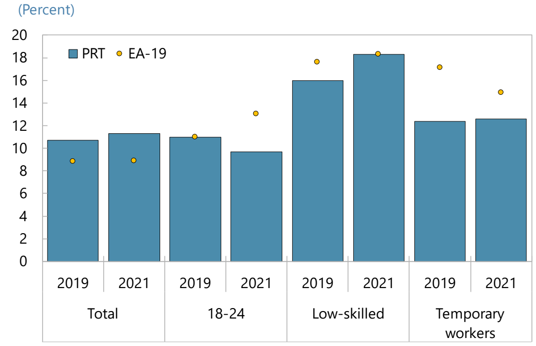


Sources: Eurostat, Haver Analytics, and IMF staff calculations.

39. Addressing long-standing issues in the labor market remains crucial to boosting productivity (Figure 8). Timely implementation of NRRP reforms should further improve labor market performance, help boost human capital, modernize the education system, and revamp active labor market policies.

- *Education and skills*: Despite significant achievements over the last decade, the share of low-skilled workers remains among the highest in the EA (32 percent versus 18 percent for EA average). However, tertiary educational levels have improved remarkably thanks to past reforms (47 percent versus 41/42 percent in EU/EA in 2021). Enrollment in vocational education and training could increase further. Active labor market policies (ALMP) promoting learning, vocational training and re-skilling for low employability groups, as expected under the NRRP, would improve the skill mix, sustain competitiveness, while also addressing income inequality.

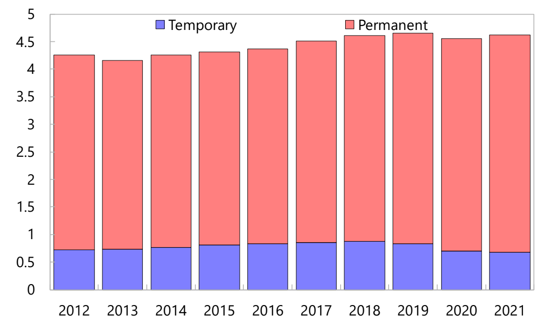
In-work At-Risk-of-Poverty Rate
(Percent)



Source: Eurostat.

- *Labor market duality*: Despite significant improvement since 2019, labor market duality e.g., the share of temporary employment (14.3 percent in 2021) is relatively high (11 and 12 percent for EA and EU), especially among young workers (45 percent against 39 for EA). The Decent Work Agenda aims to reduce the share of temporary workers, improve working conditions and job stability. At the same time, making permanent contracts more flexible would also help reduce duality while preserving efficiency. A well-targeted stronger social safety net would support increasing labor market efficiency while limiting adverse distributional effects.

Total Employment by Contract Type
(Millions employed)

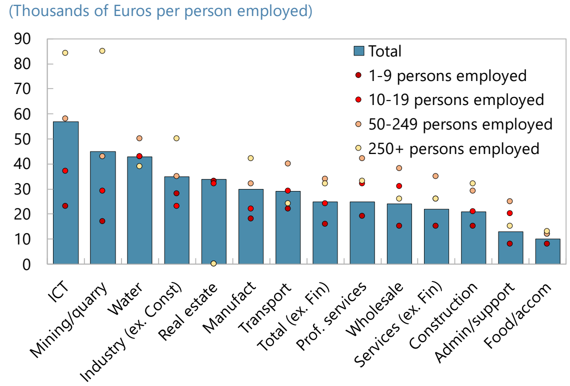


Sources: Eurostat and IMF staff calculations.

- *Digitalization*: The ICT sector still represents about 4.5 percent of total value added in 2022, and 2.6 percent of total employment (5.7 percent and 3.1 percent, respectively in EA peers). The share of population with digital skills (52 percent) could also be improved (EA 59 percent and EU 56 percent) strengthening the economy's resilience (SIP III). The NRRP envisages to channel EUR 3.7 billion to support digital transition initiatives and programs (2020 Digital Transition Action Plan and INCode2030 initiative) strengthening digital skills, digital transformation of companies and digitization of the public sector.

40. Eliminating distortions that discourage firms' growth would boost investment further. Portuguese firms are smaller, less capitalized, and less productive relative to other OECD economies (OECD, 2021). Harmonizing tax rates and reporting standards and applying the labor code regardless of firms' size would provide efficiency incentives, while policies improving access to long-term financing would facilitate firms' investment in technologies and boost their productivity. The NRRP envisages reforms supporting innovative capacity—including through higher public spending on R&D—increased access to new technologies and finance for SMEs, which are steps in the right direction.

Labor Productivity by Firm Size, 2020
(Thousands of Euros per person employed)



Sources: OECD and IMF staff calculations.

41. Despite the energy crisis, the authorities announced their plan to achieve carbon neutrality by 2045, 5 years before the original target. Portugal's share of energy from renewable sources is among the highest in the EA/EU (Figure 9, at 34 percent against 22 percent EU average) and the incentives to reduce pollution, combined with scaled-up investment—in the context of the RepowerEU and NRRP—are expected to further accelerate the energy transition (SIP in IMF 2022). Some 60 percent of electricity generation is from renewal energy, and the authorities plan to increase the share to 80 percent by 2026, However, Portugal's dependence on fossil fuels—which are all imported—has not fallen in recent years. To achieve ambitious climate targets set out in the National Energy and Climate Plan (NECP) and the Roadmap to Carbon Neutrality (RNC), while alleviating energy poverty and energy security risks, ongoing efforts to reduce carbon emissions must continue, including by increasing energy efficiency in consumption and production. With energy prices abating, consideration should be given to gradually raising carbon taxes, while protecting vulnerable households.

Authorities' Views

42. The authorities highlighted that Portugal had been at the forefront of the NRRP implementation, a pace that would continue given almost one fifth of all milestones and targets already met. Moreover, Portugal allocates a higher share of RRF funds directly to private sector than EA average, namely through Innovation Agendas programs and long-term lending programs through the Banco Português de Fomento (BPF). The Decent Work Agenda would strengthen labor security and would continue to reduce labor market segmentation, especially for younger workers. The aim of the Medium-term tripartite agreement on income, wages and competitiveness is to foster a convergence on the wage share in GDP with the European Union average until 2026. They were not concerned about the impact of wage growth on competitiveness. They agreed that ALMPs combined with expanded vocational training system would help durably reduce structural unemployment and address skill mismatches.

43. The authorities stressed that Portugal was on track to meet the Fit for 55 climate targets and the measures under the 2023 NECP should guarantee achieving carbon neutrality by 2045. NGEU is a key source of funding to accelerate green investment and mobilizing private investment. They also noted that a National Strategy to Tackle Energy Poverty is expected to be integrated into the National Poverty Strategy. The authorities confirmed that they are committed to fully eliminate energy subsidies.

STAFF APPRAISAL

44. Portugal's strong recovery continued till early 2023, but near-term growth is expected to soften. Domestic demand growth is projected to be dragged down by high cost of living and export growth to soften. After peaking in late 2022, inflation is expected to gradually ease over 2023 but remain above its target for some time, reflecting the broad-based nature of inflationary pressures.

45. Risks to the outlook are broadly balanced. Tighter financial conditions—potentially accompanied by a sharp correction in housing prices—or a deeper global or regional slowdown, and persistently higher energy prices would further hurt growth and increase risks. Conversely, continued strong tourism momentum and a resilient labor market are the main upside risks.

46. Maintaining a contractionary fiscal policy stance in 2023 is appropriate to build fiscal space and support monetary policy in reducing inflation pressures. If growth weakens appreciably, automatic stabilizers should be fully deployed; conversely fiscal overperformance must be saved. Further fiscal support should be reserved only for severe downside scenarios and designed to be temporary, non-price-distortionary, and targeted to the most vulnerable households.

47. **A stronger medium-term fiscal effort relative to the baseline, comprising both revenue and expenditure measures, would build fiscal space and mitigate debt-related risks further and improve resilience to contingency risks.** On the revenue side, simplifying the tax system and eliminating tax distortions, rolling back reduced VAT rates, reinstating carbon taxes and improving tax administration are key reforms. On the expenditure side, reforms to contain age-related spending pressures from pensions and health care are long-standing priorities. The spending composition should increase the share of public investment relative to current spending. Other important medium-term reforms include strengthening of the medium-term budgetary framework, strengthening the financial sustainability of SOEs, and further improving the social safety net.

48. **Financial policies need to maintain focus on containing systemic risks, which have risen on the back of tighter financial conditions and rising housing market vulnerabilities.** Banks and supervisors should continue to maintain vigilance on credit quality, market and interest rate risk, and liquidity management. Continuously improving capital headroom would serve as an important safeguard. Efforts to contain risks from transnational money laundering should continue.

49. **To address the build-up of vulnerabilities in the residential real estate sector, the authorities could gradually phase in a sectoral systemic risk capital buffer.** Such a measure would need to be holistically calibrated considering other macroprudential measures, the cost of complying with resolvability requirements, and avoiding procyclical effects. Further supporting housing supply and affordability, without generating market distortions, would alleviate housing market strains.

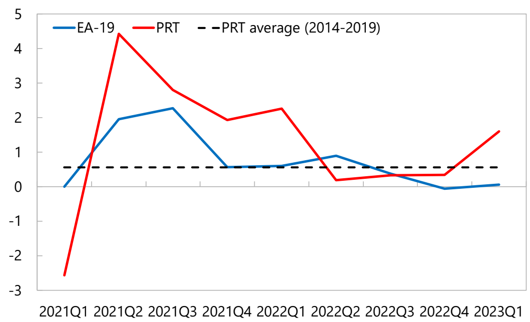
50. **Structural policies should continue focusing on boosting productivity growth.** Timely implementation of the NRRP—which focuses on raising R&D, improving the education system, judicial system and business regulations, and scaling up green investment—is crucial. Reforms to improve labor market performance and dynamism, supported by active labor market policies and support for skilling and re-skilling workers would spur further private sector driven growth. Receding energy prices provides an opportunity to gradually increase carbon taxes, combined with targeted measures to protect the most vulnerable. Efficient planning, budgeting, implementation, and oversight will be key to maintain strong investment absorption capacity of EU funds in the economy.

51. **It is proposed that the next Article IV consultation takes place on the standard 12-month cycle.**

Figure 1. Portugal: Real Sector

A dynamic recovery continued through 2022 …

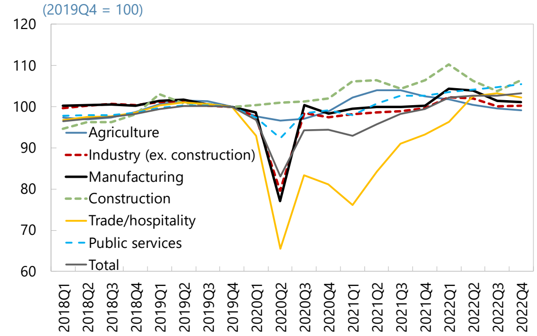
Real GDP Growth
(Percent, quarter-over-quarter)



Sources: Eurostat, Haver Analytics, and IMF staff calculations.

… and activity recovered to pre-Covid levels across most sectors…

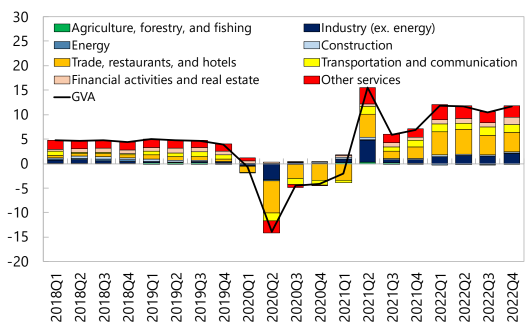
Sectoral Gross Value Added
(2019Q4 = 100)



Sources: Haver Analytics and IMF staff calculations.

…with tourism and related sectors contributing the most to overall growth.

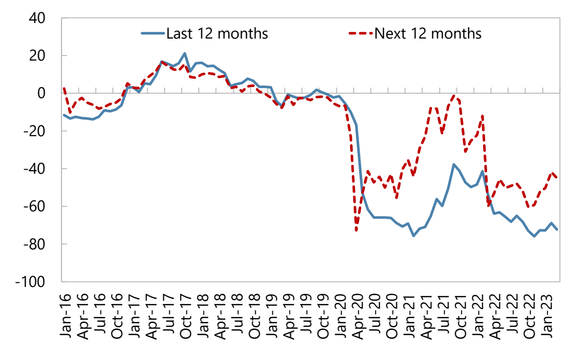
Gross Value Added Growth Decomposition
(Percent, year-over-year)



Sources: Statistics Portugal, Haver Analytics, and IMF staff calculations.

Nonetheless, economic sentiment has been deteriorating sharply since 2022H2…

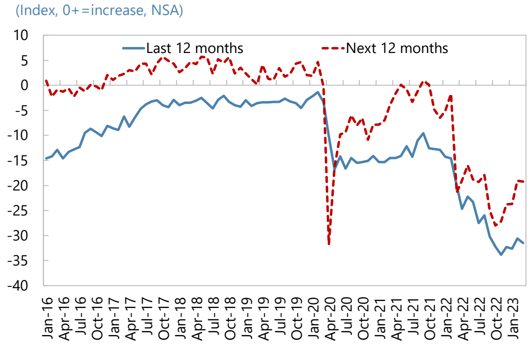
Country Economic Situation Sentiment
(Index, 0+=increase, NSA)



Sources: Statistics Portugal and Haver Analytics.

… reflecting a worsened financial situation of households…

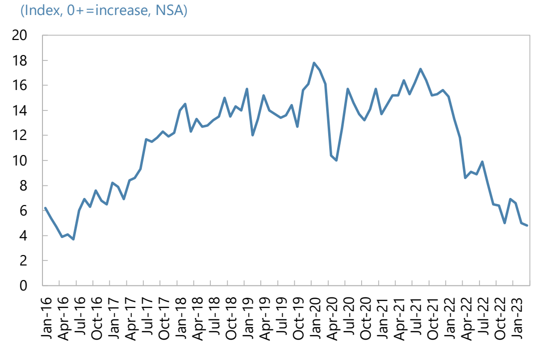
Household Financial Situation
(Index, 0+=increase, NSA)



Sources: Statistics Portugal and Haver Analytics.

… and lower savings.

Current Level of Household Savings
(Index, 0+=increase, NSA)

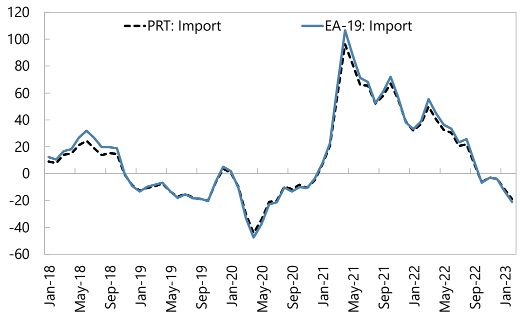


Sources: Statistics Portugal and Haver Analytics.

Figure 2. Portugal: Inflation and Price Developments

Commodity prices grew rapidly in 2022H1…

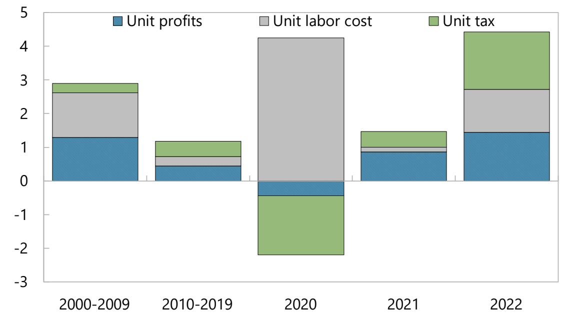
Commodity Price Growth
(Percent, year-over-year)



Sources: IMF Commodity Terms of Trade Database and IMF staff calculations.

… and higher production costs were passed through to prices.

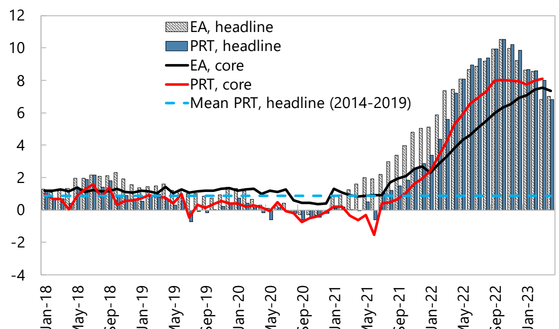
Portugal: Average Contribution to GDP Deflator
(Percent, year-over-year 1/)



Sources: Eurostat and IMF staff calculations.
1/ Quarterly average

By mid-2022 price pressures became broad-based and core inflation exceeded EA average.

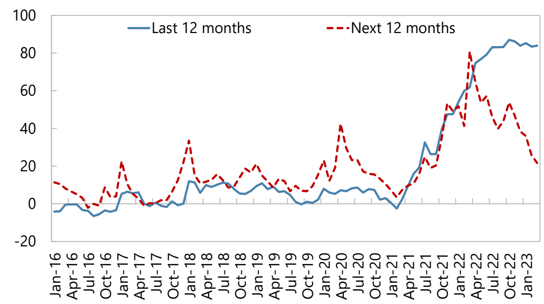
Inflation
(Percent, year-over-year)



Sources: Eurostat and Haver Analytics.

Nonetheless, inflation expectations remain anchored.

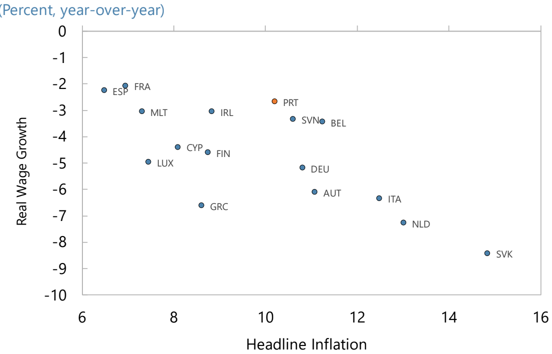
Consumer Prices: Trends over next and past 12 Months
(Percent, SA)



Sources: Statistics Portugal and Haver Analytics.
Note: Percent balance equals percent of respondents reporting an increase minus the percent of respondents reporting a decrease.

Wages have responded only partially to past inflation so far,

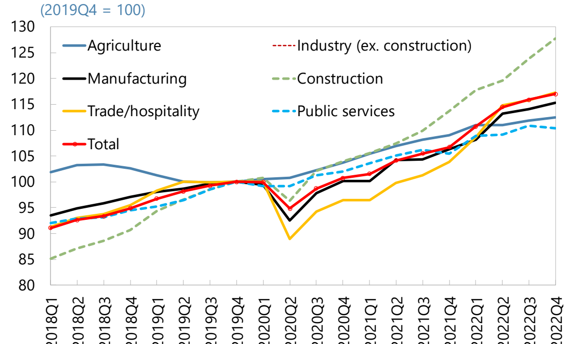
Real Wage Growth and Inflation, 2022Q4
(Percent, year-over-year)



Sources: Haver Analytics and IMF staff calculations.

though, at different paces across sectors.

Sectoral Compensation of Employees
(2019Q4 = 100)

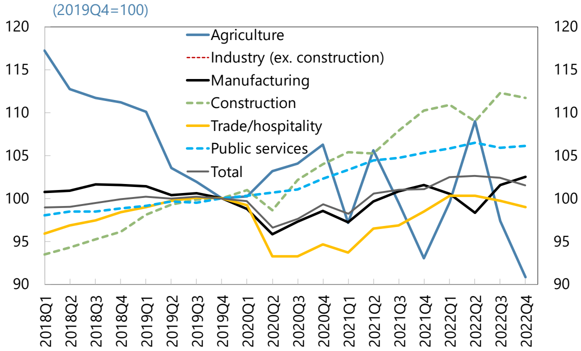


Sources: Haver Analytics and IMF staff calculations.

Figure 3. Portugal: Labor Market

The labor market has remained strong …

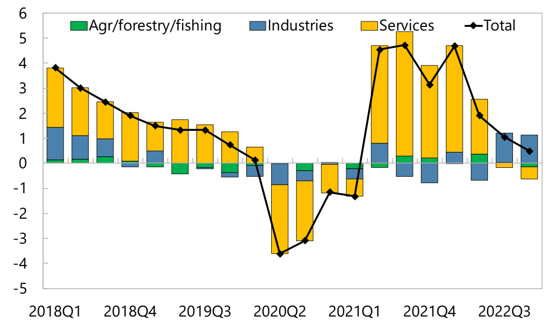
Sectoral Employment
(2019Q4=100)



Sources: Haver Analytics and IMF staff calculations.

…with employment growth largely driven by services.

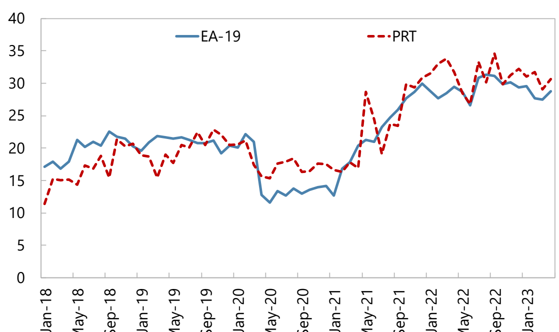
Contribution to New Employment
(Percent, year-over-year)



Sources: Instituto Nacional de Estatistica Portugal, Haver Analytics, and IMF staff calculations.

Record low unemployment, labor shortages…

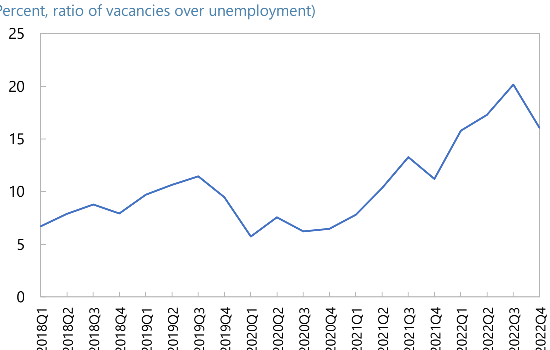
Labor Shortage in Construction
(Percent)



Sources: European Commission and Haver Analytics.

… and signs of labor market tightness indicate limited slack.

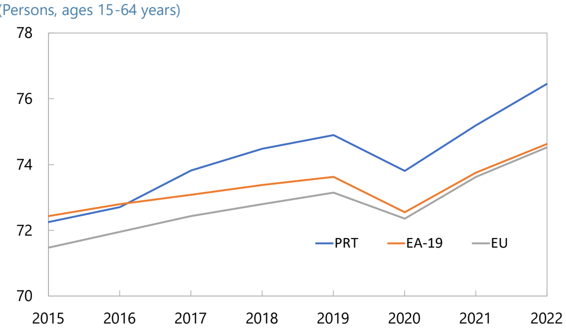
Market Tightness
(Percent, ratio of vacancies over unemployment)



Sources: Haver Analytics and IMF staff calculations.

Labor force participation has reached pre-pandemic levels overall…

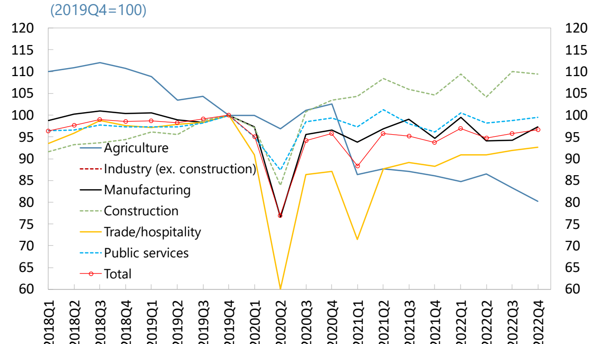
Labor Force Participation Rate
(Persons, ages 15-64 years)



Sources: Haver Analytics and IMF staff calculations.

… but hours worked remain below pre-pandemic levels in many sectors.

Sectoral Hours Worked
(2019Q4=100)

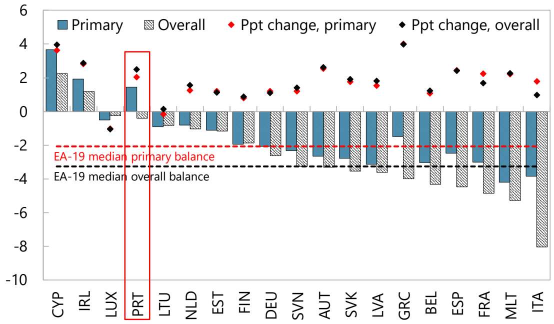


Sources: Haver Analytics and IMF staff calculations.

Figure 4. Portugal: Public Finances

Portugal's fiscal balance recovered fast, with the overall balance stronger than EA in 2022.

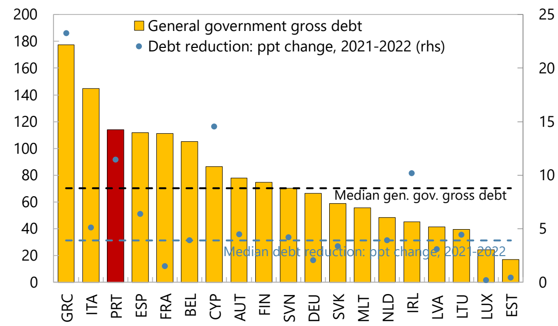
Fiscal Overall and Primary Balance, 2022 1/
(Percent of GDP)



Source: IMF WEO database and IMF staff calculations.
1/ April 2023 WEO values are used for non-PRT countries.

Public debt remains high but is on downward trend.

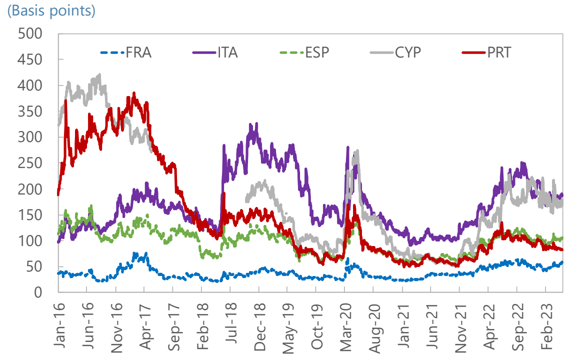
General Government Gross Debt, 2022 1/
(Percent of GDP)



Sources: IMF WEO database and IMF staff calculations.
1/ April 2023 WEO values are used for non-PRT countries.

Tighter financial conditions increased borrowing costs.

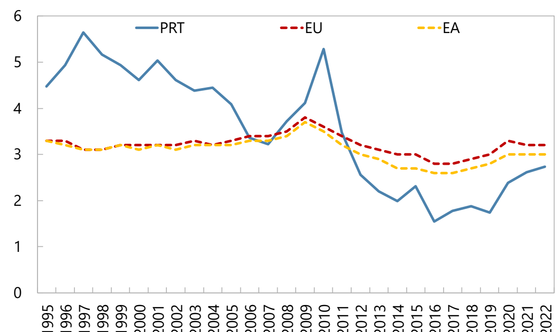
10-Year Gov. Bond Spreads Relative to German Bunds
(Basis points)



Sources: Tullet Prebon Information, Refinitiv, Haver Analytics, and IMF staff calculations.

Public investment is lower than the EA median.

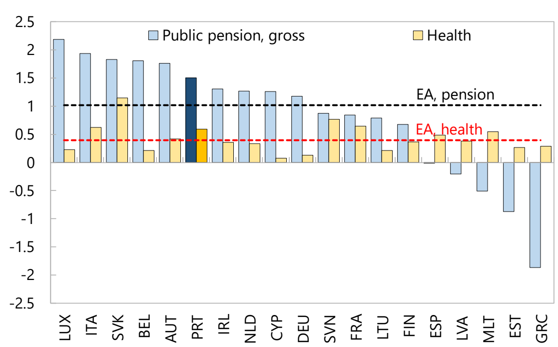
Public Gross Fixed Capital Formation
(Percent of GDP)



Sources: Eurostat and IMF staff calculations.

Pension and health spending is expected to continuously increase over the long horizon.

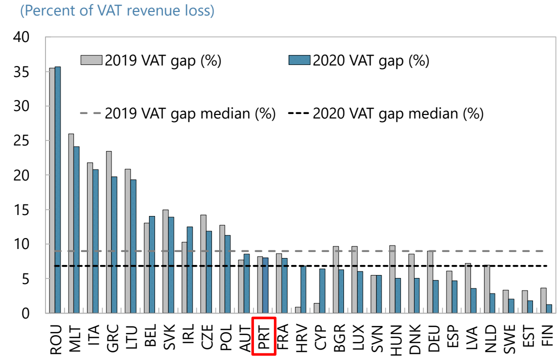
Ageing: Change in Fiscal Outlays on Pensions and Health, 2019-2030
(Percent of GDP)



Sources: European Comission and IMF staff calculations.

Tax revenue shortfalls from the VAT gap remain sizeable.

VAT Gap
(Percent of VAT revenue loss)

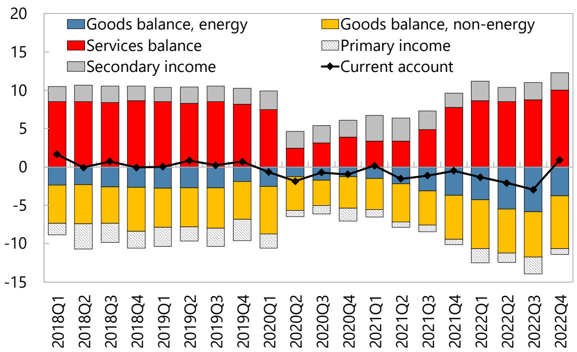


Sources: European Commission; and IMF staff calculations.

Figure 5. Portugal: External Sector

The current account mostly deteriorated in 2022…

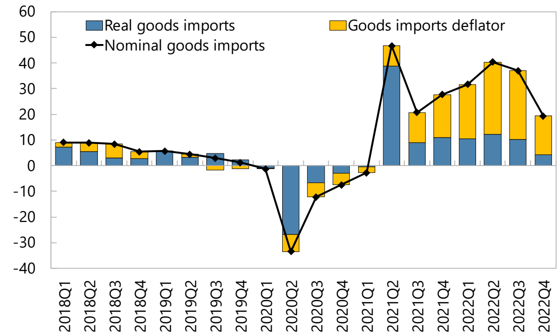
Current Account Decomposition
(Percent of GDP)



Sources: Statistics Portugal, Haver Analytics, and IMF staff calculations.

…reflecting surging commodity prices…

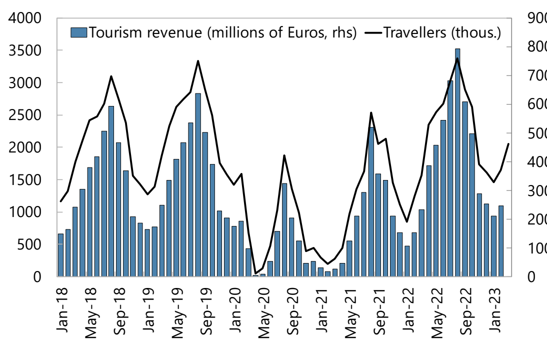
Nominal Goods Imports Growth Decomposition
(Percent, year-over-year)



Sources: Statistics Portugal, Haver Analytics, and IMF staff calculations.

… partially offset by strong revenue from tourism.

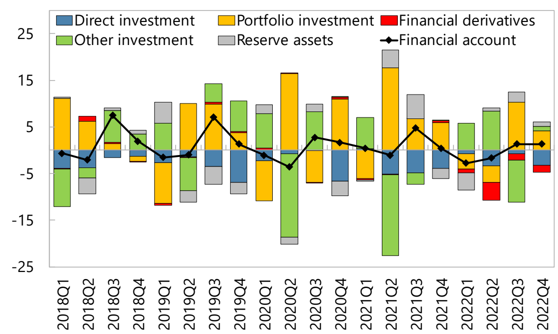
Tourism Arrivals and Revenue



Sources: Statistics Portugal, Haver Analytics, and IMF staff calculations.

The financial account recorded a small deficit for the year …

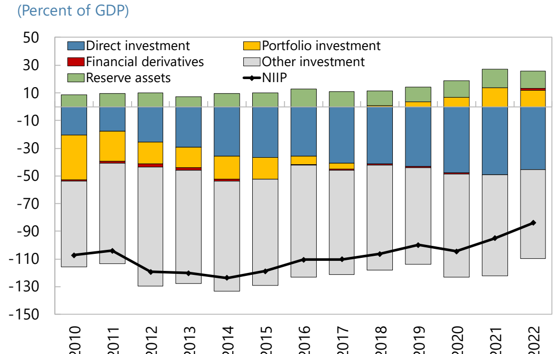
Financial Account Decomposition
(Percent of GDP)



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

… and the net international investment position continued to strengthen.

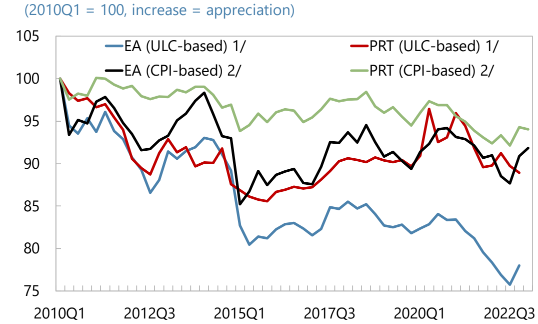
Net International Investment Position
(Percent of GDP)



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

The real effective exchange rate depreciated slightly in 2022 but remained above the EA.

Real Effective Exchange Rate
(2010Q1 = 100, increase = appreciation)

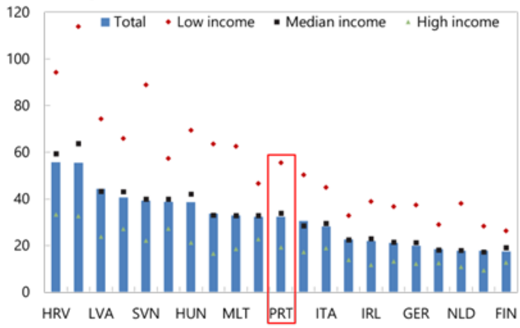


Sources: ECB and IMF staff calculations.
1/ Last observation is 2022Q4.
2/ Last observation is 2023Q1.

Figure 6. Portugal: Financial Position of Vulnerable Households and Corporates

Households are disproportionally affected by rising food and energy prices…

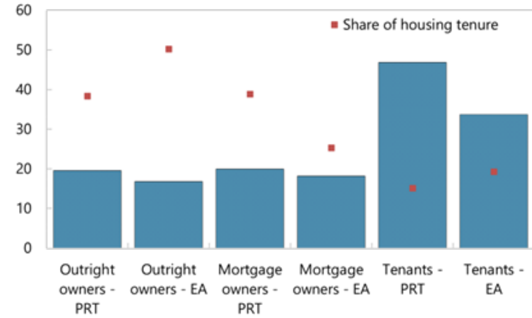
Basic Expenditure by Income Quantile
(Percent of gross household income)



Sources: HFCS microdata and IMF staff calculations.

…and overburdened by housing costs…

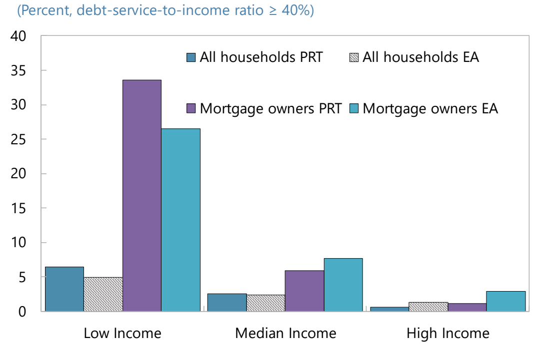
Share of Vulnerable Households by Tenure Status
(Percent, cost-of-living-adjusted debt-service-to-income ratio ≥ 70%)



Sources: HFCS microdata and IMF staff calculations.

…with one third of low-income households with a mortgage overburdened by debt service.

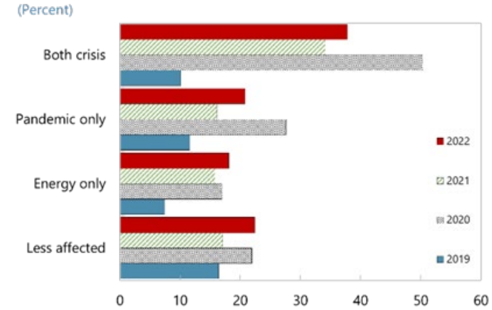
Share of Vulnerable Households by Income
(Percent, debt-service-to-income ratio ≥ 40%)



Sources: HFCS microdata and IMF staff calculations.

Over one third of firms affected by the two shocks are vulnerable.

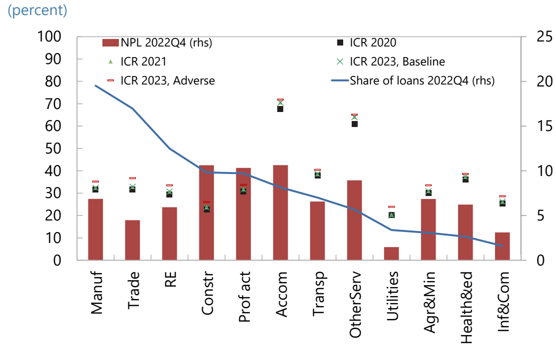
Share of Vulnerable Firms by Exposure to the Crisis
(Percent)



Sources: Banco de Portugal and IMF staff calculations.
Note: A firm is considered vulnerable if financing expenses ratio (ICR) < 2

A large share of firms faces liquidity pressures…

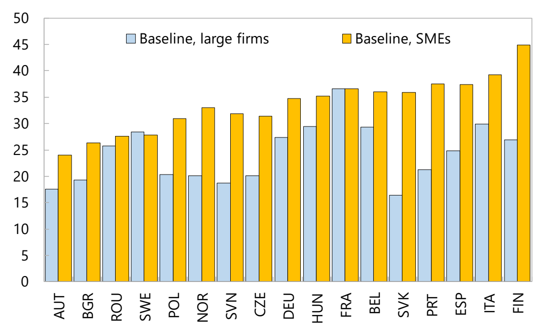
Share of Vulnerable Firms in Portugal by Sector
(percent)



Sources: Orbis, EBA Risk Dashboard, and IMF staff calculations

…particularly in the SME segment.

Share of Firms with ICR < 1, by Firm Size
(Percent of total, end-2023)



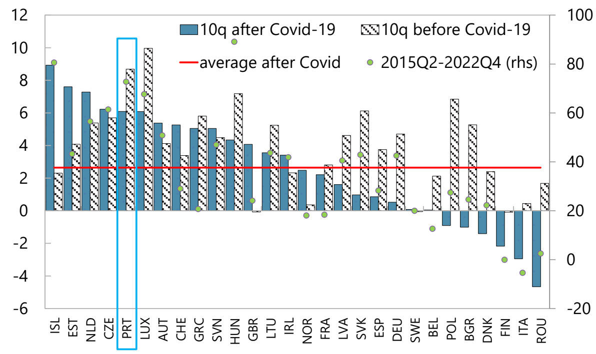
Sources: Orbis and IMF staff calculations.

Note: A household is considered vulnerable if the share of mortgage repayment exceeds 40 percent of gross income or the share of basic expenditure including food, utilities, debt repayments, and housing costs, exceeds 70 percent of gross income. A firm is considered to have liquidity pressures if the ratio of EBIT to interest payments is below 1. Simulations are conducted for 2023. The baseline scenario for firms is based on the October 2022 WEO forecast of interest rates and real GDP growth (proxy for dynamics in operational revenue). See SIP (IV) for details.

Figure 7. Portugal: Build-up of Systemic Risk in the Housing Market

Real house price increased substantially in the past several years…

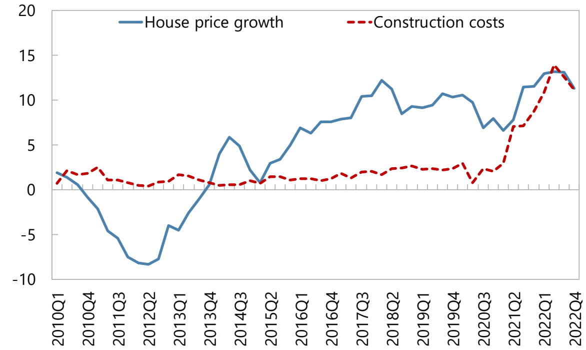
Real House Price Growth Rate
(Percent, year-over-year, annualized)



Sources: OECD, Haver Analytics, and IMF staff calculations. The latest data is 2022Q4 except for Estonia, Netherlands, and Portugal (2022Q3).

…reflecting partly strong demand and a spike in construction costs.

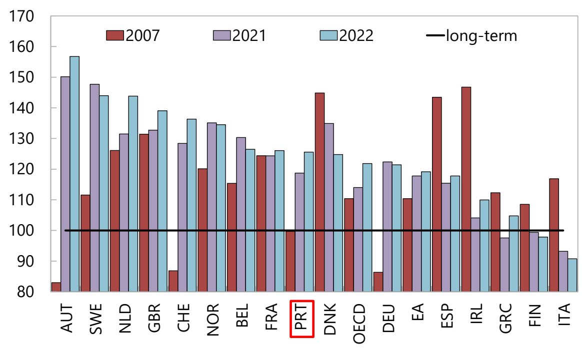
Growth in House Prices and Construction Costs
(Percent, year-over-year)



Sources: Haver Analytics and IMF staff calculations.

House prices have risen faster than fundamental factors can explain…

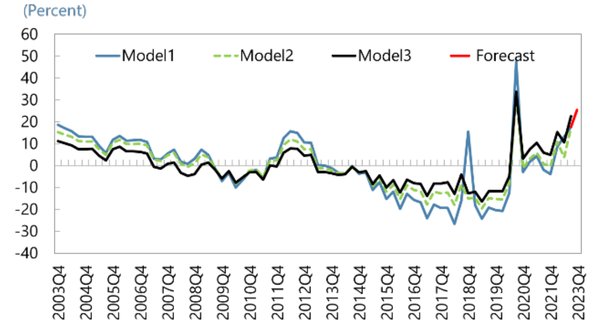
Price-to-Income in European Countries
(Long-term average = 100)



Sources: OECD, Haver Analytics, and IMF staff calculations. The latest data is 2022Q4 except for Estonia, Netherlands, and Portugal (2022Q3).

…resulting in overvaluation pressures.

House Price Deviation from Fundamentals
(Percent)



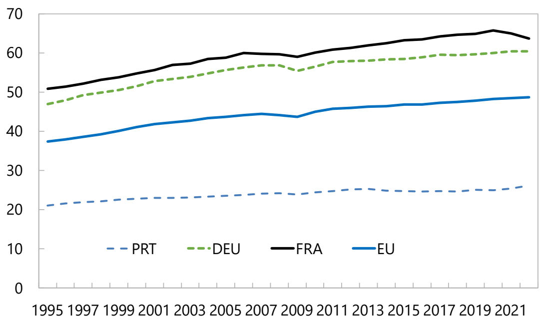
Sources: OECD, Eurostat, Hypostat, Haver Analytics, and IMF staff calculations.
Note: The analysis uses a VECM approach controlling for demand, supply, macroprudential policy interventions, and structural breaks. The chart shows overvaluation estimates under various model specification on the impact of the macroprudential variables. The red lines is a forecast of overvaluation assuming a 2 percent real interest rate shock.

Figure 8. Portugal: Productivity and Competitiveness

Despite Portugal's low productivity…

Labor Productivity

(GDP in const. 2015 prices divided by hours worked)

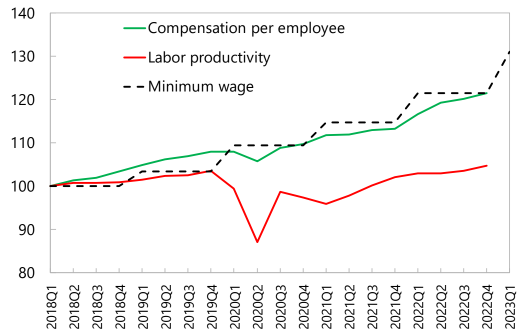


Sources: Eurostat, Haver Analytics, and IMF staff calculations.

… wages (including the minimum wage) have been growing fast, on average, both in nominal…

Wages and Productivity

(2018Q1 = 100)

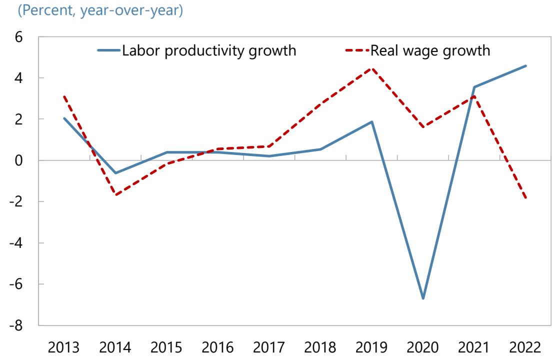


Sources: Haver Analytics and IMF staff calculations.

…and real terms…

Labor Productivity and Real Wage Growth

(Percent, year-over-year)

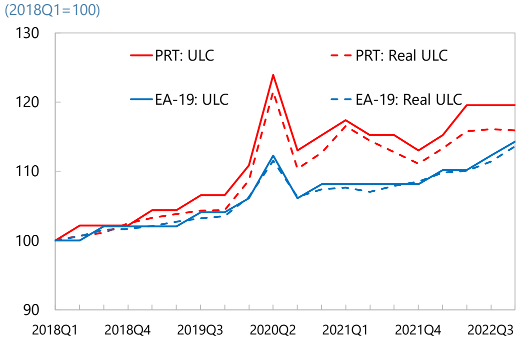


Sources: Haver Analytics and IMF staff calculations.

…resulting in growing ULC and loss of competitiveness.

Unit Labor Costs

(2018Q1=100)

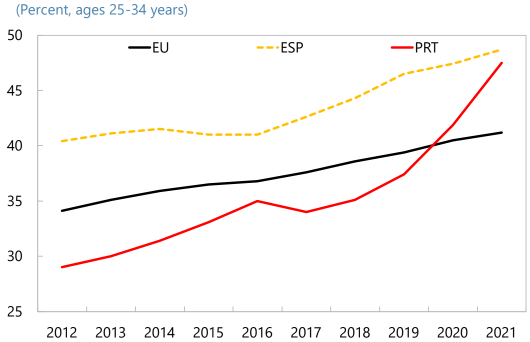


Sources: Haver Analytics and IMF staff calculations.

Structural reforms focusing on education, on-job training and digitalization are expected to boost productivity.

Tertiary Education Attainment

(Percent, ages 25-34 years)

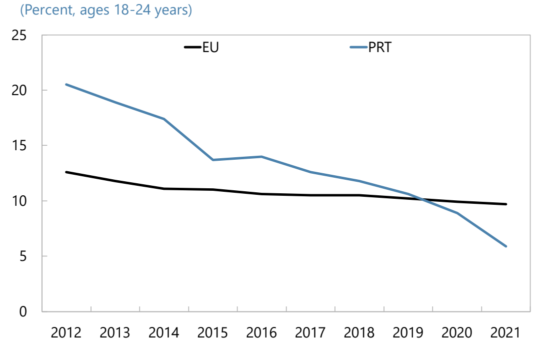


Source: Eurostat.

Some of the past policies have already started bearing fruit.

Early Leavers from Education and Training

(Percent, ages 18-24 years)

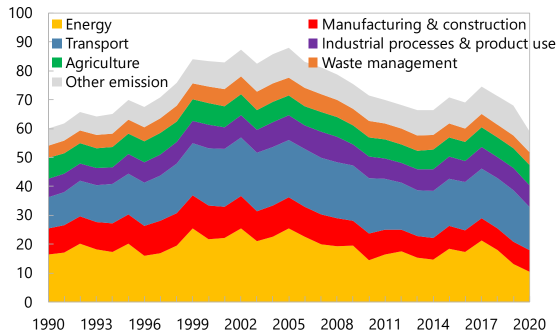


Source: Eurostat.

Figure 9. Portugal: Climate Indicators

Portugal's GHG emissions have been on a downward trend…

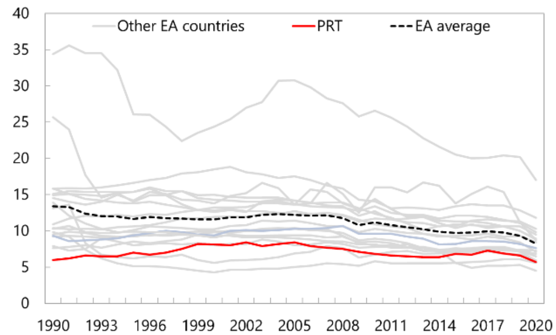
Greenhouse Gas Emission by Sector
(MtCO2e)



Sources: Eurostat and IMF staff calculations.

… as well as below the EA average.

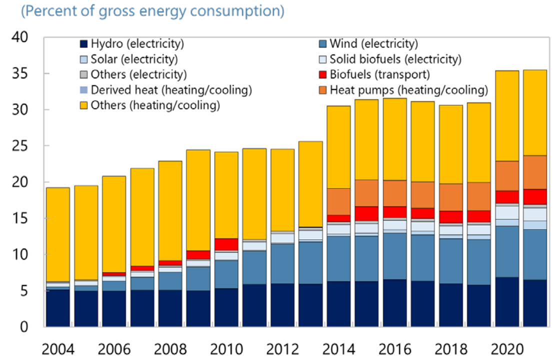
Greenhouse Gas Emission per Capita
(Tonnes)



Sources: Eurostat and IMF staff calculations.

Portugal has been a leader in renewable energy…

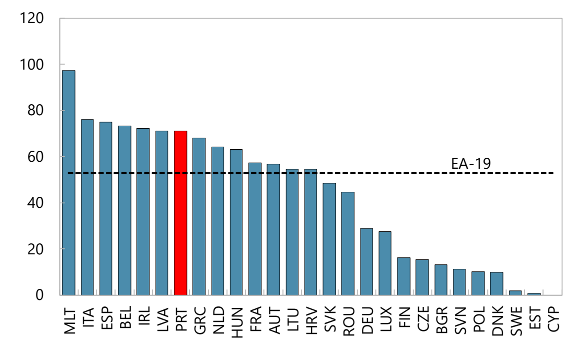
Renewable Energy
(Percent of gross energy consumption)



Sources: Eurostat and IMF staff calculations.

… still, its reliance on fossil fuels remains high.

Share of Natural Gas in Electricity Production, 2021
(Percent)



Sources: Eurostat and IMF staff calculations.

Table 1. Portugal: Selected Economic Indicators, 2018–28
(Percent, year-over-year, unless otherwise indicated)

						Projections					
	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Real GDP	2.8	2.7	-8.3	5.5	6.7	2.6	1.8	2.2	2.0	1.9	1.9
Total domestic demand	3.2	3.1	-5.4	5.6	4.5	1.9	1.7	1.9	1.8	1.7	1.7
Private consumption	2.6	3.3	-7.0	4.7	5.8	1.0	1.2	1.8	1.9	1.9	1.8
Public consumption	0.6	2.1	0.3	4.6	1.7	3.0	2.2	2.0	1.8	1.6	1.3
Gross fixed investment	6.2	5.4	-2.2	8.7	3.0	4.3	2.9	2.1	1.4	0.9	1.7
Private	6.0	6.2	-4.8	8.1	3.5	3.1	2.7	1.6	1.8	2.4	1.9
Government	7.4	-1.5	21.3	12.8	-0.4	12.8	4.5	5.5	-1.0	-8.4	0.8
Exports	4.1	4.1	-18.6	13.4	16.7	4.4	3.6	2.0	2.0	2.0	1.9
Imports	5.0	4.9	-11.8	13.2	11.1	2.8	3.3	1.5	1.5	1.5	1.5
Contribution to Growth											
Total domestic demand	3.1	3.0	-5.3	5.8	4.7	1.9	1.7	1.9	1.8	1.7	1.7
Private consumption	1.7	2.1	-4.5	3.1	3.8	0.6	0.8	1.2	1.2	1.2	1.2
Public consumption	0.1	0.4	0.1	0.8	0.3	0.5	0.4	0.3	0.3	0.3	0.2
Gross fixed investment	1.0	0.6	-0.4	1.6	0.6	0.8	0.6	0.4	0.3	0.2	0.3
Stockbuilding	0.3	-0.3	-0.5	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net exports	-0.3	-0.3	-3.0	-0.3	2.0	0.7	0.1	0.2	0.2	0.3	0.2
Savings-investment balance (Percent of GDP)											
Gross national savings	18.5	18.6	17.9	19.9	19.3	20.4	20.2	20.2	20.0	19.9	19.7
Gross domestic investment	18.3	18.5	19.1	20.6	20.6	20.7	20.6	20.5	20.4	20.0	19.8
Household saving rate	6.7	7.2	11.8	10.2	4.7	5.7	6.3	7.2	8.0	8.0	8.0
Resource utilization											
Potential GDP	1.4	1.6	-2.4	3.0	2.6	2.6	2.5	2.4	2.2	2.1	1.9
Output Gap (Percent of potential)	0.3	1.4	-4.8	-2.5	1.4	1.4	0.7	0.4	0.2	0.0	0.0
Labor											
Employment	2.3	0.8	-1.8	1.9	2.1	0.7	0.6	0.4	0.4	0.2	0.3
Unemployment rate (Percent; average)	7.2	6.7	7.1	6.6	6.0	6.6	6.5	6.3	6.2	6.2	6.2
Prices											
GDP deflator	1.8	1.7	2.0	1.5	4.4	4.0	2.7	2.2	2.1	1.9	1.8
Consumer prices (Harmonized index)	1.2	0.3	-0.1	0.9	8.1	5.6	3.1	2.4	2.2	2.0	2.0
Consumer prices excl. energy and food	0.8	0.5	0.0	0.3	6.2	5.9	3.2	2.8	2.3	2.0	2.0
Fiscal indicators (Percent of GDP)											
General government balance	-0.3	0.1	-5.8	-2.9	-0.4	-0.4	-0.2	-0.3	-0.3	-0.3	-0.3
Primary government balance	2.9	2.9	-3.1	-0.6	1.4	1.8	2.2	2.2	2.2	2.2	2.1
General government debt	121.5	116.6	134.9	125.4	113.9	107.9	103.4	99.3	95.6	92.3	89.3
External sector (Percent of GDP)											
Trade balance (Goods and Services)	0.9	0.8	-1.9	-2.6	-2.1	-1.2	-1.0	-0.5	-0.2	0.0	0.0
Current account balance	0.6	0.4	-1.0	-0.8	-1.3	-0.4	-0.4	-0.3	-0.2	0.0	0.0
Savings-investment balance (Percent of GDP) 1/	0.3	0.1	-1.2	-0.8	-1.3	-0.4	-0.5	-0.3	-0.3	-0.1	-0.1
Net international investment position	-106.4	-100.0	-104.6	-95.0	-85.7	-78.3	-73.7	-69.4	-65.8	-62.6	-59.6
REER based on ULC (2010=100) 2/	95.6	95.2	99.2	102.1	106.1	108.7	109.2	109.8	110.2	110.4	110.3
REER based on CPI (2010=100) 3/	98.0	96.4	97.2	95.4	92.5	93.0	92.9	93.2	93.4	93.6	93.7
Nominal GDP (Billions of euros)	205.2	214.4	200.5	214.7	239.3	255.3	267.0	278.8	290.2	301.5	312.8

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

1/ National Accounts concept. Differences between the savings-investment balance and the current account in the balance of payments arise from a set of factors, including a different statistical treatment given to special purpose entities in the national accounts and the balance of payments.

2/ Real effective exchange rate as a ratio of a country's unit labor cost in the manufacturing sector to a weighted average of the unit labor cost in competing countries.

3/ Real effective exchange rate for all IMF members adjusted for relative changes in consumer prices.

Table 2a. General Government Accounts, 2018–28 1/
(Billions of Euros)

	2018	2019	2020	2021	2022	Projections 2023	2024	2025	2026	2027	2028
Revenue	88.0	91.2	87.0	96.3	106.1	112.8	118.6	123.9	128.7	132.5	137.4
Taxes	51.6	52.9	49.3	53.1	61.9	64.4	68.0	71.1	74.1	77.0	79.8
Taxes on production and imports	30.9	32.1	29.2	32.3	36.2	37.9	40.0	41.8	43.6	45.3	47.0
Current taxes on income, wealth, etc. and capital taxes	20.7	20.8	20.1	20.7	25.7	26.5	28.0	29.3	30.5	31.7	32.8
Current taxes on income, wealth, etc.	20.7	20.8	20.1	20.7	25.7	26.5	28.0	29.3	30.5	31.7	32.8
Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	23.9	25.3	25.6	27.3	29.6	32.0	33.3	34.7	36.0	37.2	38.6
Grants and other revenue	12.5	13.0	12.1	16.0	14.7	16.4	17.3	18.2	18.7	18.3	18.9
Property income	1.5	1.8	1.5	1.7	1.8	1.9	2.0	2.1	2.1	2.2	2.3
Sales of goods and services	7.1	7.4	6.6	6.7	7.5	8.0	8.3	8.7	9.0	9.4	9.8
Other current revenue	3.0	3.1	3.3	5.1	3.6	3.9	4.1	4.2	4.4	4.6	4.8
Capital transfers and investment grants	1.0	0.7	0.7	2.6	1.8	2.6	2.9	3.2	3.0	2.1	2.1
Expenditure	88.7	91.0	98.7	102.5	107.1	113.7	119.0	124.7	129.5	133.3	138.4
Expense	90.3	92.7	99.8	102.8	107.2	113.2	118.2	123.7	128.7	133.5	138.6
Compensation of employees	22.0	22.9	23.9	25.0	25.8	27.7	29.1	30.5	31.9	33.3	34.8
Use of goods and services	10.8	11.1	11.3	12.4	13.5	14.4	15.0	15.3	15.7	16.0	16.4
Consumption of fixed capital	5.5	5.6	5.6	5.9	6.2	6.6	6.9	7.2	7.5	7.8	8.1
Interest	6.9	6.3	5.8	5.2	4.7	5.9	6.6	7.2	7.4	7.6	7.8
Subsidies	0.8	0.9	3.7	4.3	2.5	2.5	1.9	2.0	2.0	2.1	2.2
Social benefits	37.2	38.7	40.3	41.6	44.7	47.5	50.0	52.5	54.9	57.3	59.9
Grants and other expense	7.0	7.1	9.1	8.5	9.7	8.7	8.7	9.0	9.3	9.3	9.4
Other current expense	4.7	4.7	5.0	5.8	6.3	7.0	7.0	7.1	7.3	7.4	7.5
Capital transfers	2.4	2.4	4.2	2.6	3.4	1.6	1.7	1.9	2.0	1.9	1.9
Net acquisition of nonfinancial assets	-1.6	-1.7	-1.1	-0.3	-0.1	0.5	0.8	1.0	0.8	-0.2	-0.2
Gross fixed capital formation	3.8	3.9	4.8	5.6	6.1	7.1	7.7	8.2	8.3	7.6	7.9
Gross Operating Balance	3.1	4.1	-7.1	-0.6	5.1	6.2	7.3	7.5	7.5	6.8	6.9
Net lending (+)/borrowing (–)	-0.7	0.2	-11.7	-6.2	-0.9	-1.0	-0.4	-0.8	-0.8	-0.8	-1.0
Memorandum items:											
Primary balance	5.9	6.2	-6.2	-1.3	3.5	4.6	5.9	6.1	6.3	6.5	6.4
Structural balance	-0.3	-0.2	-4.7	-3.7	-2.9	-2.5	-1.5	-1.5	-1.1	-0.8	-1.0
Structural primary balance	6.3	5.9	0.8	1.3	1.6	3.1	4.7	5.4	6.0	6.5	6.4
Debt at face value (EDP notification)	249.3	250.0	270.5	269.2	272.6	275.6	276.0	276.7	277.5	278.3	279.2
Nominal GDP	205.2	214.4	200.5	214.7	239.3	255.3	267.0	278.8	290.2	301.5	312.8
Expenditure growth, nominal, percent	-0.2	2.5	8.5	3.9	4.4	6.2	4.6	4.8	3.8	3.0	3.8

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

1/ GFSM 2001 presentation.

Table 2b. General Government Accounts, 2018–28 1/

(Percent of GDP, unless otherwise noted)

						Projections					
	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Revenue	42.9	42.5	43.4	44.9	44.4	44.2	44.4	44.5	44.4	44.0	43.9
Taxes	25.2	24.7	24.6	24.7	25.9	25.2	25.5	25.5	25.5	25.5	25.5
Taxes on production and imports	15.1	15.0	14.6	15.1	15.1	14.8	15.0	15.0	15.0	15.0	15.0
Current taxes on income, wealth, etc. and capital taxes	10.1	9.7	10.0	9.6	10.7	10.4	10.5	10.5	10.5	10.5	10.5
Social contributions	11.6	11.8	12.8	12.7	12.4	12.5	12.5	12.4	12.4	12.3	12.3
Grants and other revenue	6.1	6.1	6.1	7.5	6.1	6.4	6.5	6.5	6.4	6.1	6.1
Property income	0.7	0.8	0.8	0.8	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Sales of goods and services	3.5	3.5	3.3	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1
Other current revenue	1.5	1.4	1.7	2.4	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Capital transfers and investment grants	0.5	0.3	0.3	1.2	0.8	1.0	1.1	1.2	1.0	0.7	0.7
Expenditure	43.2	42.4	49.2	47.7	44.8	44.5	44.6	44.7	44.6	44.2	44.2
Expense	44.0	43.2	49.8	47.9	44.8	44.3	44.3	44.4	44.4	44.3	44.3
Compensation of employees	10.7	10.7	11.9	11.6	10.8	10.8	10.9	10.9	11.0	11.0	11.1
Use of goods and services	5.3	5.2	5.6	5.8	5.7	5.7	5.6	5.5	5.4	5.3	5.2
Consumption of fixed capital	2.7	2.6	2.8	2.8	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Interest	3.4	3.0	2.9	2.4	2.0	2.3	2.5	2.6	2.6	2.5	2.5
Subsidies	0.4	0.4	1.8	2.0	1.1	1.0	0.7	0.7	0.7	0.7	0.7
Social benefits	18.2	18.1	20.1	19.4	18.7	18.6	18.7	18.8	18.9	19.0	19.1
Grants and other expense	3.4	3.3	4.6	3.9	4.1	3.4	3.3	3.2	3.2	3.1	3.0
Other current expense	2.3	2.2	2.5	2.7	2.6	2.8	2.6	2.6	2.5	2.5	2.4
Capital transfers	1.2	1.1	2.1	1.2	1.4	0.6	0.6	0.7	0.7	0.6	0.6
Net acquisition of nonfinancial assets	-0.8	-0.8	-0.5	-0.1	-0.1	0.2	0.3	0.4	0.3	-0.1	-0.1
Gross fixed capital formation	1.8	1.8	2.4	2.6	2.5	2.8	2.9	3.0	2.9	2.5	2.5
Gross Operating Balance	1.5	1.9	-3.5	-0.3	2.1	2.4	2.7	2.7	2.6	2.3	2.2
Net lending (+)/borrowing (–)	-0.3	0.1	-5.8	-2.9	-0.4	-0.4	-0.2	-0.3	-0.3	-0.3	-0.3
Memorandum items:											
Primary balance	2.9	2.9	-3.1	-0.6	1.4	1.8	2.2	2.2	2.2	2.2	2.1
Cyclically adjusted balance (Percent of potnetial GDP)	-0.5	-0.7	-2.7	-1.3	-1.3	-1.2	-0.6	-0.5	-0.4	-0.3	-0.3
Cyclically adjusted primary balance (Percent of potential GDP)	2.7	2.2	-0.1	0.9	0.6	1.0	1.8	2.0	2.1	2.1	2.1
Structural balance (Percent of potential GDP)	-0.1	-0.1	-2.3	-1.7	-1.2	-1.0	-0.6	-0.5	-0.4	-0.3	-0.3
Structural primary balance (Percent of potential GDP)	3.1	2.8	0.4	0.6	0.7	1.2	1.8	2.0	2.1	2.1	2.1
Change in structural balance (Percent of potential GDP)	0.2	0.1	-2.2	0.6	0.5	0.2	0.4	0.1	0.2	0.1	0.0
Debt at face value (EDP notification, percent of GDP)	121.5	116.6	134.9	125.4	113.9	107.9	103.4	99.3	95.6	92.3	89.3
Nominal GDP (Billions of euros)	205.2	214.4	200.5	214.7	239.3	255.3	267.0	278.8	290.2	301.5	312.8

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

1/ GFSM 2001 presentation.

Table 3a. Portugal: Balance of Payments, 2018–28

(Billions of Euros)

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
						Projections					
Current and Capital account	3.2	2.8	-0.1	2.1	-1.1	5.1	3.2	3.1	2.5	2.2	2.4
Current account	1.1	0.9	-2.1	-1.6	-3.2	-0.9	-1.2	-0.8	-0.7	-0.1	0.1
Balance on goods and services	1.8	1.7	-3.9	-5.5	-4.9	-3.1	-2.6	-1.4	-0.7	0.0	0.0
Balance on trade in goods	-15.6	-16.3	-12.5	-16.0	-26.5	-27.5	-28.8	-29.1	-29.7	-30.5	-31.9
Exports, fob	56.2	58.0	52.1	62.1	75.8	77.2	81.9	84.4	86.8	89.7	93.5
Imports, fob	71.9	74.2	64.6	78.1	102.3	104.7	110.8	113.4	116.5	120.1	125.5
Balance on trade in services	17.5	17.9	8.6	10.5	21.5	24.4	26.2	27.6	29.0	30.5	32.0
Exports	33.4	35.7	22.3	27.5	44.2	49.1	52.3	54.8	57.3	59.8	62.4
Imports	15.9	17.8	13.7	17.0	22.7	24.7	26.0	27.1	28.2	29.3	30.5
Of which:											
Balance on tourism	12.5	13.2	5.0	6.5	15.6	19.5	20.7	21.6	22.5	23.4	24.4
Exports	17.1	18.3	7.7	10.1	21.1	25.8	27.4	28.7	30.0	31.4	32.7
Imports	4.6	5.1	2.7	3.6	5.5	6.2	6.7	7.1	7.5	7.9	8.4
Primary income, net	-4.9	-5.1	-2.7	-1.7	-3.6	-3.3	-3.1	-3.8	-3.8	-3.5	-3.0
Secondary income, net	4.2	4.4	4.5	5.7	5.3	5.5	4.6	4.4	3.7	3.4	3.0
Private remittances, net	5.4	5.7	5.8	6.1	6.7	6.0	5.9	5.7	5.6	5.4	5.2
Official transfers, net	-1.2	-1.3	-1.3	-0.4	-1.4	-0.5	-1.3	-1.3	-1.8	-2.0	-2.1
Capital account	2.0	1.9	2.0	3.7	2.1	6.0	4.3	4.0	3.2	2.3	2.4
Financial account	3.5	3.2	0.1	2.5	-1.1	5.1	3.2	3.1	2.5	2.2	2.4
Direct investment, net	-5.3	-7.8	-4.9	-7.3	-4.9	-4.0	-4.2	-4.3	-4.4	-4.5	-4.3
Direct investment assets	1.3	1.4	-1.5	-0.2	3.4	3.6	3.8	4.0	4.1	4.3	4.4
Direct investment liabilities	6.6	9.2	3.4	7.1	8.3	7.6	8.0	8.2	8.5	8.8	8.7
Portfolio investment, net	8.9	8.1	5.1	13.3	4.7	-1.5	-1.9	-0.2	5.9	8.8	7.5
Financial derivatives	0.6	0.1	0.5	0.0	-4.5	0.5	0.5	0.5	0.5	0.5	0.5
Other investment, net	0.2	5.0	-0.1	-7.0	3.5	9.5	8.4	6.9	0.2	-2.9	-1.6
Reserve assets	-0.9	-2.3	-0.4	3.5	0.2	0.5	0.3	0.3	0.3	0.3	0.3
Errors and omissions	0.3	0.3	0.2	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Nominal GDP	205.2	214.4	200.5	214.7	239.3	255.3	267.0	278.8	290.2	301.5	312.8

Sources: Bank of Portugal and IMF staff projections.

Table 3b. Portugal: Balance of Payments, 2018–28

(Percent of GDP)

	2018	2019	2020	2021	2022	Projections 2023	2024	2025	2026	2027	2028
Current and Capital account	1.5	1.3	-0.1	1.0	-0.4	2.0	1.2	1.1	0.9	0.7	0.8
Current account	0.6	0.4	-1.0	-0.8	-1.3	-0.4	-0.4	-0.3	-0.2	0.0	0.0
Balance on goods and services	0.9	0.8	-1.9	-2.6	-2.1	-1.2	-1.0	-0.5	-0.2	0.0	0.0
Balance on trade in goods	-7.6	-7.6	-6.2	-7.5	-11.1	-10.8	-10.8	-10.4	-10.2	-10.1	-10.2
Exports, fob	27.4	27.0	26.0	28.9	31.7	30.2	30.7	30.3	29.9	29.7	29.9
Imports, fob	35.0	34.6	32.2	36.4	42.7	41.0	41.5	40.7	40.2	39.9	40.1
Balance on trade in services	8.5	8.4	4.3	4.9	9.0	9.6	9.8	9.9	10.0	10.1	10.2
Exports	16.3	16.7	11.1	12.8	18.5	19.2	19.6	19.7	19.7	19.8	20.0
Imports	7.8	8.3	6.8	7.9	9.5	9.7	9.7	9.7	9.7	9.7	9.7
Of which:											
Balance on tourism	6.1	6.1	2.5	3.0	6.5	7.7	7.8	7.8	7.8	7.8	7.8
Exports	8.3	8.5	3.8	4.7	8.8	10.1	10.3	10.3	10.3	10.4	10.5
Imports	2.2	2.4	1.4	1.7	2.3	2.4	2.5	2.5	2.6	2.6	2.7
Primary income, net	-2.4	-2.4	-1.4	-0.8	-1.5	-1.3	-1.2	-1.4	-1.3	-1.2	-1.0
Secondary income, net	2.0	2.0	2.3	2.6	2.2	2.2	1.7	1.6	1.3	1.1	1.0
Private remittances, net	2.6	2.7	2.9	2.8	2.8	2.3	2.2	2.1	1.9	1.8	1.7
Official transfers, net	-0.6	-0.6	-0.6	-0.2	-0.6	-0.2	-0.5	-0.5	-0.6	-0.7	-0.7
Capital account	1.0	0.9	1.0	1.7	0.9	2.4	1.6	1.4	1.1	0.8	0.8
Financial account	1.7	1.5	0.1	1.2	-0.4	2.0	1.2	1.1	0.9	0.7	0.8
Direct investment, net	-2.6	-3.6	-2.5	-3.4	-2.0	-1.6	-1.6	-1.5	-1.5	-1.5	-1.4
Direct investment assets	0.6	0.7	-0.8	-0.1	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Direct investment liabilities	3.2	4.3	1.7	3.3	3.5	3.0	3.0	2.9	2.9	2.9	2.8
Portfolio investment, net	4.4	3.8	2.5	6.2	2.0	-0.6	-0.7	-0.1	2.0	2.9	2.4
Financial derivatives	0.3	0.0	0.2	0.0	-1.9	0.2	0.2	0.2	0.2	0.2	0.2
Other investment, net	0.1	2.4	-0.1	-3.3	1.5	3.7	3.2	2.5	0.1	-1.0	-0.5
Reserve assets	-0.4	-1.1	-0.2	1.6	0.1	0.2	0.1	0.1	0.1	0.1	0.1
Errors and omissions	0.1	0.2	0.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Tourist receipts (percent of total exports)	19.0	19.5	10.4	11.2	17.6	20.4	20.4	20.6	20.8	21.0	21.0
Net international investment position (% GDP)	-106.4	-100.0	-104.6	-95.0	-85.7	-78.3	-73.7	-69.4	-65.8	-62.6	-59.6
Annual Change in NIIP valuation1/	-5.3	-1.0	-0.5	..	..	..	..	..	..	..	..

Sources: Bank of Portugal and IMF staff projections.

1/ End-of-period data.

Table 4. Portugal: Selected Financial Indicators of the Banking System, 2018–22

(Percent)

	2018				2019				2020				2021				2022			
	2018Q1	2018Q2	2018Q3	2018Q4	2019Q1	2019Q2	2019Q3	2019Q4	2020Q1	2020Q2	2020Q3	2020Q4	2021Q1	2021Q2	2021Q3	2021Q4	2022Q1	2022Q2	2022Q3	2022Q4
Capital adequacy																				
Regulatory capital to risk-weighted assets	15.0	15.2	15.3	15.1	16.0	16.1	16.4	16.9	16.7	17.2	17.5	18.0	17.7	17.8	17.8	18.0	17.5	17.6	17.1	18.1
Common Equity Tier 1 capital to risk-weighted assets	13.5	13.4	13.5	13.2	13.8	13.9	13.9	14.3	14.1	14.6	14.8	15.3	15.2	15.3	15.2	15.5	14.9	15.0	14.6	15.3
Regulatory tier 1 capital to risk-weighted assets	14.2	14.1	14.1	13.9	14.8	14.8	15.0	15.4	15.3	15.7	15.9	16.4	16.2	16.3	16.3	16.3	15.7	15.8	15.3	16.1
Capital to assets 1/	7.6	7.4	7.3	7.0	7.4	7.4	7.4	7.6	7.5	7.2	7.2	7.4	7.1	7.1	6.9	6.6	6.3	6.3	NA	NA
Asset composition and quality																				
Non-performing loans to total gross loans	12.7	11.7	11.3	9.4	8.9	8.3	7.7	6.2	6.0	5.6	5.3	4.9	4.6	4.3	4.0	3.7	3.6	3.4	3.2	3.0
Sectoral distribution of loans																				
Residents	91.6	91.4	91.6	91.5	91.3	91.6	91.0	91.7	91.4	92.1	92.0	92.4	NA	NA	NA	NA	NA	NA	NA	NA
Nonresidents	8.4	8.6	8.4	8.5	8.7	8.4	9.0	8.3	8.6	7.9	8.0	7.6	NA	NA	NA	NA	NA	NA	NA	NA
Earnings and profitability																				
Return on assets	0.8	0.6	0.6	0.3	0.6	0.6	0.6	0.4	0.2	0.1	0.1	0.0	0.4	0.4	0.5	0.5	0.7	0.7	0.7	0.7
Return on equity	8.2	6.1	6.3	3.0	6.7	6.0	6.2	4.8	2.5	0.9	1.6	0.5	4.7	5.2	5.4	5.4	8.5	8.9	8.3	8.8
Interest margin to gross income	50.4	50.8	51.7	54.9	53.2	53.4	54.5	55.6	55.2	58.4	57.0	56.3	50.6	50.5	51.3	51.0	51.2	51.4	NA	NA
Noninterest expenses to gross income	60.6	61.2	59.6	62.6	59.8	60.7	60.7	62.3	63.6	65.5	62.3	62.0	57.4	59.6	59.0	58.2	57.0	58.1	NA	NA
Liquidity																				
Liquid assets to total assets 2/	14.1	15.3	15.0	16.1	17.1	17.5	17.6	18.5	18.5	21.7	21.3	21.7	23.2	24.0	24.1	25.6	24.8	25.0	NA	NA
Liquid assets to short-term liabilities 2/	20.9	22.0	21.7	23.3	26.4	23.9	23.9	25.3	24.9	31.3	31.1	31.6	33.9	31.3	31.8	34.3	33.6	34.4	NA	NA
Loans to deposits 3/	92.5	89.1	89.5	89.0	87.8	88.1	87.8	87.1	86.4	84.6	85.2	84.7	83.5	82.5	82.4	81.1	80.1	79.2	79.0	78.2
Foreign-currency-denominated liabilities to total liabilities 4/	4.1	4.3	4.3	4.6	4.2	3.9	4.3	4.1	4.1	3.7	3.6	3.5	3.5	3.2	3.3	3.1	3.7	3.8	NA	NA

Sources: Bank of Portugal; and IMF Financial Soundness Indicator Database.

1/ On accounting basis; consolidated.

2/ 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.

3/ 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.

4/ 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).

Annex I. 2022 Article IV Recommendations

2022 Article IV Key Recommendations	Authorities' Actions
Fiscal Policy	
Near-term. Maintain an accommodative fiscal stance in 2022 given headwinds to growth and economic slack. Target any discretionary support to vulnerable households and most affected and viable firms. Starting 2023, engage in gradual and growth-friendly fiscal adjustment, while increasing the share of investment spending.	The outlook was overtaken by spillovers from Russia's war in Ukraine and broader inflation pressures. Nevertheless, growth remained strong and the fiscal deficit in 2022 was reduced significantly more than staff's projections (during the 2022 Article IV Consultations) and the public debt-to-GDP ratio fell below its 2019 level to 107.9 percent. A sizeable fiscal support package, mostly broad based, was implemented in 2022-23 (annually 2 percent of GDP), especially to support vulnerable households and firms with higher cost of living.
Medium-term. Implement tax reforms to reduce tax distortions and expenditures, raise property tax revenues and roll back reduced VAT tax rates; reforms to bolster pension sustainability, review of public employment and compensation structure, strengthen social assistance; structural fiscal reforms including through the full implementation of the 2015 Budgetary Framework Law, reform of the NHS and boost efficiency and health of SOEs.	On pensions, the government provided two payouts in 2022 and 2023 fully reflecting CPI indexation. A spending review is expected to be launched in Spring 2023, with technical support from the OECD, mostly focused on improving efficiency. VAT rate reductions have been introduced on several essential food products. A multi-year expenditure ceiling has been submitted to the Parliament and multi-year budgetary plans are being developed for the NHS.
Financial Sector and Macro-Financial Issues	
Corporate sector. Engage in prompt recapitalization of viable NFCs - supported by commercial banks technical expertise.	The envelope for recapitalization of NFCs, as managed by Banco Portugues de Fomento (BdF) via several programs, was increased to account for broader needs from two consecutive shocks. All recapitalizations require market tests as BdF only provides up to 70 percent of funding requested. There are plans for closer cooperation with commercial banks.

2022 Article IV Key Recommendations	Authorities' Actions
Financial Sector and Macro-Financial Issues	
Banks. Continued close monitoring of banks' credit quality and financial soundness, including with forward-looking assessments. Exposures to restructuring funds and deferred tax assets should follow prudent valuations.	Supervisors are closely monitoring vulnerabilities and risks. Banks have made significant efforts to reduce their exposure to restructuring funds; capital inefficiencies related to deferred tax assets are contained.
Macroprudential measures. Once the recovery is well established, a positive-rated CCyB or a sectoral risk buffer should be considered to contain risks from banks real-estate exposures.	The authorities did not consider the timing appropriate for implementing additional macroprudential sectoral or cyclical capital buffers. New housing relief measures were put in place to support families with interest burden relief and rental support (Mais Habitaçao).
Insolvency Regime. Lift the suspension of the duty to file for insolvency. Further strengthen the insolvency regime by building on recent reforms.	A bill revoking the suspension on the duty to file for insolvency was submitted to the Parliament and the law is expected to take effect later in 2023.
Anti-money laundering. Address cross-border money laundering risks, e.g., by improving the coverage and information of the central register of the beneficial owner (RCBE).	The government announced an end of the golden visa regime, which has been seen as a risk factor for money laundering. Progress has been made in strengthening risk-based AML supervision.
Structural Reforms	
Labor market flexibility. Alleviate labor market duality by allowing permanent contracts to be more flexible and by active labor market policies.	The Decent Work Agenda' (Agenda do Trabalho Digno) was adopted on May 1, 2023. It is expected to further reduce labor market duality, reducing the share of precarious jobs.
Skills/digitalization. More vocational and on-the-job training, also for older cohorts, by increasing training incentives. Leverage digitalization to improve productivity, in particular among SMEs.	The NRRP is focused on projects related to digitalization, for example, Enterprises 4.0, Quality and Sustainability of Public Finances, Economic Justice System and Business Environment, Digital Public Administration, and Digital School.
Effective carbon pricing. Increase effective cost of carbon emission by gradual increases in carbon prices, eliminating subsidies and a broader coverage of the carbon tax.	With the onset of the energy crisis, the carbon tax update was temporarily suspended.

Annex II. External Sector Assessment

Overall Assessment: *The external position in 2022 was broadly in line with the level implied by medium-term fundamentals and desirable policies.* The NIIP-to-GDP ratio further improved from -95 percent in 2021 to -86 percent in 2022, and under baseline assumptions is projected to fall to -59.6 percent by 2028, reflecting both, an improvement in the current account balance and sustained GDP growth. However, IMF staff assesses Portugal's current account norm to be relatively high due to external sustainability risks from a still large negative NIIP. A stronger current account balance over the medium term would enable a faster strengthening of the NIIP.

Potential Policy Responses: Keeping the current account in line with its norm requires sustained fiscal consolidation efforts and structural reforms to improve Portugal's savings rate, competitiveness, diversification, and economic resilience. Improvements in wage flexibility and labor market duality, as well as further measures to enhance education outcomes and encourage innovation would contribute to productivity gains. Public investments under the RRP provide an opportunity to transition to a greener, more competitive, and digital economy. Private investment can be further spurred by enhancing business conditions, streamlining regulations, and implementing labor market reforms to raise skills and reduce duality.

Foreign Asset and Liability Position and Trajectory

Background. The negative NIIP declined from its peak in 2014 of 124 percent of GDP to 86 percent of GDP in 2022, after a rebound to 105 percent in 2020, because of the pandemic-induced decline in GDP. The improvement compared to 2021 reflects a larger decrease in gross liabilities than in assets as a percent of GDP, even though the current account balance deteriorated in 2022. The gross external debt position has also been on a downward trend (see Annex V), but still remains high at 168 percent in 2022. Both NIIP and gross external debt are expected to continue to decline, but at a decelerating rate over the medium term as the evolution of the CA remains less favorable.

Assessment. The still large negative NIIP position induces external vulnerabilities, particularly from large gross financing needs from external debt (estimated at an average 66 percent of GDP over 2023-28, Annex V), and potential valuation changes. However, past debt management efforts to reduce sovereign external risk, including by smoothing the profile for redemptions and lengthening the average maturity, and sizeable central bank holdings through the ECB's asset purchase programs are important risk mitigants. Going forward, the NIIP is projected to stay on a downward path and reach -59.6 percent of GDP by 2028, reflecting a sustained improvement in the current account.

2022 (% GDP)	NIIP: -85.7	Gross Assets: 158.7	Debt Assets: 127.3	Gross Liab.: 244.4	Debt Liab.: 41.6

Current Account

Background. The current account was in surplus during 2013–19, after an extended period of deficits. The surpluses were driven by a significant improvement in the balance of trade in goods and services, including on the heels of strong growth in tourism, and a substantial improvement in the savings-investment balance from fiscal adjustment. The current account balance registered a modest deficit of 1.3 percent of GDP in 2022, widening by 0.5 pp relative to 2021, driven by surging global commodity prices that were partially offset by higher tourism revenues.

Assessment. EBA model-based estimates suggest a cyclically adjusted current account balance at 0.1 percent of GDP. Adjusting by 0.5 percent to account for the effect of the Covid-19 pandemic on transportation costs, yields a staff cyclically adjusted current account amounting to 0.6 percent of GDP. The EBA CA model suggests a norm of -1.4 percent of GDP. However, given external risks from a large and negative NIIP, staff's assessment puts more weight on external sustainability, aligned with past advice (see staff reports of the 2018-2022 IMF Article IV Consultations). Guided by the objective of reducing the negative NIIP position to under -50 percent over the medium-term, and assuming no valuation effects, which adds some 1.9 pp of GDP to the model's CA norm, results in an adjusted CA norm of 0.5 percent of GDP (within a range of -0.2 to 1.2 percent to recognize the uncertainty in the economic outlook), implying a staff gap of 0.1 percent of GDP. Accounting for uncertainty in the estimates, this implies a CA gap in the range of -0.6 to 0.8 percent of GDP. Policy gaps, reflecting deviations of current policy settings in Portugal from their desired settings, contribute 1.3 percent while the unexplained residual represents 0.2 percent. Key to strengthen the external position, given the high level of public debt, remains a sustained fiscal adjustment paired with structural reforms to support both saving and investment and improve external competitiveness.

2022 (% GDP)	CA: -1.3	Cycl. Adj. CA: 0.1	EBA Norm: -1.4	EBA Gap: 1.5	Covid-19 Adj.: 0.5	Other Adj.: -1.9	Staff Gap: 0.1

Real Exchange Rate

Background. The CPI-based real effective exchange rates (REER) for Portugal and the Eurozone are on a similar level. However, since 2010, the ULC-based REER measure fell by 11 pp in Portugal, while the decrease for the Euro area was twice as high (22 pp). Focusing on the manufacturing sector only, the ULC-based REER continued to appreciate and is now above its 2010 level.

Assessment. The EBA REER index model[1] suggest a marginal undervaluation of -0.8 percent while the level REER model implies a marginal overvaluation of 1.8 percent in 2022.[2] Putting the NIIP on a continued downward track will require an improvement in the REER to contain further appreciation, which could be accomplished through sustained quality upgrades and innovation to improve non-price competitiveness. Reforms under the NRRP focused on raising productivity are critical in this regard.

Capital and Financial Accounts: Flows and Policy Measures

Background. Financing conditions have become more challenging in 2022 on the back of market uncertainty and a tighter monetary stance by the ECB amid inflationary pressures. As a result, sovereign spreads relative to the bund reached 100 basis points in 2022, from a level of around 70 basis points at the end of 2021. The financial account recorded a small deficit driven by negative contributions of financial derivatives and direct investments. Credit ratings have been positive with a one notch rating upgrade by S&P and Fitch to BBB+ in 2022 (Moody's maintained their grade rating at Baa2).

Assessment. An active debt management has not only helped support external financing rollover needs for the near term in the public sector but has also had positive spillover effects for the private sector, including by lowering funding costs. Still, existing external financing needs leave Portugal exposed to market volatility, especially in a context of tightening global financial conditions.

FX Intervention 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.

[1] EBA REER models are based on CPI-based REER.

[2] Based on the 0.38 model elasticity, the REER gap obtained from the staff-assessed CA gap is assessed to be in the range of -2.12 to 1.58 percent, with a midpoint at -0.26 percent.

Annex III. Risk Assessment Matrix[1]

Risks (Likelihood)	Impact if Realized	Policy Responses
Global Risks		
Intensification of regional conflicts (High). Escalation of Russia's war in Ukraine or other regional conflicts and resulting economic sanctions disrupt trade (e.g., energy, food, tourism, and/or critical supply chain components), remittances, refugee flows, FDI and financial flows, and payment systems.	**High:** Negative energy, food and tourism shocks would impede the recovery. Increased inflow of refugees could raise unemployment pressures and trigger social tensions.	• Full use of automatic stabilizers if a recession begins to unfold • Avoid broad-based discretionary support unless the shock amplifies in scale. • Augment the scope of ALMPs to facilitate refugees' transitions into the labor market, particularly in sectors facing labor shortages.
Commodity price volatility (Medium). A succession of supply disruptions (e.g., due to conflicts and export restrictions) and demand fluctuations (e.g., reflecting China reopening) causes recurrent commodity price volatility, external and fiscal pressures, and social and economic instability.	**High:** Higher commodity price volatility may discourage investment and consumption and dampen growth further.	• If prolonged and begins to materially affect domestic demand, reintroduce temporary and targeted support to the most vulnerable households and highly affected firms that are under pressure. • The intensity of firm support could be linked to energy efficiency targets. • Speed up green transition by investing in renewable energy. • Pre-announced fiscal measures to reduce fiscal imbalances can reinforce fiscal discipline and maintain investor confidence.
Monetary policy miscalibration (Medium). Amid high economic uncertainty and volatility, major central banks slow monetary policy tightening or pivot to loosen monetary policy stance prematurely, de-anchoring inflation expectations and triggering a wage-price spiral in tight labor markets.	**Medium:** Monetary tightening would increase the borrowing costs and if combined with de-anchored inflation expectations could push the economy to a stagflation. It would amplify the financial strains on both households and firms.	• Engage in fiscal policy consolidation (while protecting the poor), to reduce domestic demand pressures and further support the ECB in containing inflation and avoid inflation de-anchoring to minimize the risk of an emergence of wage-price spiral. • Promote flexible work arrangements to boost labor supply to mitigate the increase in labor market tightness.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path. The relative likelihood 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 between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. The conjunctural shocks and scenarios highlight risks that may materialize over a shorter horizon (between 12 to 18 months) given the current baseline. Structural risks are those that are likely to remain salient over a longer horizon. This is based on the Global Risk Assessment Matrix from February 2023.

Risks (Likelihood)	Impact if Realized	Policy Responses
Abrupt global slowdown or recession (High for Europe). Global and idiosyncratic risk factors combine to cause a synchronized sharp growth downturn, with recessions in some countries, adverse spillovers through trade and financial channels, and markets fragmentation. • **U.S. (Medium):** Amid tight labor markets, supply disruptions and/or commodity price shocks, inflation remains elevated, prompting the Fed to keep rates higher for longer and resulting in dollar strengthening, a more abrupt financial and housing market correction, and "hard landing". • **Europe (High).** Intensifying fallout from the war in Ukraine, worsening energy crisis and supply disruptions, and monetary tightening exacerbate economic downturns and housing market corrections. • **China (Medium):** Greater-than-expected economic disruptions from Covid resurgence, rising geopolitical tensions, and/or a sharper-than-expected slowdown in the property sector disrupt economic activity. • **EMDEs (Medium)**: A new bout of global financial tightening, possibly combined with volatile commodity prices, leads to spiking risk premia, debt distress, widening of external imbalances, fiscal pressures, and sudden stops.	**High.** Negative spillover effects on Portugal through trade linkages and supply chains, and lower tourism arrivals.	• Full use of automatic stabilizers if a recession begins to unfold. • Provide temporary and targeted support to the most vulnerable groups.

Risks (Likelihood)	Impact if Realized	Policy Responses
• **Systemic financial instability (Medium).** Sharp swings in real interest rates, risk premia, and assets repricing amid economic slowdowns and policy shifts trigger insolvencies in countries with weak banks or nonbank financial institutions, causing markets dislocations and adverse cross-border spillovers.	**Medium**: A sharp increase in interest rates will deteriorate both public and private sector balance sheets. Floating rate loans for house purchase (90 percent of the stock) make borrowers vulnerable to interest rate shocks. A sudden correction in house prices could increase bank losses on defaulted exposures. Lower bank capital could unduly constrain credit and would also worsen banks' credit quality through their sizeable exposure to housing mortgages. The negative wealth effect and weaker consumer confidence would weigh on consumption.	• Intensify monitoring of banks' capital positions and risk management practices to contain systemic risk. • Further strengthen guidance on prudent lending standards. • In the event of a sharp downturn, relax macroprudential settings so that banks can keep credit flowing.
	Structural risks	
Deepening geo-economic fragmentation and geopolitical tensions (High). Broader and deeper conflict(s) and weakened international cooperation lead to a more rapid reconfiguration of trade and FDI, supply disruptions, technological and payments systems fragmentation, rising input costs, financial instability, a fracturing of international monetary and financial systems, and lower potential growth.	**High:** Extended supply-side disruptions due to deepening of geo-economic fragmentation could induce higher commodity prices and will slow down the recovery and impact private and public balance sheets. Inflow of refugees could induce social tensions.	• Accelerate investments in digitalization and green energy. • Continue to promote international cooperation via active participation in joint efforts to promote green transitions and policy coordination in Euro Area and beyond.
	Domestic Risks	
A sharp tightening of domestic financial conditions combined with a sharp correction in real estate markets (High). Tighter financial conditions, including because of continued tightening in bank lending standards, in the context of a high share of floating rate loans and stretched valuation in housing market, result in a sharp house price correction.	**Medium:** A sudden correction in house prices could increase bank losses on defaulted exposures. Lower bank capital could unduly constrain credit. The negative wealth effect and weaker consumer confidence could weigh on consumption.	• Ensure that banks adopt appropriate provisioning practices and capital conservation practices. • Continue to closely monitor the build-up of systemic risk and consider building capital buffers on real estate exposures. • Further macroprudential policy interventions if imbalances in the housing market persist.
Lower absorption of NGEU funds (Medium). Slow implementation of the NGEU investment and reform agenda	**Medium:** Repeated underspending of investment financed by NGEU funds could slow medium-term growth and delay the push for a more digital and greener economy.	• Further strengthen administrative capacity to implement projects.

Annex IV. The Sovereign Risk and Debt Sustainability Assessment

Portugal's public debt remains high at 113.9 percent of GDP in 2022, although sustained reduction of overall deficits and high nominal GDP growth since the pandemic have helped keep debt on a downward path. Under the baseline scenario, the debt-to-GDP ratio is projected to continue its downward trajectory, declining to 89.3 percent of GDP by 2028, on the back of sustained growth and projected improvement in the primary balance. Negative growth shocks along with (i) higher pension and health-related spending, (ii) a slow ramp-up of public investment under the NRRP, (iii) real wage pressures beyond productivity growth would pose risks to this projected downward path.

A. Background

1. **Public debt has declined substantially since the Covid-19 recession, driven by the economic growth and improvements in primary surpluses.** The Covid-19 recession and the fiscal response raised the debt-to-GDP ratio by more than 18 percentage points to 134.9 percent of GDP in 2020. Subsequently, however, the debt-to-GDP ratio declined slightly below 2019 levels to 113.9 percent by end-2022, driven by strong GDP growth in 2021-22 (5.5 and 6.7 percent in 2021 and 2022, respectively), high inflation in 2022 (nominal GDP growth rate of 11.4 percent in 2022) and improvements in the primary balance from - 3.1 percent in 2020 to a primary surplus of 1.4 percent by 2022.

B. Baseline Scenario

2. **Baseline projections: Portugal's debt is projected to decline by an annual average of about 4.1 pp of GDP during 2023–28, mainly driven by the economic growth and attendant improvements in the primary balance.** Public debt is projected to decline to 89.3 percent by 2028, driven by (i) strong real GDP growth (accounting for around 50 percent of the total reduction or 12.5 pp of GDP), followed by (ii) primary balance improvement, and (iii) *real* interest rate (each contributing some 8.9 pp and 2.5 pp reduction, respectively).

- **GDP growth.** Staff's baseline scenario projects medium-term growth to converge to about 2 percent, bolstered by public investments and reforms under the NRRP. However, medium-term TFP growth could deteriorate if global fragmentation risks materialize, and/or corporate vulnerabilities risk and zombification of firms materialize, or regional conflict intensifies.

- **Fiscal deficit.** The overall balance is projected to remain flat at -0.4 percent in 2023 with full withdrawal of Covid-19 measures largely offsetting cost-of-living fiscal support measures. Over the medium term, the overall balance is projected to average around -0.3 percent of GDP, reflecting in part continued pressures from pension and health-related spending due to a rapidly aging population, and a slightly increasing public wage bill, which would offset gradual revenue gains.

- **Interest rates and gross financing needs (GFN):** Gross financing needs are expected to remain around 10 percent of GDP over the medium and long term. Long-term interest rates on Portuguese sovereign bonds are projected to peak in 2024 before gradually stabilizing over the medium-term projection horizon. Long-term sovereign yields are assumed to increase from 2.2 percent in 2022 to 4.0 in 2024 and edge down to 3.5 percent by 2028. The effective interest rate is expected to rise to reach 2.5 percent by 2028 (the effective interest rate is also impacted by the fact that over time more expensive long-term debt is issued to replace past debt that was incurred at lower interest rates).

C. Risk Assessment

3. Public debt is expected to remain high despite its downward path under the baseline. Large negative growth shocks, similar to the two deep recessions that Portugal has experienced in the past decade (cumulative real GDP contraction of 6.6 percent during 2011–13 and an 8.3 percent contraction in 2020), could push debt up and sharply increase borrowing costs. Although a negligible share of foreign currency debt keeps foreign exchange rate risk low, a faster-than-expected normalization of monetary policy, with higher policy rates and lower reinvestment of maturing sovereign debt held by the ECB, would increase yields and could still generate vulnerabilities. The prolonged war in Ukraine could also put additional fiscal pressure.

4. Mitigating factors. Despite the high debt and its sizable external financing profile under the baseline, important mitigating factors include: (i) the financing from the EU under the NGEU; (ii) a considerable share of debt to official creditors (close to 20 percent of the total debt at end-2022); (iii) the relatively long tenure of the existing debt (7.5 years of average residual maturity) and (iv) the negligible share of foreign currency debt.

5. Realism of baseline assumptions.

- **Forecast track record:** In the past, forecast errors of debt-related variables for Portugal, including primary balance, r-g, and gross financing needs remained in the range of 25th to 75h percentile for one-year, three-year and five-year horizons, except for the public debt, which is shown to be optimistic mainly due to the past two deep recessions Portugal experienced.

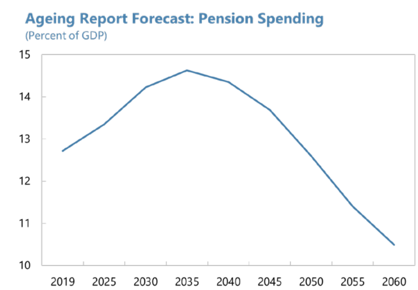
- **Contributing Factors:** Realism analysis compares the contributions of public debt creating flows between the past five years and the next five years. Real GDP growth is expected to be the largest driver, followed by primary balance and real interest rates.

- **Projected fiscal adjustment.** Portugal's three–year adjustment of the cyclically-adjusted primary balance (CAPB) is around the 75th percentile. However, the projected fiscal adjustment remains feasible as fiscal responses to the cost-of-living crisis are expected to unwind after 2023.

6. Fan chart. The fan chart based on historical observations shows that the projected public debt could deteriorate. The baseline projection for the debt path close to the lower end of the fan chart is mainly attributable to the past two deep recessions that Portugal experienced in the past decade. However, if such large negative growth shocks materialize, debt could derail from its downward path.

7. Long-term risk assessment: A long-term risk assessment includes debt related stress that could materialize beyond the next five years. Out of four broad modules (i) the implication of demographic changes on social security/pension funds and public health programs, (ii) the effects of discovery or depletion of natural resource wealth, (iii) rollover risks from large future debt amortization, and (iv) the consequences of adaptation and mitigation investments to combat climate change, only (i)—demographics on pension and health—was triggered for Portugal.[1]

Pension costs: The 2021 Ageing Report projects an increase in pension costs for Portugal, peaking in 2035 before gradually coming down. The gradual decline in pension spending is partly explained by the projected increase in employment rate among the people aged between 55 and 74 and the old-age dependency ratio beginning to plateau slightly towards the late 2040s. While the scenario is illustrative, it emphasizes the importance of pension reforms (See the [European Commission's 2021 Ageing Report]() for details).



Source: 2021 European Commission Ageing Report.

Health Expenditure: The health expenditure module considers potential risks from rising healthcare expenditure spending. Gross financing needs decline slowly over time due to strong primary balance offsetting changes in demographics. If healthcare expenditure were to exceed medium-term inflation (labeled as ECG), public debt would be pressured over the long horizon.

[1] The module is purely mechanical and does not consider any pension reforms or pension payment adjustments to minimum wage for receiving pensions as life expectancy increases. The exercise can be considered as a worst-case scenario.

Annex IV. Figure 1. Portugal: Risk of Sovereign Stress

Horizon	Mechanical signal	Final assessment	Comments
Overall	...	**Moderate**	The overall risk of sovereign stress is moderate: relatively low level of vulnerability in the near- and medium-term horizons on the basis of a projected fiscal consolidation path, and moderate level of vulnerability in the long-term horizon due to the current high-level debt and age-related expenditure pressures.
Near term 1/			
Medium term	**Low**	**Low**	Medium-term risks are assessed as low, consistent with mechanical low signal.
Fanchart	**Moderate**	...	
GFN	**Low**	...	
Stress test	...	...	
Long term	...	**Moderate**	Long-term risks are moderate given long-term aging-related expenditure pressures in the absence of comprehensive reforms.
Sustainability assessment 2/	...	...	Not required for surveillance countries
Debt stabilization in the baseline			Yes

DSA summary assessment

Commentary: Portugal is at moderate overall risk of sovereign stress. Most indicators have started to normalize as the recovery from the Covid-19 shock has proceeded well and some of policy measures in response to the cost-of-living crisis are projected to expire after 2024. Medium-term liquidity risks are assessed as moderate based on the Fan chart but low based on the GFN Financiability Module. Over the longer run, Portugal should continue with reforms to tackle risks arising from population aging on pension spending and from continued pressures to increase wages beyond the level consistent with productivity growth. However, in the long horizon at which these risks would materialize, the authorities' planned measures are expected to help contain risks.

Source: Fund staff.
Note: The risk of sovereign stress is a broader concept than debt sustainability. Unsustainable debt can only be resolved through exceptional measures (such as debt restructuring). In contrast, a sovereign can face stress without its debt necessarily being unsustainable, and there can be various measures—that do not involve a debt restructuring—to remedy such a situation, such as fiscal adjustment and new financing.
1/ The near-term assessment is not applicable in cases where there is a disbursing IMF arrangement. In surveillance-only cases or in cases with precautionary IMF arrangements, the near-term assessment is performed but not published.
2/ A debt sustainability assessment is optional for surveillance-only cases and mandatory in cases where there is a Fund arrangement. The mechanical signal of the debt sustainability assessment is deleted before publication. In surveillance-only cases or cases with IMF arrangements with normal access, the qualifier indicating probability of sustainable debt ("with high probability" or "but not with high probability") is deleted before publication.

Annex IV. Figure 2. Portugal: Debt Coverage and Disclosures

1. Debt coverage in the DSA: 1/

CG	GG	NFPS	CPS	Other
	chosen			

1a. If central government, are non-central government entities insignificant? n.a.

2. Subsectors included in the chosen coverage in (1) above:

Sector grouping		Subsectors captured in the baseline	Inclusion	Comments
CPS / NFPS / GG: expected / CG	1	Budgetary central government	Yes	
CPS / NFPS / GG: expected / CG	2	Extra budgetary funds (EBFs)	No	Not applicable
CPS / NFPS / GG: expected / CG	3	Social security funds (SSFs)	Yes	
CPS / NFPS / GG: expected	4	State governments	Yes	
CPS / NFPS / GG: expected	5	Local governments	Yes	
CPS / NFPS	6	Public nonfinancial corporations	Yes	
CPS	7	Central bank	Yes	
CPS	8	Other public financial corporations	Yes	

3. Instrument coverage:

Currency & deposits	Loans	Debt securities	Oth acct. payable 2/	IPSGSs 3/
Included	Included	Included	Missing	Missing

4. Accounting principles:

Basis of recording		Valuation of debt stock		
Non-cash basis 4/	Cash basis	Nominal value 5/	Face value 6/	Market value 7/
	chosen	chosen		

5. Debt consolidation across sectors:

Consolidated	Non-consolidated
	chosen

Color code: chosen coverage; Missing from recommended coverage; Not applicable

Reporting on intra-government debt holdings

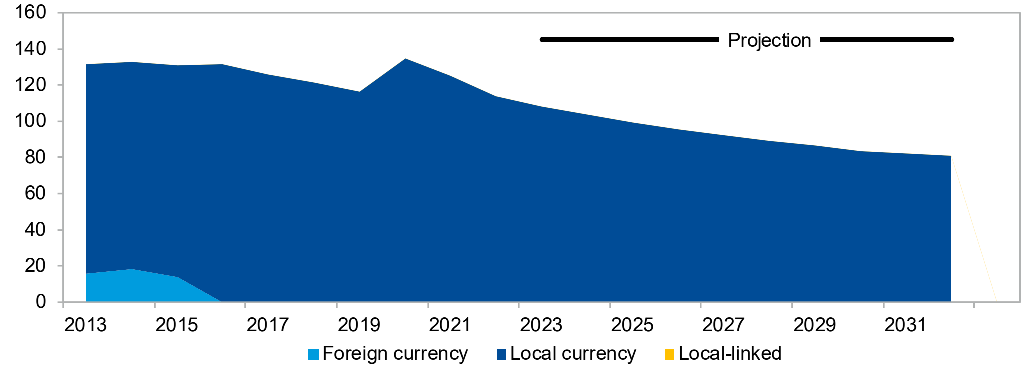
Issuer \ Holder		Budget. central govt	Extra-budget. funds	Social security funds	State govt.	Local govt.	Nonfin. pub. corp.	Central bank	Oth. pub. fin corp	Total
1	Budget. central govt			20.6		0.5	1.6	70.4	6.4	99.6
2	Extra-budget. funds									0.0
3	Social security funds	0				0	0	0	0	0.0
4	State govt.									0.0
5	Local govt.	1.9		0				0.92	0.80	3.6
6	Nonfin pub. corp.	0.6								0.6
7	Central bank									0.0
8	Oth. pub. fin. corp									0.0
	Total	2.5	0.0	20.6	0.0	0.5	1.6	71.4	7.2	103.8

1/ CG=Central government; GG=General government; NFPS=Nonfinancial public sector; PS=Public sector.
2/ Stock of arrears could be used as a proxy in the absence of accrual data on other accounts payable.
3/ Insurance, Pension, and Standardized Guarantee Schemes, typically including government employee pension liabilities.
4/ Includes accrual recording, commitment basis, due for payment, etc.
5/ Nominal value at any moment in time is the amount the debtor owes to the creditor. It reflects the value of the instrument at creation and subsequent economic flows (such as transactions, exchange rate, and other valuation changes other than market price changes, and other volume changes).
6/ The face value of a debt instrument is the undiscounted amount of principal to be paid at (or before) maturity.
7/ Market value of debt instruments is the value as if they were acquired in market transactions on the balance sheet reporting date (reference date). Only traded debt securities have observed market values.

Commentary: A large fraction of central government's debt is held by central bank and social security funds.

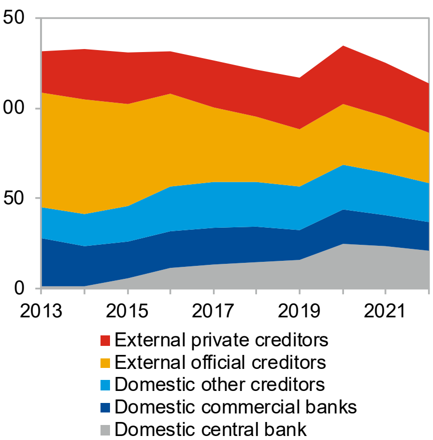
Annex IV. Figure 3. Portugal: Public Debt Structure Indicators

Debt by Currency (percent of GDP)



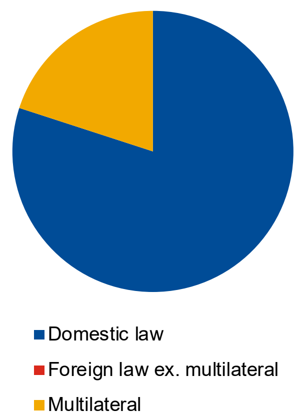
Note: The perimeter shown is general government.

Public debt by holder (percent of GDP)



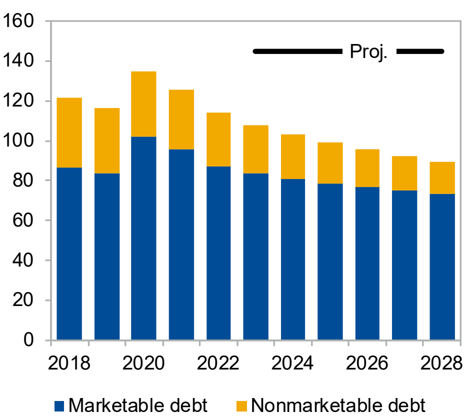
Note: The perimeter shown is general government.

Public debt by governing law, 2022 (percent)



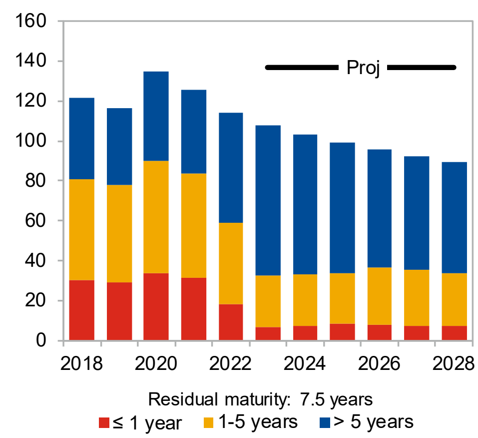
Note: The perimeter shown is general government.

Debt by instruments (percent of GDP)



Note: The perimeter shown is general government.

Public debt by maturity (percent of GDP)



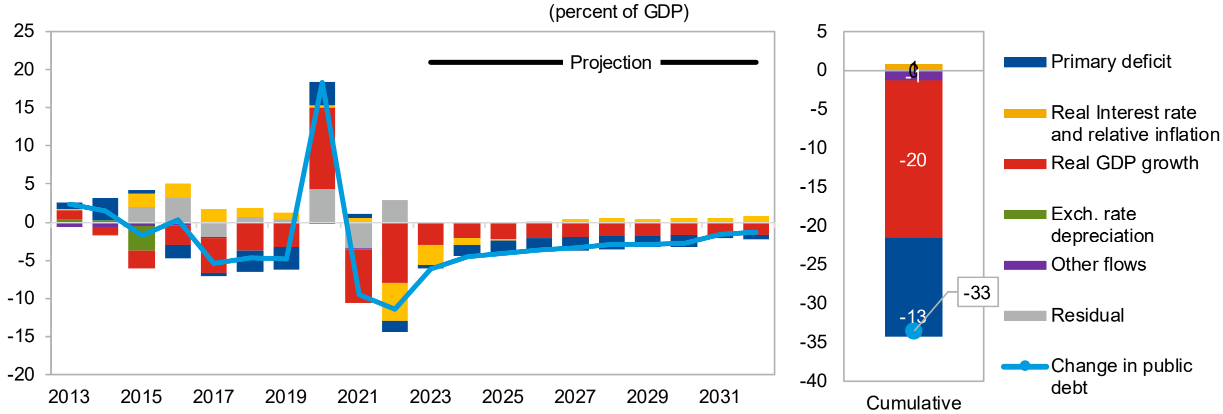
Note: The perimeter shown is general government.

Annex IV. Figure 4. Portugal: Baseline Scenario
(Percent of GDP unless indicated otherwise)

	Actual	Medium-term projection						Extended projection				
	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
Public debt	113.9	107.9	103.4	99.3	95.6	92.3	89.3	86.4	83.6	82.0	80.7	80.5
Change in public debt	-11.5	-6.1	-4.5	-4.1	-3.7	-3.4	-3.0	-3.0	-2.8	-1.5	-1.3	-0.2
Contribution of identified flows	-14.4	-6.1	-4.5	-4.1	-3.7	-3.3	-3.0	-3.0	-2.8	-1.5	-1.3	-0.2
Primary deficit	-1.4	-0.5	-1.5	-1.7	-1.7	-1.8	-1.7	-1.5	-1.6	-0.5	-0.5	0.4
Noninterest revenues	44.2	44.0	44.3	44.3	44.2	43.8	43.8	43.8	43.8	43.8	43.8	43.8
Noninterest expenditures	42.8	43.6	42.8	42.7	42.5	42.1	42.1	42.3	42.2	43.3	43.3	44.2
Automatic debt dynamics	-12.8	-5.5	-2.8	-2.3	-1.8	-1.5	-1.1	-1.3	-1.1	-1.0	-0.7	-0.5
Real interest rate and relative inflation	-5.0	-2.6	-0.9	-0.1	0.1	0.4	0.6	0.4	0.5	0.6	0.9	1.0
Real interest rate	-5.0	-2.6	-0.9	-0.1	0.1	0.4	0.6	0.4	0.5	0.6	0.9	1.0
Relative inflation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real growth rate	-7.9	-2.9	-1.9	-2.2	-1.9	-1.8	-1.7	-1.7	-1.6	-1.6	-1.5	-1.5
Real exchange rate	0.0	…	…	…	…	…	…	…	…	…	…	…
Other identified flows	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other transactions	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Contribution of residual	2.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross financing needs	6.8	6.8	6.7	7.7	8.6	7.8	7.7	7.2	7.9	12.1	8.3	8.6
of which: debt service	8.4	7.4	8.3	9.4	10.4	9.7	9.6	8.9	9.6	12.7	8.9	8.3
Local currency	8.4	7.4	8.3	9.4	10.4	9.7	9.6	8.9	9.6	12.7	8.9	8.3
Foreign currency	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memo:												
Real GDP growth (percent)	6.7	2.6	1.8	2.2	2.0	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Inflation (GDP deflator; percent)	4.4	4.0	2.7	2.2	2.1	1.9	1.8	1.8	1.8	1.8	1.8	1.8
Nominal GDP growth (percent)	11.4	6.7	4.6	4.4	4.1	3.9	3.8	3.8	3.8	3.8	3.8	3.8
Effective interest rate (percent)	0.0	1.6	1.8	2.1	2.2	2.3	2.5	2.3	2.5	2.6	2.9	3.1

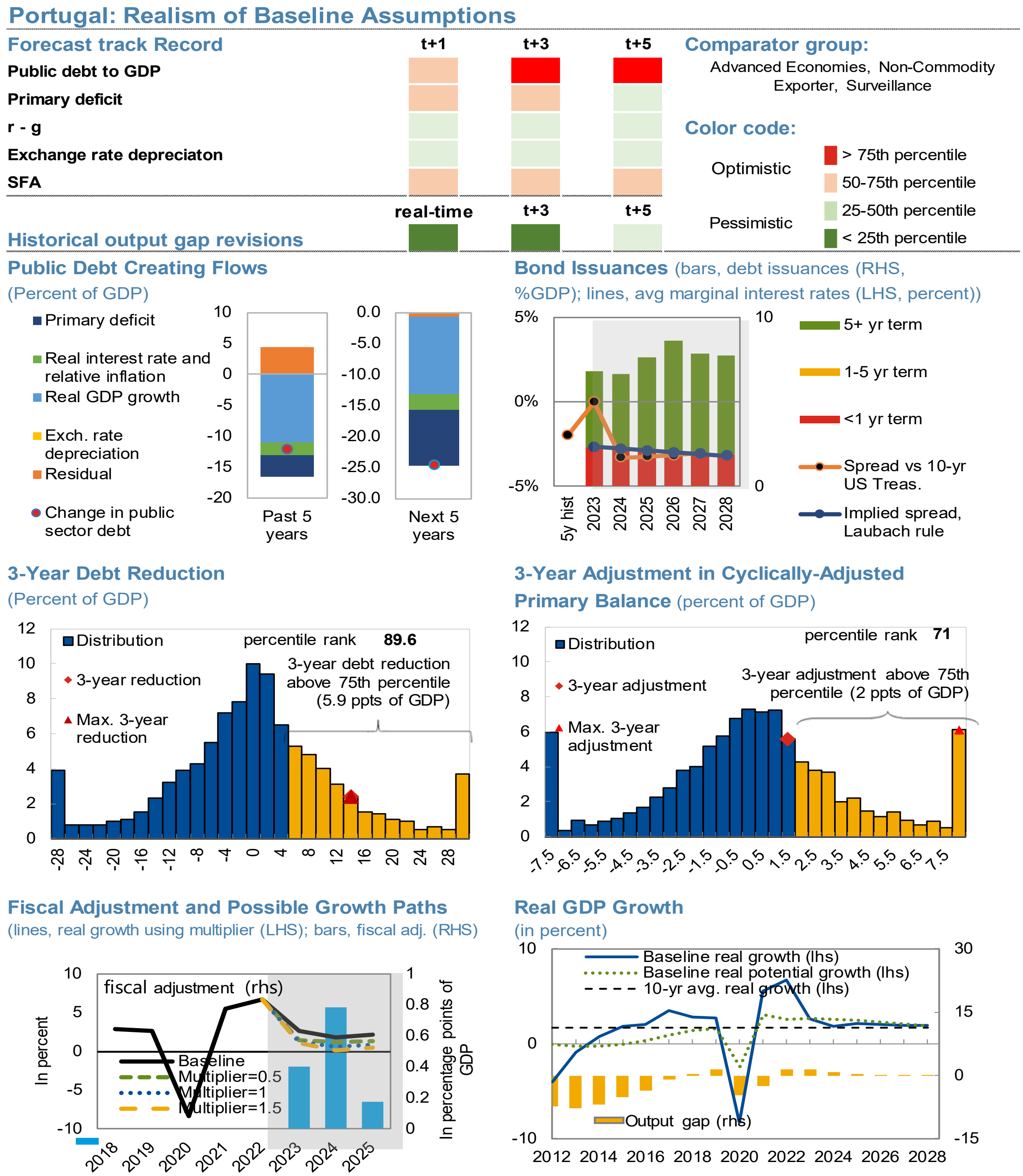
Contribution to change in public debt

(percent of GDP)



Staff commentary: Public debt continues its downward trajectory, mainly driven by GDP growth and improvement in primary balance.

Annex IV. Figure 5. Portugal: Realism of Baseline Assumptions



Commentary: The recovery from COVID-19 will impart complicated effects on the growth path. However, realism analysis does not point to major concerns: past forecast errors do not reveal any systematic biases and the projected fiscal adjustment and debt reduction are well within norms. The public debt is shown to be optimistic mainly due to the past two deep recessions Portugal experienced. Real GDP growth seems to be the largest driver for debt reduction, followed by real interest rates and the primary balance. The cyclically adjusted primary balance (CAPB), which is above the 75th percentile, also reflects unwinding of the cost of living crisis measures.

Annex IV. Figure 6. Portugal: Medium-term Risk Analysis

Debt fanchart and GFN financeability indexes

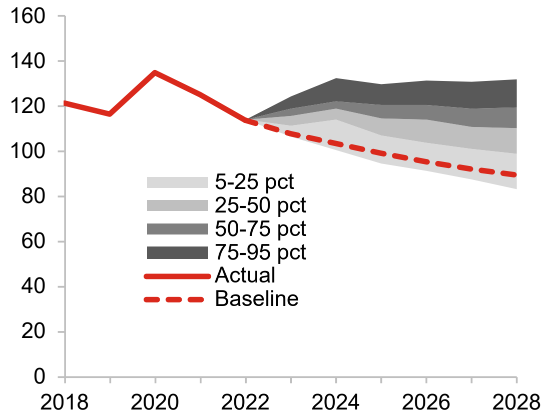
(percent of GDP unless otherwise indicated)

Module	Indicator	Value	Risk index	Risk signal
Debt fanchart module	Fanchart width	49.0	0.7	…
	Probability of debt not stabilizing (pct)	1.5	0.0	…
	Terminal debt level x institutions index	40.4	0.9	…
	Debt fanchart index	**…**	**1.6**	**Moderate**
GFN finance-ability module	Average GFN in baseline	7.5	2.6	…
	Bank claims on government (pct bank assets)	8.6	2.8	…
	Chg. in claims on govt. in stress (pct bank assets)	0.0	0.0	…
	GFN financeability index	**…**	**5.4**	**Low**

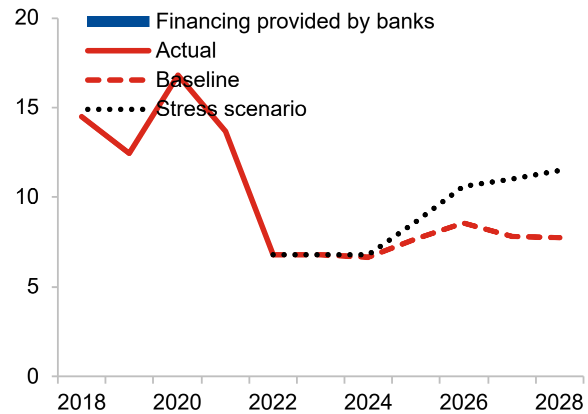
Adv. Econ., Non-Com. Exp, Program: 0 25 50 75 100

Legend: Interquartile range; Portugal

Final fanchart (pct of GDP)



Gross Financing Needs (pct of GDP)

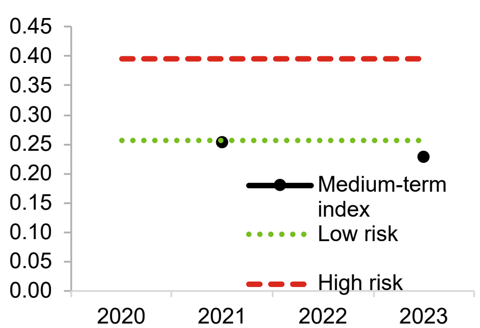


Triggered stress tests (stress tests not activated in gray)

Banking crisis | Commodity prices | Exchange rate | Contingent liab. | Natural disaster

Medium-term index

(index number)



Medium-term risk analysis

	Low risk threshold	High risk threhsold	Weight in MTI	Normalized level
Debt fanchart index	1.1	2.1	0.5	0.4
GFN finaceability index	7.6	17.9	0.5	0.1
Medium-term index (MTI)	0.3	0.4	…	0.2, Low

Prob. of missed crisis, 2023-2028 (if stress not predicted): 9.1 pct.

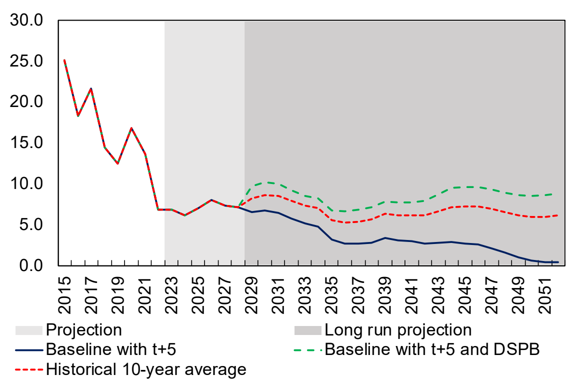
Prob. of false alarm, 2023-2028 (if stress predicted): 48.9 pct.

Commentary: Of the two medium-term tools, the Debt Fanchart Module is pointing to moderate level of risk, while the GFN Financeability Module suggests low level of risk. Note that final fan chart is not centered because it is based on a combination of the historical and our baseline forecast. Moreover, historical charts suggests much higher debt paths given much lower GDP growth rates experienced during the sovereign debt crisis.

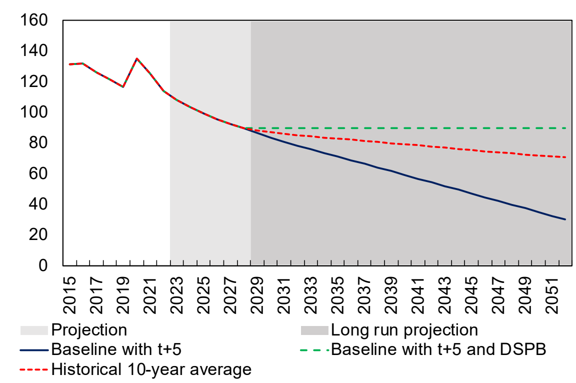
Annex IV. Figure 7. Portugal: Long-term Risk Assessment

Projection	Variable	Risk Indication
Medium-term extrapolation	GFN-to-GDP ratio Amortization-to-GDP ratio Amortization	
Medium-term extrapolation with debt stabilizing	GFN-to-GDP ratio Amortization-to-GDP ratio Amortization	
Historical average assumptions	GFN-to-GDP ratio Amortization-to-GDP ratio Amortization	
Overall Risk Indication		

GFN-to-GDP ratio

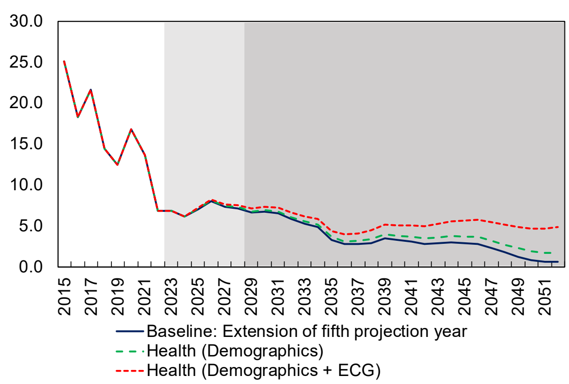


Total public debt-to-GDP ratio

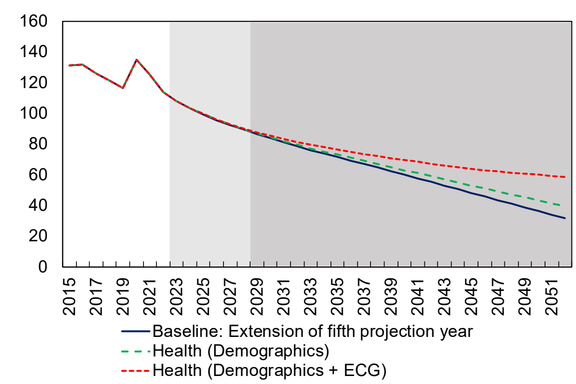


Demographics: Health

GFN-to-GDP ratio



Total public debt-to-GDP ratio



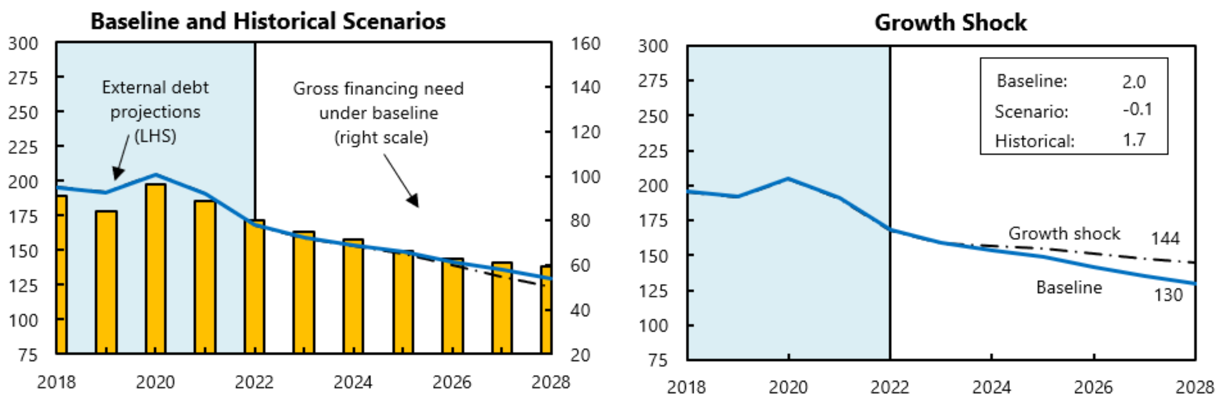
Annex V. External Debt Sustainability

External debt is assessed to be sustainable over the medium term, but subject to risks related to the growth outlook.

1. **Gross external debt fell to 168 percent of GDP in 2022, a reduction by 23 pp compared to 2021.** This level outperformed staff's pre-Covid projection of 182 percent of GDP for 2022 (see Staff Report for the 2019 Article IV Consultation), in part reflecting stronger automated debt dynamics (real growth and valuation effects). Under staff's current baseline projections, gross external debt is projected to decline to 130 percent of GDP at the end of the forecast horizon (solid line), with gross external financing needs at 66 percent of GDP on average.

2. **The external debt path is sensitive to growth shocks.** If growth shocks increase permanently by a one-half standard deviation (roughly 2.1 pp reduction in growth), the external debt position is projected to decline more slowly, reaching 144 percent of GDP at the end of the projection horizon (dashed line). Other shocks do not increase the external debt trajectory in a material way.

Portugal: External Debt Sustainability 1/ 2/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and Fund staff estimates.
1/ Shaded areas represent actual data. The growth shock is a permanent one-half standard deviation shock. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

Portugal. External Debt Sustainability Framework, 2018-2028

(In percent of GDP, unless otherwise indicated)

	Actual							Projections					
	2018	2019	2020	2021	2022			2023	2024	2025	2026	2027	2028
Baseline: External debt	195.6	191.6	204.8	191.0	168.1			**158.9**	**153.9**	**148.7**	**141.8**	**135.6**	**129.7**
Change in external debt	-5.5	-4.0	13.2	-13.8	-23.0			-9.2	-5.0	-5.2	-7.0	-6.2	-5.9
Identified external debt-creating flows (4+8+9)	-7.8	-5.9	15.9	-10.2	-14.8			-7.3	-3.6	-3.3	-2.8	-2.5	-2.3
Current account deficit, excluding interest payments	-3.9	-3.8	-2.2	-2.7	-1.6			-2.4	-2.1	-2.2	-2.7	-2.9	-2.9
Deficit in balance of goods and services	-0.9	-0.8	1.9	2.6	2.1			1.2	1.0	0.5	0.2	0.0	0.0
Exports	43.7	43.7	37.1	41.7	50.2			49.5	50.3	49.9	49.6	49.6	49.9
Imports	42.8	42.9	39.1	44.3	52.2			50.7	51.2	50.4	49.9	49.6	49.8
Net non-debt creating capital inflows (negative)	1.8	2.9	1.7	2.6	3.4			2.9	2.9	2.9	2.8	2.8	2.7
Automatic debt dynamics 1/	-5.7	-5.0	16.5	-10.1	-16.6			-7.9	-4.4	-4.0	-2.9	-2.4	-2.1
Contribution from nominal interest rate	3.4	3.4	3.3	3.5	3.0			2.7	2.5	2.5	3.0	2.9	2.8
Contribution from real GDP growth	-5.5	-5.0	17.0	-10.5	-11.5			-4.1	-2.8	-3.2	-2.9	-2.6	-2.5
Contribution from price and exchange rate changes 2/	-3.6	-3.4	-3.8	-3.0	-8.1			-6.5	-4.2	-3.3	-3.0	-2.7	-2.5
Residual, incl. change in gross foreign assets (2-3) 3/	2.3	1.9	-2.7	-3.5	-8.2			-1.9	-1.4	-1.8	-4.2	-3.7	-3.6
External debt-to-exports ratio (in percent)	447.9	438.5	551.8	457.9	335.1			321.1	306.1	297.9	285.6	273.4	260.2
Gross external financing need (in billions of US dollars) 4/	186.3	181.0	192.8	190.2	192.0			191.7	191.1	185.4	182.5	183.6	184.9
in percent of GDP	90.8	84.4	96.1	88.6	80.3			75.1	71.6	66.5	62.9	60.9	59.1
Scenario with key variables at their historical average 5/						10-Year Historical Average	10-Year Standard Deviation	**158.9**	**153.2**	**147.2**	**138.8**	**131.0**	**123.6**
Key Macroeconomic Assumptions Underlying Baseline													
Real GDP growth (in percent)	2.8	2.7	-8.3	5.5	6.7	1.7	4.1	2.6	1.8	2.2	2.0	1.9	1.9
Exchange rate appreciation (US dollar value of local currency, change in percent)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GDP deflator in US dollars (change in percent)	1.8	1.7	2.0	1.5	4.4	2.0	1.0	4.0	2.7	2.2	2.1	1.9	1.8
Nominal external interest rate (in percent)	1.8	1.8	1.6	1.8	1.7	2.0	0.3	1.7	1.7	1.7	2.1	2.2	2.2
Growth of exports (US dollar terms, in percent)	6.5	4.5	-20.6	20.4	33.9	7.3	13.9	5.3	6.2	3.7	3.5	3.8	4.3
Growth of imports (US dollar terms, in percent)	8.0	4.8	-14.9	21.5	31.3	7.5	12.4	3.6	5.7	2.8	3.0	3.3	4.3
Current account balance, excluding interest payments	3.9	3.8	2.2	2.7	1.6	3.6	1.5	2.4	2.1	2.2	2.7	2.9	2.9
Net non-debt creating capital inflows	-1.8	-2.9	-1.7	-2.6	-3.4	-1.9	1.6	-2.9	-2.9	-2.9	-2.8	-2.8	-2.7

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 in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

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; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

INTERNATIONAL MONETARY FUND

PORTUGAL

June 1, 2023

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of May 15, 2023)

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	1,594.00	77.37
Reserve position in Fund	466.27	22.63

SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	2,780.99	100.00
Holdings	2,524.20	90.77

Outstanding Purchase and Loans: None

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				
	2023	**2024**	**2025**	**2026**	**2027**
Principal					
Charges/Interest	4.90	9.67	9.66	9.66	9.66
Total	**4.90**	**9.67**	**9.66**	**9.66**	**9.66**

[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.

Exchange Rate Arrangement:
Portugal's currency is the euro. The exchange rate arrangement of the euro area is free floating. Portugal participates in a currency union (EMU) with 19 other members of the EU and has no separate legal tender. The euro, the common currency, floats freely and independently against other currencies. Portugal has accepted the obligations under Article VIII, Section 2(a), 3, and 4, and maintains an exchange system free of multiple currency practices and restrictions on the making of 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 May 9-13, 2022, and the staff report (Country Report No. 22/203) was discussed on June 23, 2022.

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 May 15, 2023

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. Government finance statistics (GFS) are compiled on an accrual basis according to the *ESA 2010* methodology and reported to Eurostat on a quarterly and annual basis. Data have undergone a number of revisions during the transition to the *ESA 2010*, sizably altering revenue and expenditure and hampering comparisons across years. Fiscal data in the *GFSM 2014* framework are reported through the Eurostat convergence project with the IMF. The IMF GFS datasets cover data on the general government operations and financial balance sheet.
External sector. The BdP compiles and disseminates balance of payments and international investment position (IIP) statistics on quarterly basis following the IMF's sixth edition of the *Balance of Payments and International Investment Position Manual*. The BdP participates in the IMF's surveys on direct and portfolio investments, special purpose entity data collection initiative and reports the Data Template on International Reserves and Foreign Currency Liquidity regularly. 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 BdP'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. Portugal reports data on some key series and indicators of the Financial Access Survey (FAS) including the two indicators adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs).

Financial sector surveillance: Portugal reports thirteen core FSIs (excluding the net open position in foreign exchange capital), sixteen 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 has adhered to the Special Data Dissemination Standard Plus (SDDS Plus) since February 11, 2015 and publishes data on its National Summary Data Page. Metadata are posted on the Dissemination Standards Bulletin Board.	No data ROSC is available.

Portugal: Table of Common Indicators Required for Surveillance (As of May 15, 2023)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	Current	Current	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Apr/23	May/23	M	M	M
Reserve/Base Money	Mar/23	Apr/23	M	M	M
Broad Money	Mar/23	Apr/23	M	M	M
Central Bank Balance Sheet	Apr/23	May/23	M	M	M
Consolidated Balance Sheet of the Banking System	Mar/23	Apr/23	M	M	M
Interest Rates[2]	Mar/23	May/23	M	M	M
Consumer Price Index	April/23	May/23	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Mar/23	May/23	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Mar/23	May/23	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Dec/22	April/23	M	M	M
External Current Account Balance	2022:Q4	Feb/23	Q	Q	Q
Exports and Imports of Goods and Services	2022:Q4	Feb/23	Q	Q	Q
GDP/GNP	2022:Q4	Feb/23	Q	Q	Q
Gross External Debt	2022:Q4	Feb/23	Q	Q	Q
International Investment Position	2022:Q4	Feb/23	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 state 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).