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Portugal: 2000 Article IV Consultation—Staff Report; Supplement to the Staff Report; and Public Information Notice Following Consultation

As required under Article IV of its Articles of Agreement, the International Monetary Fund conducts periodic consultations with its member countries. In the context of the 2000 Article IV consultation with Portugal, the following documents have been released and are included in this package:

- the staff report for the 2000 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **July 5, 2000,** 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 September 28, 2000.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement to the report reflecting new information and/or developments and policies since the consultation discussions,

- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during the October 20, 2000, Executive Board discussion** of the staff report that concluded the Article IV consultation.

Further background documentation prepared by IMF staff for the consultation may be published separately at a later date. The policy of publication of Article IV staff reports and PINs allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

PORTUGAL

Staff Report for the 2000 Article IV Consultation

Prepared by the Staff Representatives for the 2000 Consultation with Portugal

Approved by Alessandro Leipold and G. Russell Kincaid

September 28, 2000

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I. Introduction

1. The 2000 Article IV consultation discussions with Portugal were held in Lisbon during June 26–July 5, 2000.[1] At the conclusion of the last consultation on October 6, 1999 (SUR/99/119), Directors commended the authorities for their stability-oriented policies, which had yielded impressive results, including vigorous growth, markedly lower inflation, and declining fiscal deficits. Nonetheless, economic policies needed to address signs of emerging macroeconomic imbalances, including the brisk growth of private sector credit, tight labor markets, and a persistent inflation differential vis-à-vis other euro-area countries. Moreover, an acceleration of structural reforms and further fiscal consolidation would be essential for a rapid and sustained convergence to European Union (EU) income levels.

2. The minority socialist government was reelected in the fall of 1999, falling just short of a parliamentary majority.

II. Background and Prospects

3. **Portugal's economic performance since the mid-1990s has been impressive with sustained growth and historically low inflation, but has also given rise to concerns about emerging imbalances**. The third stage of European Economic and Monetary Union (EMU) provided an anchor for expectations and facilitated a reduction in inflation and interest rates (Table 1; and Figures 1 and 2), contributing to a surge in domestic demand-led growth. This was fueled in part by strong credit growth that pushed private sector bank debt to one of the highest levels in the euro area; and there has also been a sharp widening of the external current account deficit.

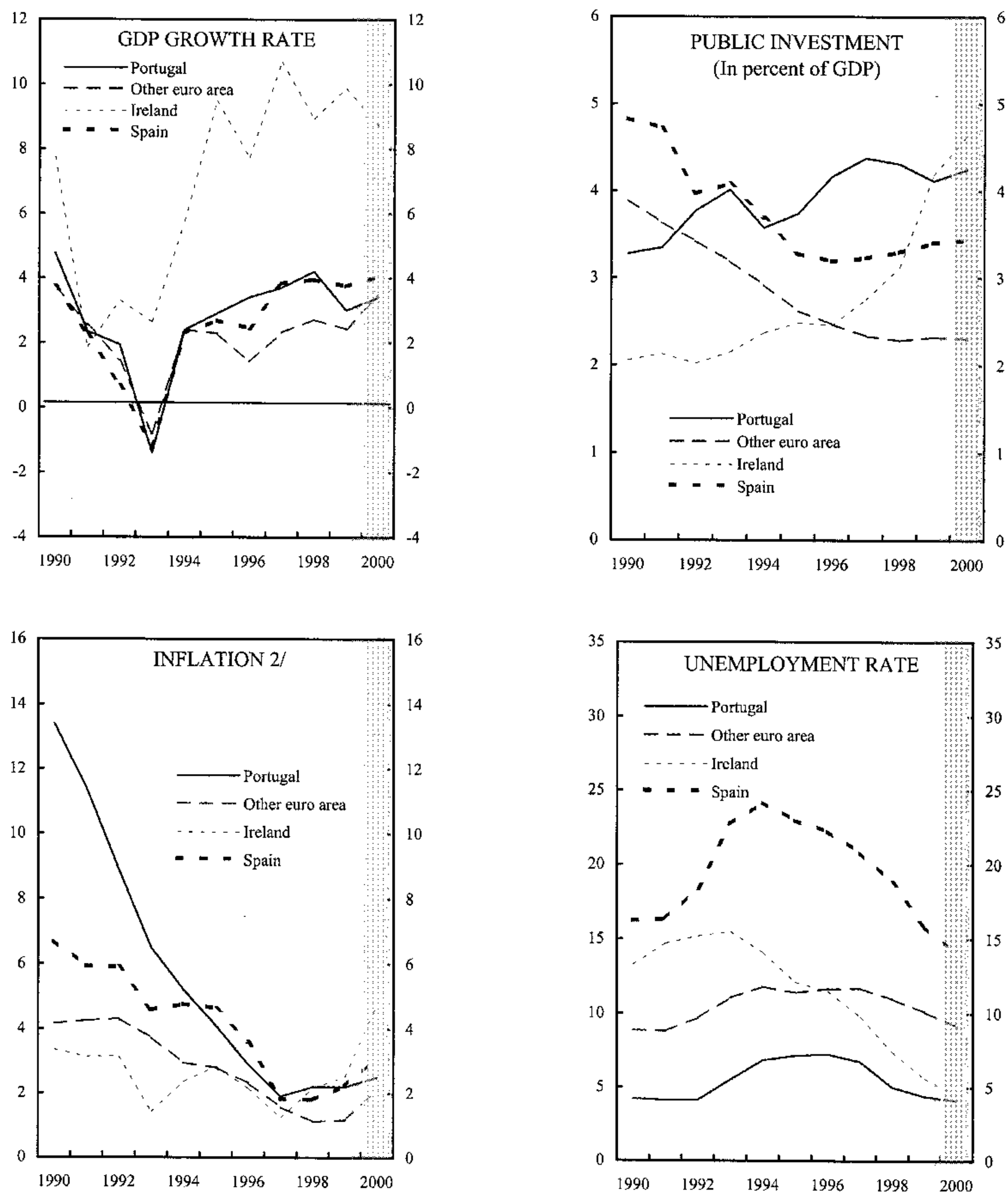
Growth, Inflation, and Unemployment in Portugal and the Euro Area

	1990-99	1999	2000
GDP growth			
Portugal	2.7	3.0	3.4
Euro area	2.1	2.4	3.5
Inflation			
Portugal	5.9	2.2	2.5
Euro area	2.9	1.2	2.1
Unemployment			
Portugal	5.5	4.4	4.1
Euro area	10.5	9.9	9.0

Sources: WEO database; and Fund staff estimates.

[1] The mission—comprising Messrs. Krueger, Clements, Decressin, and Disyatat (EP) from the European I Department—met with the Governor of the Bank of Portugal, the Minister of Finance and Economy, and other senior government officials, representatives of regulatory agencies, and labor and business leaders. Mr. Santos, advisor in the Executive Director's office, participated in the meetings and Mr. Faini, Executive Director, attended some meetings. Portugal has accepted the obligations of Article VIII, Sections 2, 3, and 4 (Appendix I).

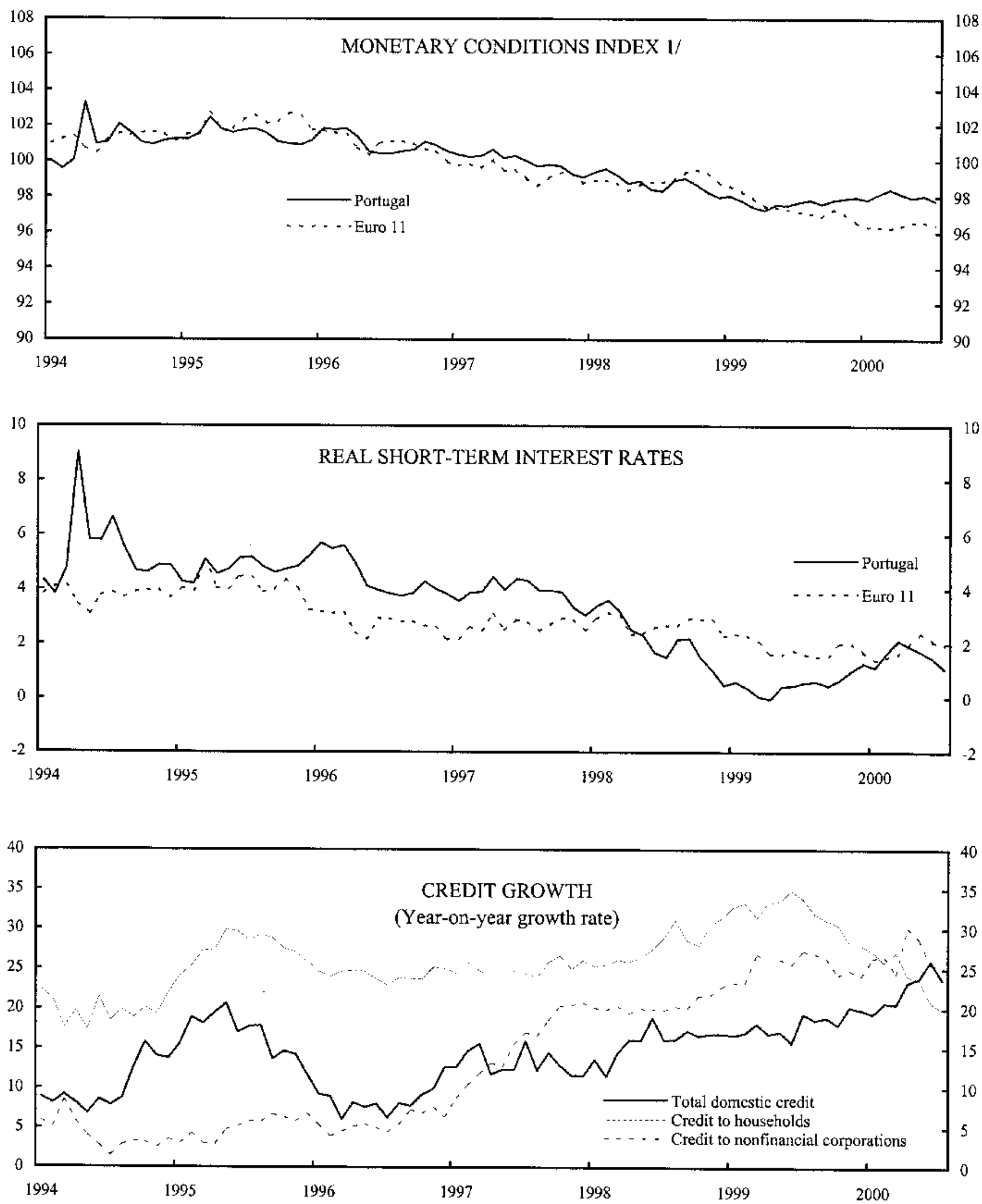
Figure 1. Portugal: Comparison of Selected Economic Indicators, 1990-2000 1/
(In percent)



Sources: IMF, *World Economic Outlook*; and Fund staff projections.

1/ Shaded areas show staff projections.
2/ Based on national consumer price indices until 1995, and harmonized price index for 1996-2000.

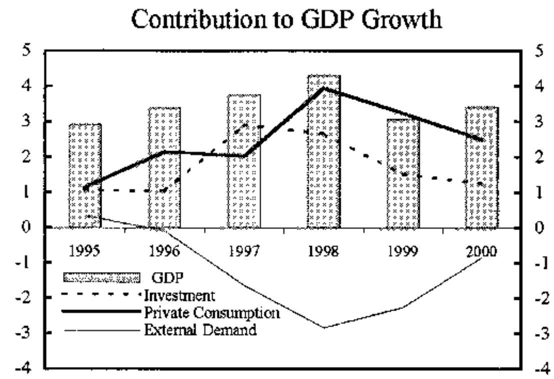
Figure 2. Portugal: Monetary Conditions Index, Real Interest Rates, and Credit Growth, 1994:1-2000:7



Sources: Bank of Portugal; IMF, Information Notice System; and Fund staff estimates.

1/ The index (average 1994-99=100) is the weighted average of real short-term interest rates and real exchange rates (based on unit labor cost differentials).

4. **While domestic demand has gradually decelerated during 1999/2000, a revival in exports is expected to accelerate GDP growth from 3 percent in 1999 to around 3½ percent in 2000.** Private consumption has cooled off somewhat from its blistering pace in 1998, but is still expanding faster than income, as households continue their adjustment to the earlier decline in interest rates with a further fall in the savings rate. Brisk household credit growth has helped finance the ongoing boom in housing and durables consumption. As elsewhere in Europe, exports began to rebound in the second half of 1999, and while the external recovery is likely to have more than compensated for the slowdown in domestic demand, the latter, including investment, has remained the main engine of growth.



5. **Tight labor markets have contributed to a differential in core inflation (excluding energy and food items) of 1–2 percentage points vis-à-vis the euro area.** Steady employment growth, concentrated in fixed-term contracts, has resulted in a further decline of the unemployment rate to 3.8 percent in the second quarter of 2000, one of the lowest rates in the euro area (Figure 3). The relatively tight labor market contributed to wage increases well above the euro-area average. Without commensurate productivity gains, this has resulted in rising unit labor costs vis-à-vis the euro area. In 1999 and early 2000, differences in underlying cost pressures were not fully reflected in headline inflation differentials, due to sizable cuts in domestic petroleum taxes (tax rates can be adjusted within a band and adjustments were made to stabilize domestic prices). It was only in late March that some of the previous tax cuts were reversed, and headline HICP inflation accelerated to above 3 percent in mid-2000. Inflation differentials reflect also real income and productivity convergence, with the effect estimated by staff at roughly ½ percentage point.[2]

6. **Higher oil prices are contributing to a further widening of the external current account deficit in 2000 and, including capital transfers,[3] the deficit is likely to reach 8 percent of GDP (after 6½ percent of GDP in 1999)—the largest deficit among advanced economies** (Figure 4; and Table 2). The additional widening of the deficit in 2000 would come despite a recovery in external demand and the weakness of the euro, which are expected to narrow the negative growth contribution of the external sector. Taking a longer

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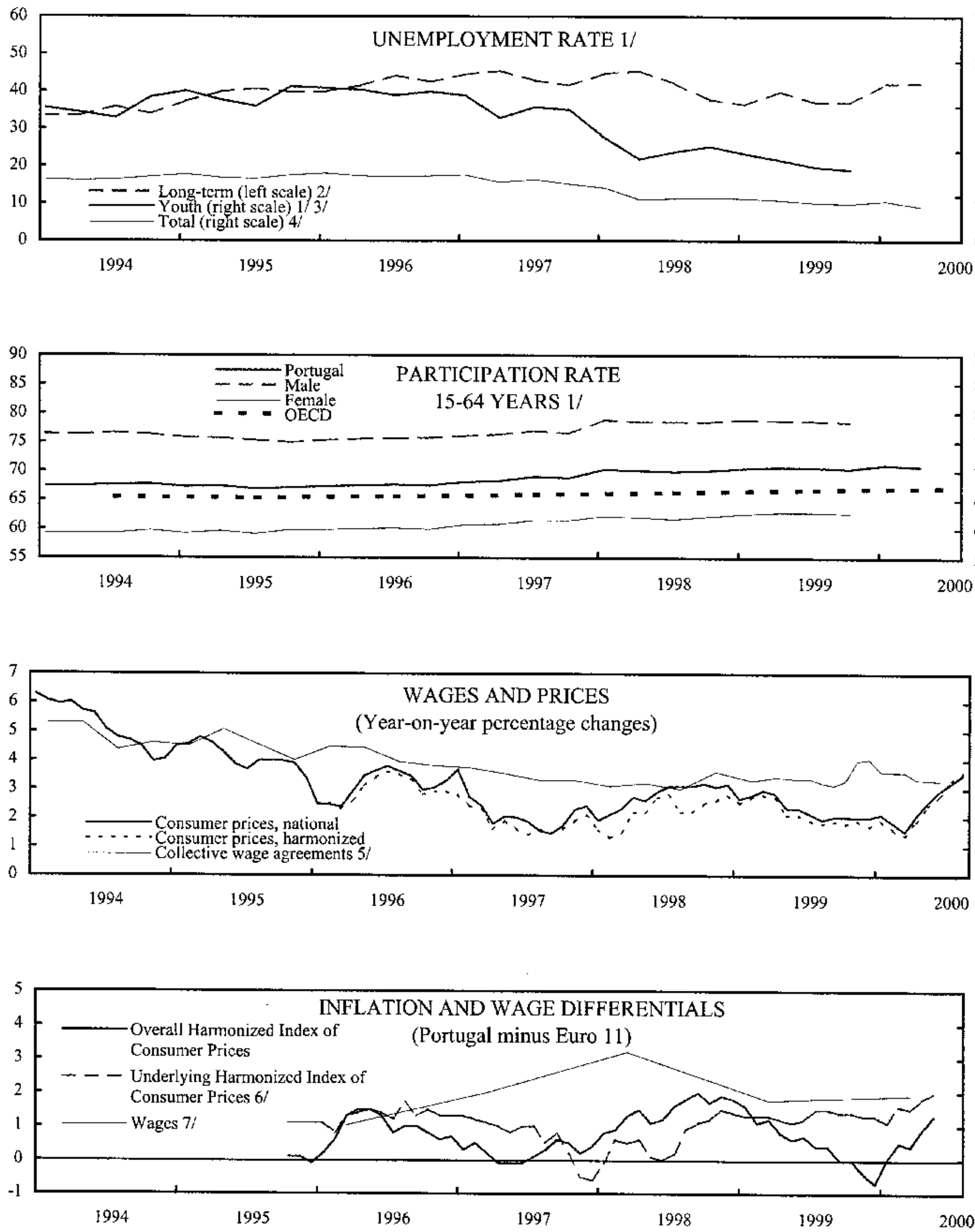
[2] See SM 99/232 (9/15/99); and Phillip Swagel, "The Contribution of the Balassa-Samuelson Effect to Inflation: Cross-Country Evidence," International Monetary Fund, mimeo (2000).

[3] Capital transfers are mostly received under the EU Community Support Framework and provide a relatively steady, nondebt source of financing, at least through the end of 2006.

Figure 3. Portugal: Labor Market Conditions and Price Developments, 1994-2000
(In percent)



Sources: Bank of Portugal; National Statistics Office (INE); EUROSTAT; and WEO database.

1/ Change in methodology starting in 1998.

2/ Proportion of total unemployed who have been unemployed for a year or more.

3/ Proportion of those 15-24 years of age who are unemployed.

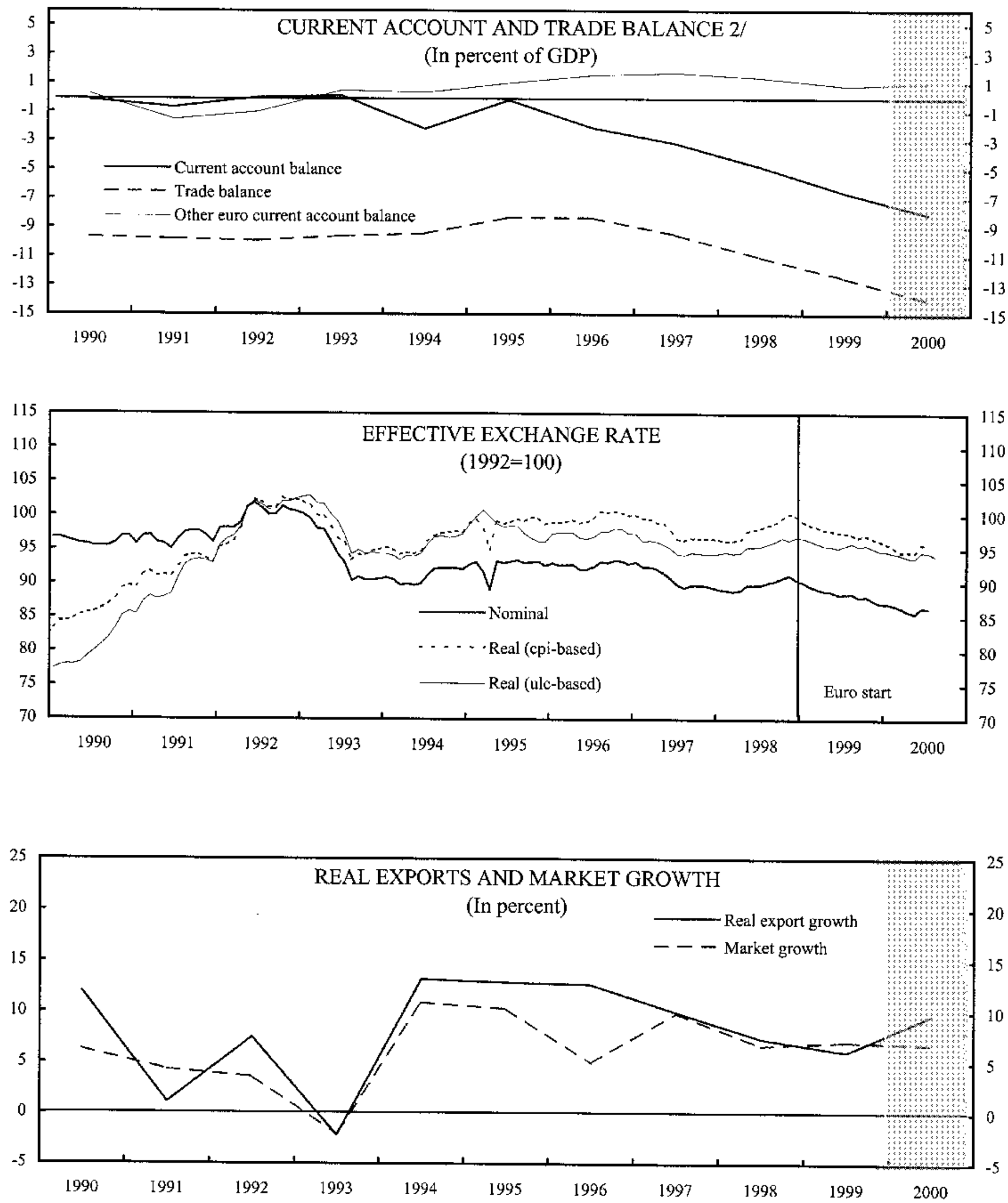
4/ In percent of the labor force.

5/ Three month moving average weighted by the number of workers covered in each month.

6/ Excluding energy, food, tobacco, and alcohol.

7/ Annual rate of change of wages in manufacturing. Figure for 2000 refers to Fund staff estimate.

Figure 4. Portugal: External Performance and Exchange Rates, 1990-2000 1/

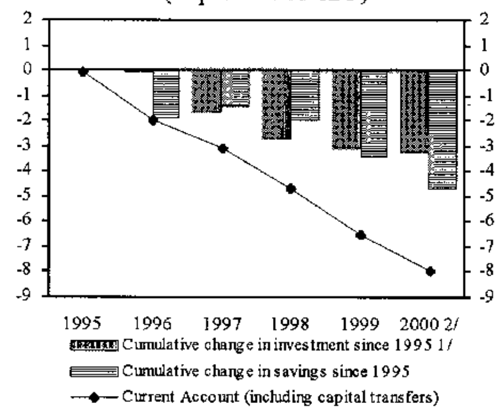


Sources: IMF, Information Notice System; IMF, *World Economic Outlook*; and Fund staff projections.

1/ Shaded areas show staff projections.

2/ To limit the effect of a statistical break in 1996, capital transfers are included in the current account.

External Current Account and the Role of Savings and Investment (In percent of GDP)

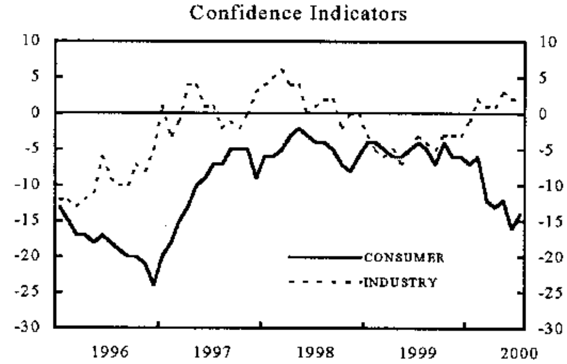


1/ Negative number indicates increase in investment.
2/ Fund staff projection.

view, more than half of the deterioration from broad balance in the mid-1990s was due to a decline of national saving; and while investment increased strongly, this was partly for housing, with limited effects on future export capacity. The widening current account deficit was not related to a deterioration in traditional measures of competitiveness (although comparisons are hampered by weaknesses in Portugal's labor market data; Appendix II): the real exchange rate remained broadly unchanged after the mid-1990s, before depreciating through most of 1999 and until the fall of 2000, as the weakening of the euro more than offset domestic price and unit labor cost increases above those in trading partners. The current account deficit in 1999 continued to be financed predominantly by rising net foreign liabilities of the banking system; net flows of FDI turned negative as inward direct investment fell substantially, while the ongoing internationalization of Portuguese firms led to sizable investment outflows.

7. **A recent decision to meet the original 2000 fiscal deficit target through recourse to UMTS receipts would leave Portugal's relatively high structural deficit (excluding these receipts) essentially unchanged, with public expenditure set for a further strong rise**. Rapidly increasing expenditure resulted in a weakening of the structural primary balance in 1998–99 and has left the general government structural deficit at the highest level in the euro area. For 2000, the budget targeted a cut in the deficit by ½ percentage point to 1.5 percent of GDP, excluding UMTS receipts. Following the substantial rise in world oil prices, petroleum tax cuts aimed at stabilizing domestic prices were expected to result in a revenue shortfall of about ½ percent of GDP. This prompted a package of expenditure measures in the Spring which, together with allocations frozen in the original budget (including for current outlays), totaled about 1 percent of GDP. By the summer, however, the authorities forecast that expenditure cuts would not match revenue shortfalls and announced that the deficit target would only be met *inclusive* of expected UMTS receipts of 0.4 percent of GDP.

Confidence Indicators



8. **The near-term economic outlook points to broadly stable economic growth, as strengthening exports are likely to offset a gradual deceleration of domestic demand—leaving GDP growth at around 3½ percent in 2000/01**. Growth prospects benefit from monetary conditions that remain, in the staff's view, accommodative

(see below); and the present weakness of the euro is also facilitating a rebalancing of growth toward the tradable sector. At the same time, rising interest rates and household indebtedness have begun to be reflected in a deceleration of household credit growth; with a weakening of consumer confidence, this points to reduced reliance on consumption as the driving force for Portugal's economic growth. The main near-term risks to growth relate, on the downside, to external factors (notably, a deceleration in global demand—possibly related to oil price developments—or a sharp appreciation of the euro). On the domestic front, there is some downside risk to construction demand, especially if interest rates were to rise more rapidly than embedded in present market rates; on the upside, continued strong labor market performance may result in a rebound in consumer confidence and stronger consumption. Over the **medium-term**, Portugal's prospects for more rapid convergence to average EU living standards and an acceleration of the sustainable rate of output growth—estimated by staff, on unchanged policies, at around 3 percent—will depend on strengthening productivity growth.

III. Policy Issues

9. The discussions in Lisbon took place against the background of a prolonged rise in economic prosperity, culminating in entry as a founding member of the euro area. There was a general consensus, however, that policy challenges remained formidable: with large increases in public expenditures amid a rising tax burden, the structural fiscal deficit had stayed essentially unchanged and was well above the Stability and Growth Pact's (SGP's) target of "close to balance or surplus in the medium term;" private sector bank indebtedness had risen rapidly to one of the highest levels in the euro area; and despite the highest investment rate in the area, the speed of real income convergence had remained modest, with growth rates lower than in some of the more dynamic countries, including in several prospective EU members in central Europe. Against this background, the discussions focused on three topics:

- **Stabilization policies, public expenditure and tax reform**—notably the appropriate fiscal stance in light of both cyclical conditions and medium-term fiscal priorities;

- **Policies to safeguard the health of the financial sector** in light of the rapid increase in private sector indebtedness; and

- **Policies to raise factor productivity growth,** accelerating real income convergence.

The policy discussions were framed against the background of present cyclical conditions and the implications of the ECB's monetary stance for Portugal—issues covered first below.

A. Monetary Conditions and Cyclical Juncture

Monetary conditions

10. **The authorities considered monetary conditions to be broadly appropriate for Portugal, following the recent interest rate increases by the ECB**. They viewed the present stance as consistent with a deceleration in inflation in 2001, assuming that oil prices stabilized, and with output growth close to potential. The staff was, however, not convinced

that current monetary conditions were well aligned with the economy's relatively advanced cyclical position: the impact of rising ECB interest rates was being offset by the euro's weakness (Figures 2 and 5), leaving monetary conditions more accommodative than historically observed for a similar stage of the cycle—an assessment that also applied to 2001, using forward rates. This contributed to strong growth in monetary and credit aggregates, financed primarily from abroad, with private sector credit growth at around 25 percent. The authorities acknowledged that although household credit growth had moderated somewhat since mid-1999, credit to nonfinancial corporations continued to expand strongly, with a notable pick up in the first part of 2000, including for construction.

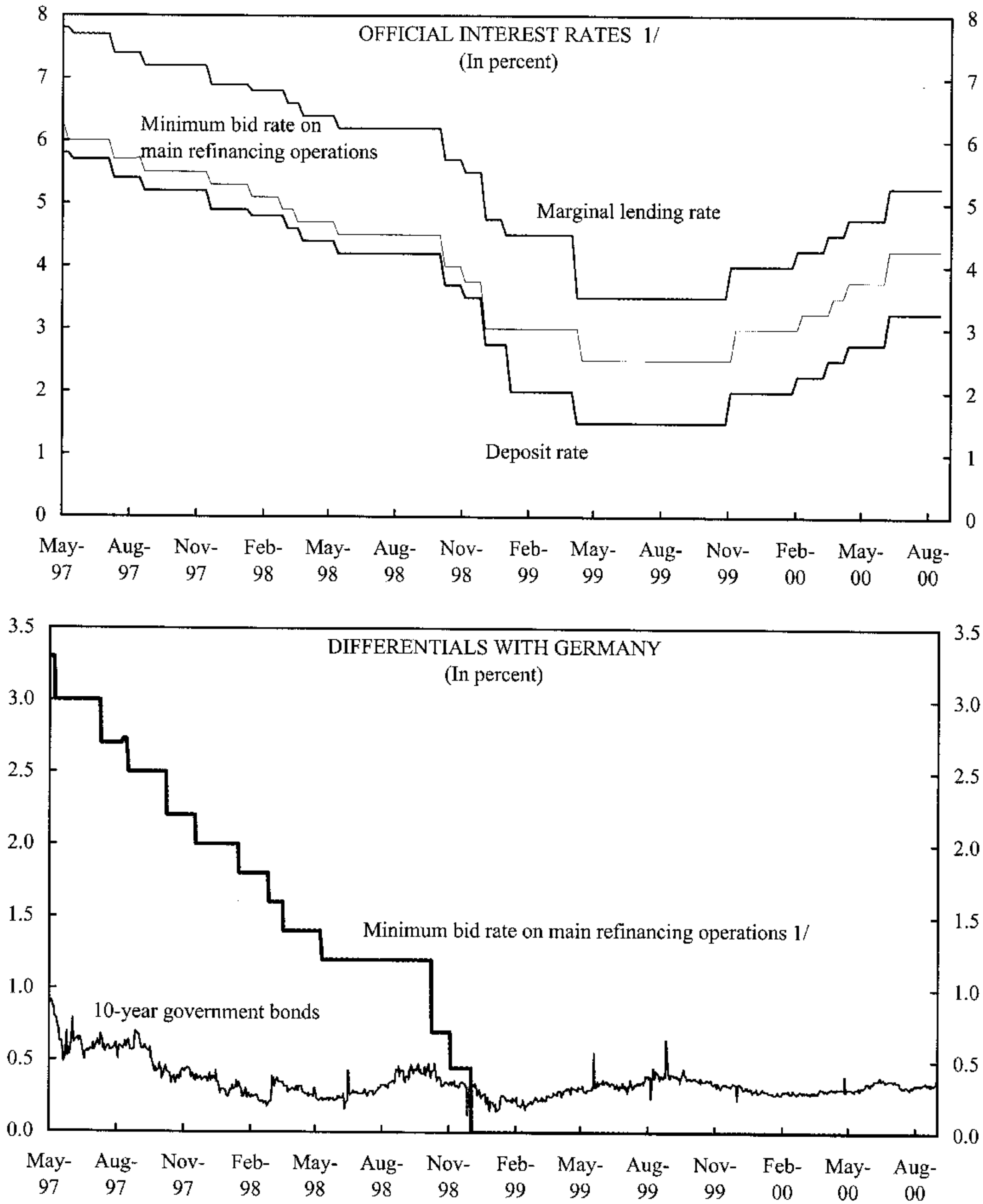
Cyclical juncture and macroeconomic imbalances

11. **The authorities agreed that a number of indicators pointed to advanced cyclical conditions**. These indicators included: a tight labor market—unemployment was somewhat below most estimates of the NAIRU, and wages and unit labor costs were rising faster than in major partner countries (compensation differentials in manufacturing remained at about 2 percentage points, Figure 3); a high capacity utilization rate; a recent pickup in real estate inflation to around 8 percent per annum (Figure 6); a sizable differential (about 1-2 percentage points) for underlying inflation with the euro area, about half of which may represent divergent cyclical positions; rapid private sector credit growth and high indebtedness (see below); and a large and rising external current account deficit. As in some other cyclically advanced euro-area countries, however, evidence of overheating was not clear-cut:[4] divergent cost and price developments vis-à-vis the euro area reflected, in part, continued economic slack elsewhere; and standard measures of the output gap suggested no significant deviation from potential at present (Figure 7). There was agreement that traditional measures of the economy's cyclical position had to be interpreted with caution in the new euro environment. On the one hand, the disciplining effect of euro-area competition was likely to affect also nontraded goods and wage inflation differentials, resulting in smaller deviations in consumer price inflation due to cyclical divergences. On the other hand, with the closer integration of goods and capital markets, cyclical divergences may be reflected more strongly in swings in the balance of payments—thereby meeting excess domestic demand pressure from abroad rather than pushing output well above (traditional measures of) potential.

12. **Against this background, the discussion reviewed the extent to which the external current account balance remains, under monetary union, a useful indicator for assessing macroeconomic imbalances**. The authorities viewed the worsening of the current account (including transfers) from near balance in 1995 to an expected deficit of some

[4] "Cyclically Advanced Euro-Area Economies—Consequences and Policy Options" (SM/00/182, 7/27/00) provides a cross-country perspective, covering Portugal.

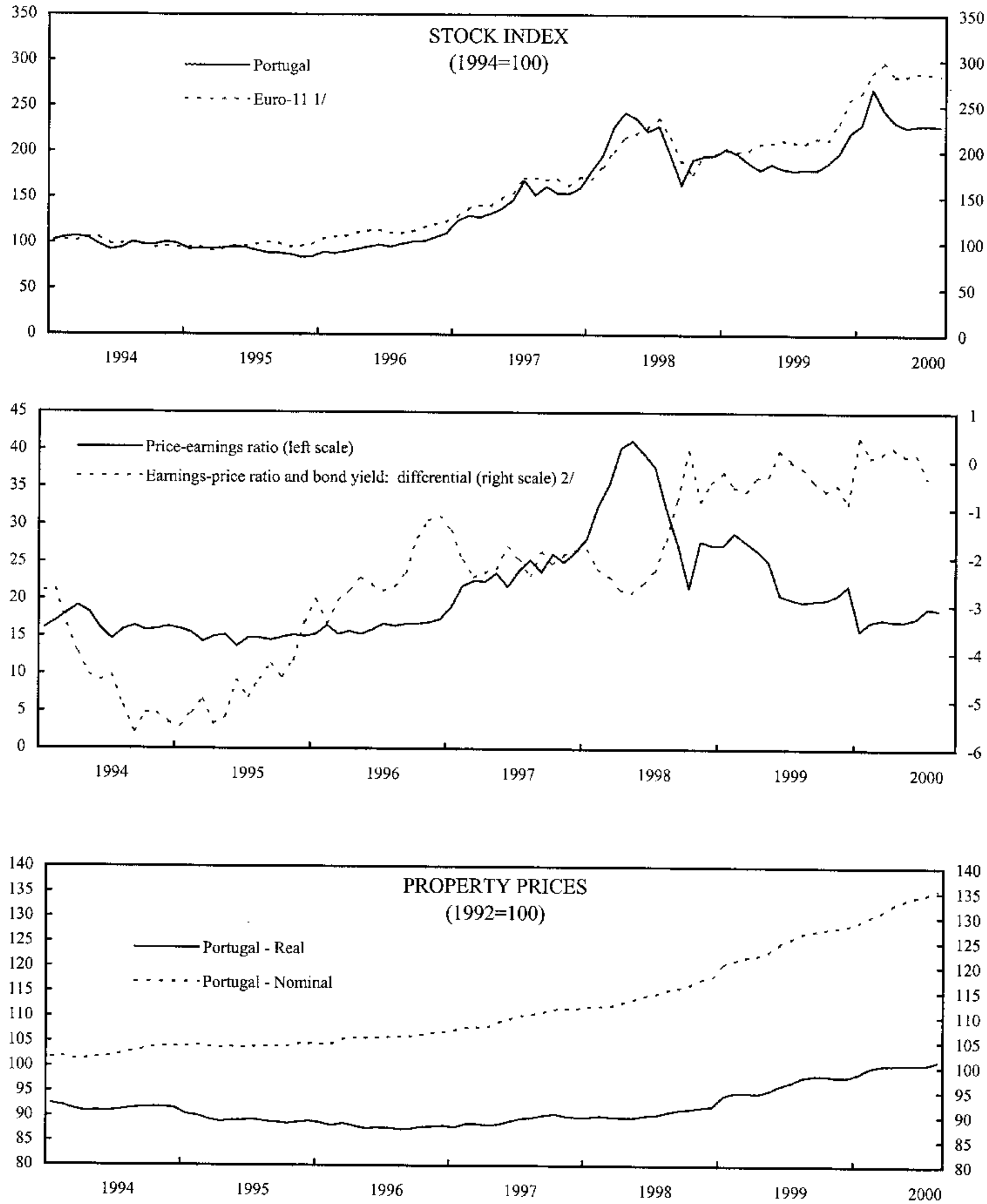
Figure 5. Portugal: Official Interest Rates and Differentials with Germany, 1997:05-2000:08



Sources: IMF, Surveillance Database; and Bloomberg.

1/ Prior to January 1, 1999, figures refer to official rates of the Bank of Portugal.

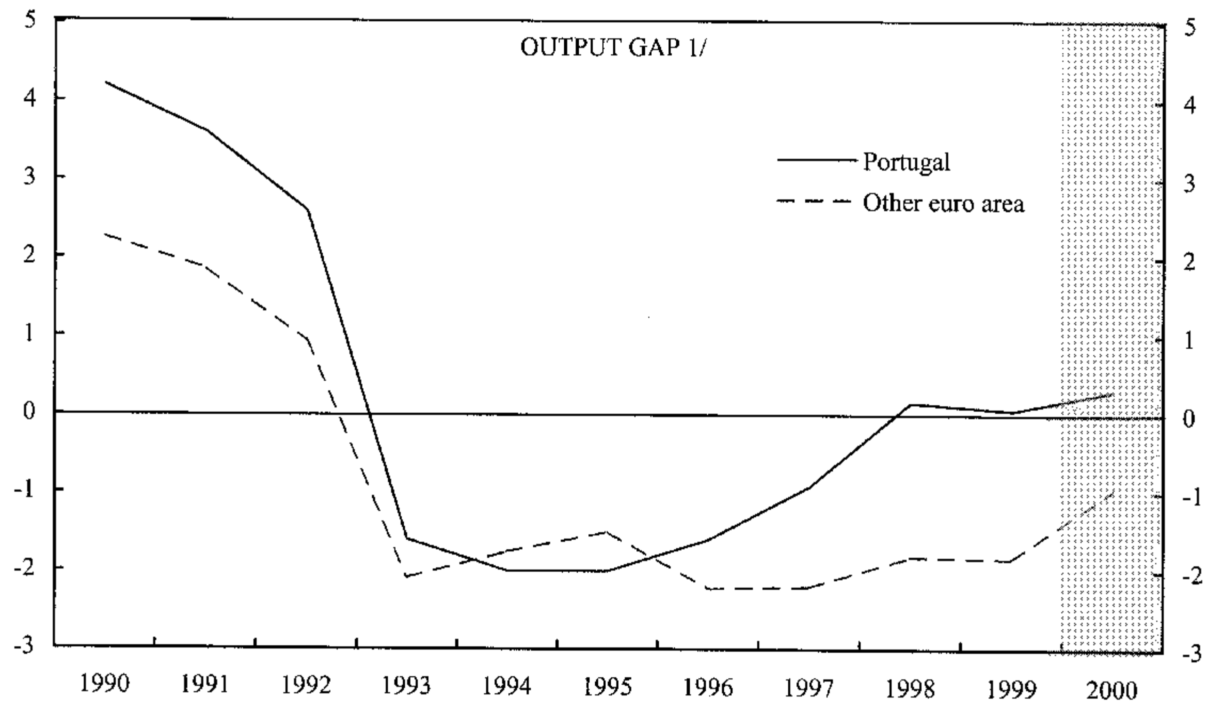
Figure 6. Portugal: Asset Market Indicators, 1994:1-2000:8

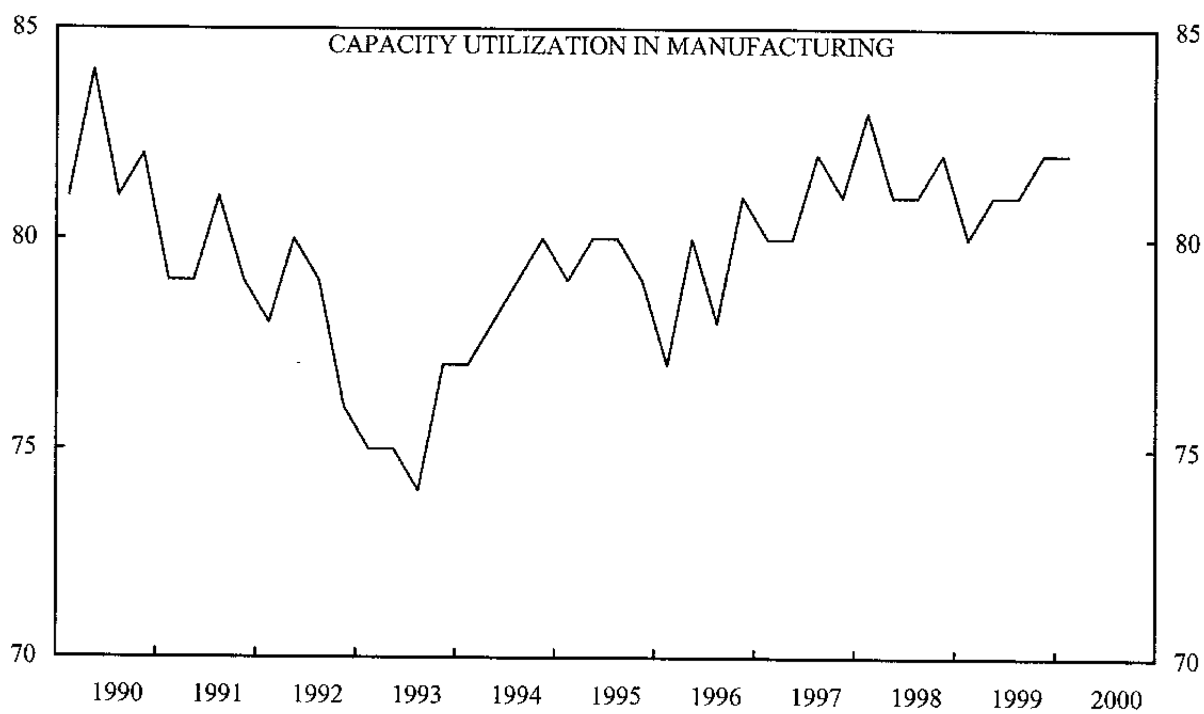


Sources: Bank of Portugal; *Datastream* ; and Fund staff estimates.

1/ Figures for January-August 2000 based on movements in Dow Jones Euro Stoxx Index.
2/ Differential calculated using 10-year bond rates.

Figure 7. Portugal: Cyclical Conditions, 1990-2000





Sources: IMF, *World Economic Outlook;* and National Statistics Office (INE).

1/ Shaded area shows staff projections.

8 percent of GDP in 2000 as part of a "catch-up phase," with the private sector adjusting to the new euro environment. A reduction of interest rates, along with the absence of exchange rate risk for external borrowing in a currency union, had paved the way for stock adjustments, reflected in the rapid expansion of domestic demand—much of which was met by imports, including for consumer durables. In addition, the 2000 deficit was affected by the sharp rise in world oil prices. Correspondingly, the widening current account deficit was not seen as reflecting a loss in price or cost competitiveness, although the economy was somewhat vulnerable should the euro appreciate sharply.[5] Absent a sharp exchange rate adjustment, the authorities expected import growth to slow considerably with the waning of the consumption and housing boom. As a result, they saw no immediate grounds for concern, noting no signs of limits on external financing, almost all of which was provided in the euro market.

13. **Staff agreed that the current account had become a less proximate indicator of economic imbalances under monetary union, but emphasized that it seemed difficult to attribute the very sharp rise in the external deficit to factors emanating from monetary union**. The staff's analysis (see Box 1) found little evidence for expecting a major impact on Portugal's external current account from monetary union *per se*, either through an easing of liquidity constraints or further capital market integration. These results suggested a continued useful role for monitoring Portugal's external current account, a view shared by the authorities; and raised concerns that the present size of the current account deficit, not easily attributable to changes emanating from euro-area membership, may not be sustainable.

14. **Overall, while the authorities concurred that the rapid rise in private sector credit and in the external current account deficit were not sustainable, they were more confident than staff that a healthy rebalancing of economic growth was in sight—thus assuaging concerns about overheating**. They argued that domestic demand and credit growth could be expected to decelerate in the wake of higher interest rates and the borrowing constraints imposed by high levels of household bank debt—which, at around 75 percent of disposable income, exceeded the euro-area average. Together with a revitalization of the export sector, they saw a more balanced pattern of growth in the offing. A consensus existed, however, that the strength of these self-correcting mechanisms was uncertain. On balance, the staff thought that the weight of available evidence—credit expansion far above the growth in incomes, rising external imbalances, and tight domestic labor markets—pointed to important risks. In particular, the weakening of balance sheets left the economy exposed to an abrupt reversal in sentiment, notably if households or banks were to revise sharply their expectations about future debt service capacity; and the economy had also become more

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[5] Vis-à-vis the euro area, unit labor costs in manufacturing appreciated by an estimated 10 percent during 1997–99 and a further rise was expected for 2000. These developments had, on a multilateral global basis, been broadly matched by the weakening of the nominal exchange rate. However, the authorities pointed out that the large share of intra-euro area trade limited the impact of movements in the euro on Portugal's external sector.

Box 1. Portugal's External Current Account: Considerations under Monetary Union[1]

Portugal's external current account deficit has moved rapidly from around 2½ percent of GDP in the early 1990s to 8.8 percent of GDP in 1999, and may exceed 10 percent of GDP in 2000 (8 percent including capital transfers). This has been associated with a large deterioration in its net international investment position from a deficit of 7.6 percent of GDP in 1996 to a deficit of 26.6 percent of GDP in 1999. This raises the questions of whether participation in monetary union, *in and of itself*, fundamentally changes the role of the current account and its relevance for policymakers, and whether the deterioration is justified considering Portugal's changed prospects under euro membership.

Current Account for Selected Euro-Area Countries
(In percent of GDP)

	1995	1996	1997	1998	1999
Portugal	-2.0	-4.0	-5.7	-7.0	-8.8
(with capital transfers)	-0.1	-2.1	-3.2	-4.8	-6.6
Ireland 1/	2.5	2.8	2.4	0.9	0.6
Spain	0.0	0.0	0.4	-0.2	-2.2

Sources: WEO database; and Fund staff estimates.
1/ Statistical break in 1998.

Policymakers do not worry about the current account of regions within some single currency areas, such as the United States. However, the countries in Europe differ from regions in the United States in three crucial respects: (i) the countries are more heterogeneous and thus likely to experience more asymmetric shocks and current account developments which are not reflected in the aggregate euro-area current account; (ii) factor mobility, notably for labor, is not as high between the countries and thus both repayment capacity and external debt are closely related to country-specific developments; and (iii) there is no supranational government to redistribute from booming to declining countries (through the tax and expenditure system) to mitigate the effect of country-specific shocks on repayment capacity. In all, these factors suggest that the current account remains a useful indicator of euro-area countries' macroeconomic positions (see also Decressin and Disyatat, 2000).

Countries that run current account positions which are *fundamentally* unsustainable—those driven by borrowing and lending decisions based on unsound analysis, incorrect information, or unrealistic expectations—will eventually have to revise their consumption profile downwards to repay their debts, even in the context of a currency union. What is different is the nature of the required adjustment. Whereas beforehand the change in real exchange rates required to correct these imbalances could be achieved quickly through movements in the value of the currency, the adjustment will now have to come from domestic wages and prices. However, with monetary union reducing individual countries' vulnerability to shifts in market sentiment, adjustment can probably be spread out over a longer time horizon.

A key issue is whether the large increase in foreign borrowing undertaken by Portugal is warranted by euro participation, and thus fundamentally sustainable. In standard open-economy intertemporal models, a sizeable deterioration in the current account deficit can be justified if current output is below its permanent level or current investment needs are higher than their permanent ones as agents optimally utilize foreign savings to smooth consumption. This situation can occur, for example, in the face of an unexpected improvement in tradables productivity. Another possibility is that low capital mobility and liquidity constraints initially prevented agents from pursuing their optimal consumption profile and capital from flowing to countries that offered the highest real returns. In this case, greater capital market integration and the easing of borrowing constraints associated with euro-area membership would entail an increase in the current account deficit, which is optimal from the standpoint of the country as well as international lenders.

Has the euro improved the integration of capital markets, easing previous financing constraints, or were the returns to capital largely equalized already? Decressin and Disyatat (2000) investigate this question by comparing the degree of capital mobility between regions in two countries where detailed data were available (Canada and Italy) to that between euro-area countries. If exchange rate risk and transaction costs constituted important barriers to capital flows in the past, the evidence should point to more mobility within rather than across countries. Surprisingly, however, the results do not make a compelling case for a large difference; in other words, capital markets appear to have been fairly integrated between countries even before the onset of monetary union. Moreover, real interest rate differentials (and levels) seem to have moved little (at least so far) compared with historical averages.

The deterioration in Portugal's current account is thus unlikely to mainly reflect investors' exploitation of a sizeable differential, in Portugal's favor, of real rates of return to capital, stemming from exchange rate risk and currency-related transaction costs. Accordingly, while part of the debt that is being accumulated by Portugal could be repaid with the fruits of real convergence (higher productivity), a sizeable adjustment in agents' consumption is likely to be needed to foot higher interest and amortization payments in the future. Such an assessment is also buttressed by developments in the banking system, which acts as an intermediator between domestic and foreign agents and has seen its net foreign asset position deteriorate rapidly (Box 2). Most of the increase in credit between 1996-99 has been for housing; and about one-third of credit for corporations finances real estate-related activities, with potentially limited effects on tradable production and future repayment capacity. The main text discusses policy implications, including for the timing of fiscal adjustment.

[1] For further discussion, see Jörg Decressin and Piti Disyatat (2000), "Capital Markets and External Current Accounts: What to Expect from the Euro" (forthcoming IMF Working Paper).

vulnerable to sudden shifts in euro-market liquidity. Limiting these risks needed to be taken into account in the policy design.

B. Fiscal Stabilization Policies: Near- and Medium-Term Deficit Targets

15. **Against the background of emerging macroeconomic imbalances, the authorities and the staff discussed the case for a more restrictive fiscal policy than envisaged in the *Stability Program*.** While the authorities saw some merit in accelerating fiscal consolidation—with staff arguing for reducing the relatively high structural deficit by about ½ percent of GDP per annum (net of receipts from the sale of UMTS licenses) and achieving nominal balance by 2002—they considered the *Stability Program* targets (i.e., a deficit of 1.5 percent of GDP in 2000 and balance by 2004) as remaining broadly appropriate to secure the desired rebalancing of the economy.

16. **For 2000, the authorities decided in late summer to effectively relax an original budget target that staff thought should, and could, be improved upon**. The authorities' decision consisted in using expected UMTS receipts of 0.4 percent of GDP to meet the original deficit target of 1.5 percent of GDP. At the time of the discussions in July, they agreed that staff's recommendation—fully implementing the previously announced expenditure measures; or reversing some of the earlier petroleum tax cuts—would likely more than offset revenue shortfalls, reducing the deficit to 1¼ percent of GDP. The implied strengthening of the structural balance by about ½ percent of GDP would help restrain

Fiscal Developments and Prospects, 1999–20011/
(In percent of GDP)

	1999	2000		2001	
	Est.	Budget	Revised estimate 2/	Stability program	Staff normative scenario
Revenues	43.0	45.6	44.8	45.8	44.7
Excluding capital revenues	40.8	42.5	42.2	42.6	41.9
Expenditure	45.0	47.1	46.6	46.8	45.4
Of which: interest	3.2	3.2	3.2	3.3	3.1
Overall balance	-2.0	-1.5	-1.9	-1.1	-0.7
Primary balance	1.2	1.7	1.3	2.2	2.4
Structural primary balance 3/	1.2	1.5	1.1	1.7	2.1
Memorandum item					
GDP growth	3.0	3.3	3.4	3.6	3.3

Sources: Ministry of Finance, *Stability Program* (February 2000); and Fund staff estimates.

1/ Figures incorporate recent revisions in the fiscal and national accounts (see Tables 3 and 4).
2/ Excludes UMTS receipts, projected at 0.4 percent of GDP.
3/ Fund staff estimates.

domestic demand. They pointed out, however, that budget execution had become considerably more challenging due to sizable revenue shortfalls on petroleum taxes—where tax cuts had been aimed at cushioning the impact of rising world market prices, with a political commitment to stabilize domestic prices for the remainder of 2000 after the March tax increase. These considerations contributed to the subsequent effective relaxation of the original deficit target of 1.5 percent of GDP through the inclusion of UMTS receipts. Compared to the staff's recommendation, these receipts would finance higher expenditure, leaving the structural deficit (excluding UMTS receipts) unchanged in 2000.

17. **For 2001, the authorities considered the key policy challenge to curtail the rapid growth of public expenditure; at the same time, reducing the fiscal deficit to 1.1 percent of GDP, as targeted in the *Stability Program*, was seen as appropriate**. While staff agreed with the importance of expenditure restraint (see below), it argued for a path of more accelerated fiscal adjustment—a deficit of ¾ percent of GDP—both to address economic imbalances and to progress with needed fiscal consolidation at a time of expected strong growth.[6] During the discussions, there was a consensus on the benefits of a broadly steady pace in reducing the structural fiscal deficit, as indeed implied by the *Stability Program* and, at a somewhat faster speed, the staff's scenario. On the other hand, the authorities' use of UMTS receipts within the original deficit target in 2000—and the reaffirmed 1.1 percent of GDP target for 2001—would result in a more uneven path: excluding the license receipts, the estimated structural deficit would decline by over ½ percent of GDP in 2001, after remaining unchanged in 2000.

18. **There was broad agreement on the appropriate medium-term deficit target for Portugal—balance over the cycle—even if not on the pace for reaching the target**. Reflecting its concerns about macroeconomic imbalances, preferably to be addressed within the relatively favorable near-term economic environment, the mission suggested eliminating the deficit by 2002 (two years ahead of the *Stability Program*'s goal) and allowing the full operation of fiscal stabilizers around this target path; ECOFIN had also recommended more accelerated deficit reduction than envisaged in the *Stability Program.* The authorities responded that they would aim for faster deficit reduction under more favorable economic developments; they had, indeed, often overachieved on original budget targets in the past. Otherwise, they saw the *Stability Program's* adjustment as broadly adequate: within two years, the deficit would be below ¾ percent of GDP, thus providing sufficient margin for automatic stabilizers in the case of a cyclical downturn. On the other hand, staff pointed out that even nominal balance by 2002 was likely to imply a small structural deficit that, to comply with the spirit of the SGP, would still need to be eliminated. With respect to the longer term, there was general agreement that the *Program's* target of balance was appropriate for Portugal: it would reduce public debt decisively, to some 25 percent of GDP by 2015—about

[6] Staff estimates that a 1 percent of GDP reduction in public consumption would lower GDP by about 0.5 percent in the near term. With the proposed fiscal adjustment, GDP growth in 2001 is likely to remain above potential (see text table).

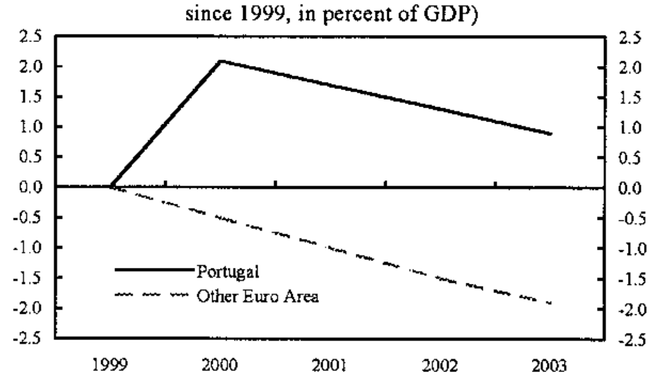
the time that the old age dependency ratio (and the associated pension outlays) would begin to rise more rapidly.

C. Fiscal Expenditure and Tax Reform

Expenditure policy

19. **The key fiscal policy challenge facing Portugal is to rein in the growth of current primary expenditure**. In recent years, budgeted increases and successive slippages pushed expenditure (in terms of GDP) close to the euro-area average (Figure 8). These fiscal trends were unique in the euro area—only Portugal recorded a significant rise in current primary expenditure in the second half of the 1990s (Figures 9a and 9b)—and staff viewed the rising tax burden as jeopardizing real income convergence. A driving force behind escalating primary spending had been the steady rise of government employment and, more importantly, in public sector wages: with further structural pay adjustments, the estimated wage bill increase was 9 percent in 1999 (and a staggering 30 percent during 1997–99), and is now, as a share of GDP, the highest in the euro area. While the extent of the wage bill increases had caught the authorities by surprise—budgetary costs of structural pay scale adjustments were much higher than anticipated—the general rise in public spending was, in the past, also a deliberate policy objective. Notably, it reflected a perceived need for higher investment and social expenditure—to foster the catch-up process, strengthen social cohesion, and address deficiencies in educational attainment levels.

Portugal and the Euro Area: Primary Expenditure Targets in Stability Programs (Cumulative change since 1999, in percent of GDP)



20. **The authorities emphasized that the 2001 budget would be a watershed for reducing the growth rate of public expenditures.** Preliminary plans for the 2001 budget were based on a halving of the growth rate for primary current outlays, and the *Stability Program* envisaged a further modest reduction in primary expenditures (in terms of GDP) through 2004 (Table 4)—although the burst of spending in 2000 would keep these outlays above their 1999 level.[7] Staff recognized the authorities' intention to slow the growth of spending as a clean break with the past; but it also pointed out that other euro-area countries were aiming for more ambitious goals, typically targeting a decline of 2 percent of GDP in primary spending ratios between 1999 and 2003. With respect to specific steps to achieve these expenditure reductions, the discussions focused on four key areas:

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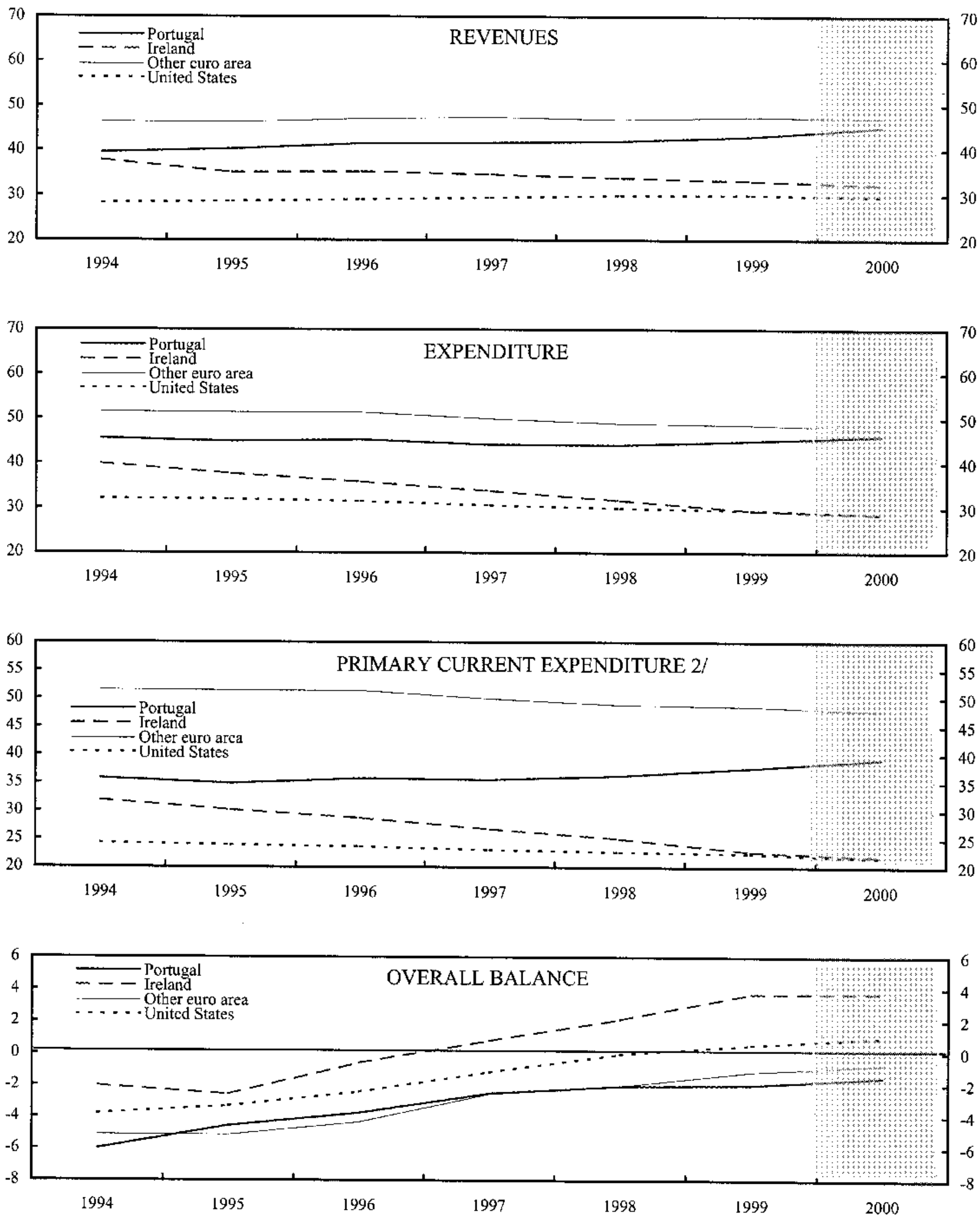
[7] Revisions in the fiscal and national accounts data must be taken into account in interpreting the original *Stability Program*; these are incorporated in the text (see footnote 1 of Table 4).

Figure 8. Portugal: Comparison of Fiscal Trends,1994-2000 1/
(In percent of GDP)

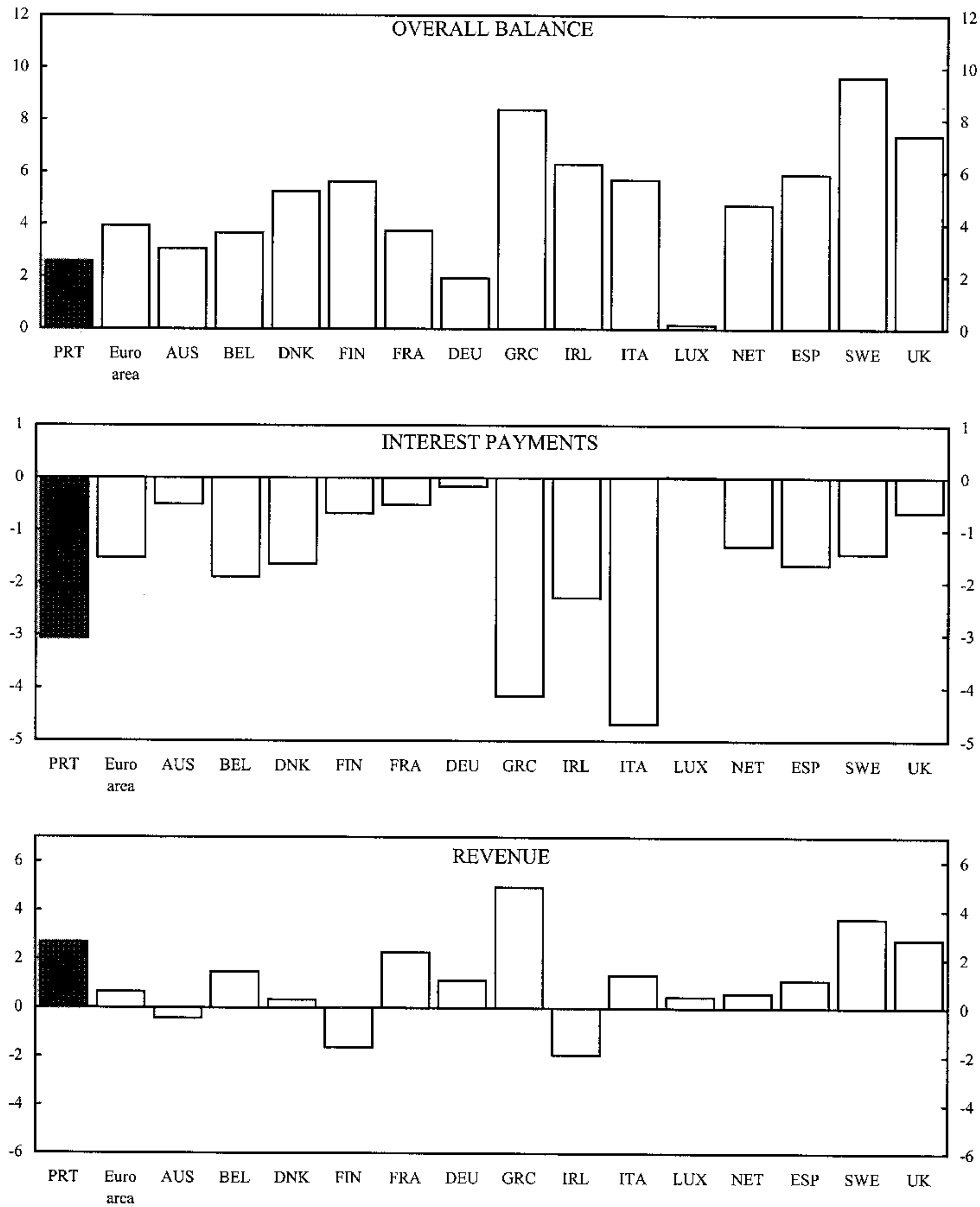


Sources: IMF, *World Economic Outlook*; and Fund staff estimates.

1/ Shaded areas show staff projections. Figures for Portugal for 2000 include capital receipts of 0.4 percent of GDP for sale of licenses for Universal Mobile Telephone Service (UMTS).

2/ Includes capital transfers.

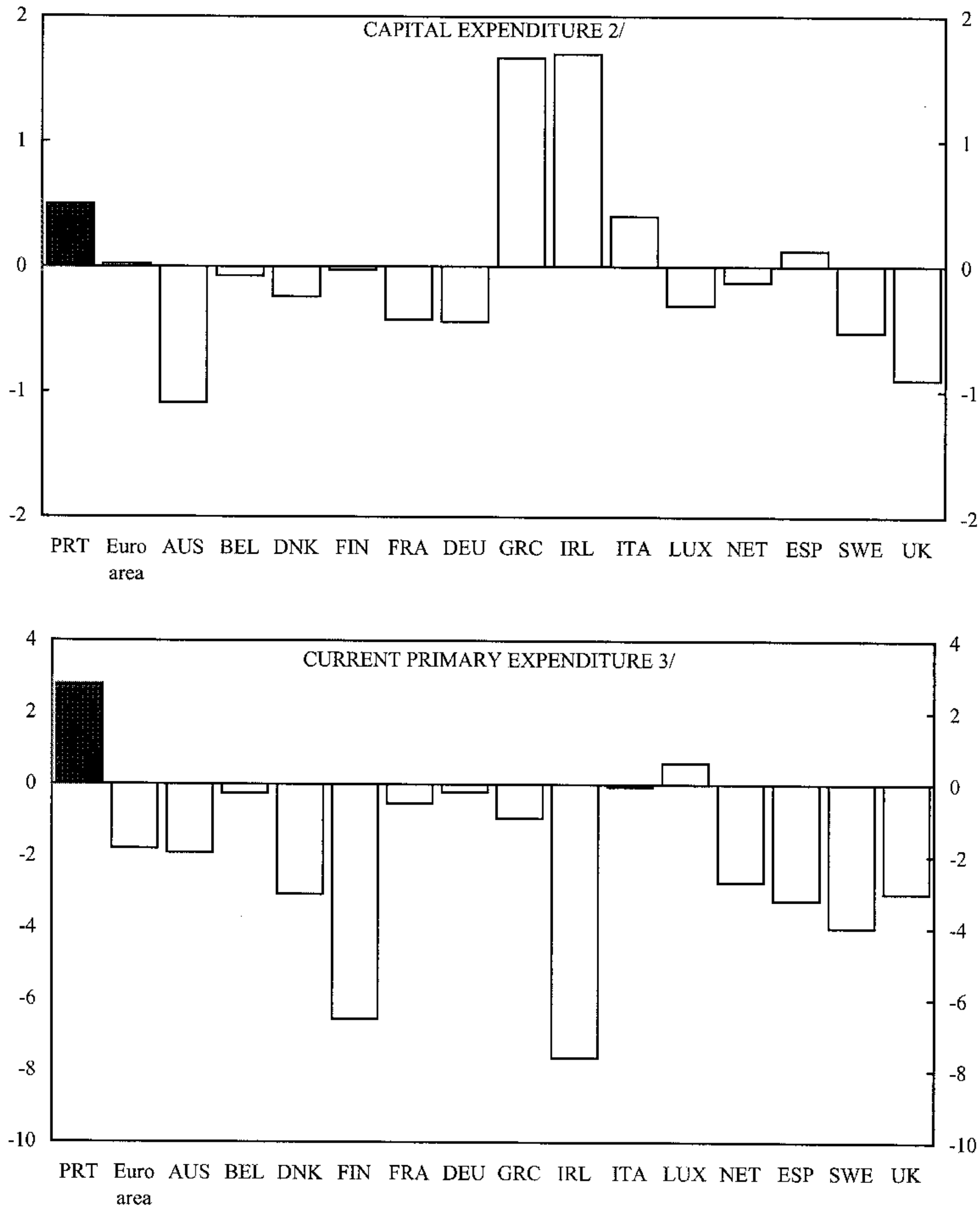
Figure 9a. Portugal: Composition of Fiscal Adjustment, 1995-1999 1/
(Cumulative change, in percent of GDP)



Sources: IMF, *World Economic Outlook*; and Fund staff estimates.

1/ Euro area figures are unweighted averages.

Figure 9b. Portugal: Composition of Fiscal Adjustment, 1995-1999 1/
(Cumulative change, in percent of GDP)



Sources: IMF, *World Economic Outlook*; and Fund staff estimates.

1/ Euro area figures are unweighted averages.

2/ Excludes capital transfers. These increased in Portugal by 0.8 percentage point between 1995 and 1999.

3/ Includes capital transfers.

General Government Wages and Employment

	1995	1999
Government wage bill		
	(In percent of GDP)	
Portugal	13.8	14.4
Rest of euro area 1/	10.8	10.2
Government employment		
	(In percent of total employment)	
Portugal	15.0	13.8
Rest of euro area 1/	17.6	16.6

Sources: OECD Analytical Database; WEO database; and Fund staff estimates.

1/Unweighted average. Excludes Luxembourg.

- **Public sector employment and wages**: The *Stability Program* envisaged a decline in employment by attrition as a major factor in achieving fiscal consolidation over the medium term, as an estimated 40 percent of civil servants were expected to retire over the next decade. While generous civil service pensions would initially leave little room for overall public expenditure savings, the turnover provided an opportunity for making strategic choices on expenditure priorities. The authorities intended to take advantage of savings from new information technologies; and they welcomed the suggestion of setting specific employment targets within a well-specified medium-term budget plan—a step that could be incorporated into their planned "budgeting by objectives," which is expected to become operational by 2002. In addition, they underscored a commitment to limit wage drift; and staff saw a case for reviewing the wage structure of the public vis-à-vis the private sector, with available information pointing to high relative public sector wages compared with other euro-area countries;

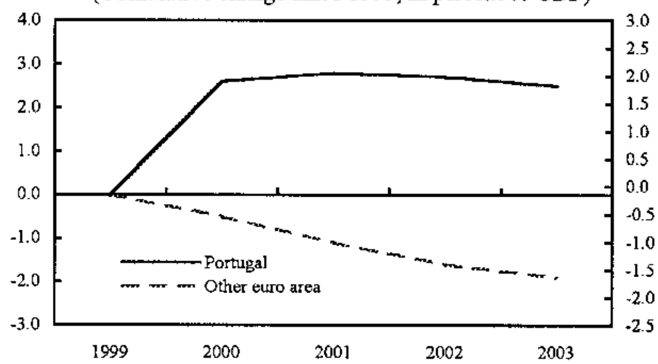
- **Health care**: While the authorities noted improved monitoring of health care spending, staff was concerned that fundamental steps to control chronic expenditure overruns remained to be taken, and that a viable strategy for medium-term expenditure containment was not in place. Although public health expenditures (about 5 percent of GDP) were not high by international standards, the OECD had pointed to relatively low efficiency, raising further concerns about the rapid increase in employment in this area over the past few years;

- **Pensions**: A new framework law was approved in July, providing the groundwork for the introduction of a fully funded system to complement the existing pay-as-you-go system. In addition, the actuarial soundness of the existing system had been strengthened by a revision of the benefit formula, as pension payments were to be based on a worker's entire contributive career. With the gradual phase-in of the new system, fiscal savings were only expected over the longer term, and spending would rise in the short run on account of an increase in benefits for low-income pensioners. The authorities acknowledged concern about the prospects of the pension system for civil servants, where outlays were expected to rise markedly with the large number of retirements over the next decade;

- **Subsidies and enterprise support**: The authorities explained that the ongoing economic restructuring of the remaining public enterprises should, over time, allow a reduction in financial assistance from the state, including in the transportation sector (see below). In other areas, there were no immediate plans for eliminating mortgage subsidies, following the tightening of eligibility requirements in 1999; and responding to staff's suggestion that ex ante fiscal transparency would be improved by ending all government debt assumptions of public enterprise debt and capital injections financed from privatization proceeds, the authorities pointed out that the lion's share of all privatization receipts was already used for government debt reduction.

Tax policy

Portugal and the Euro Area: Revenue Targets in Stability Programs
(Cumulative change since 1999, in percent of GDP)



21. **While other euro-area countries were targeting aggressive tax reductions, Portugal's *Stability Program* aimed for a roughly unchanged revenue effort over the next few years (following a further increase in 2000).** The revenue burden had risen sharply in past years, approaching now the high average of the euro area. Moreover, the revenue-to-GDP ratio was substantially above that of other countries with similar per capita income and, according to the *Stability Programs,* was set to exceed that of Ireland and Spain by a wide margin (Table 4).[8] Nevertheless, the authorities did not feel that their tax system left the country at a competitive disadvantage. They emphasized that rising revenues were, to an important extent, the fruits of improved tax administration and not due to increased tax rates; these efforts included a strengthening of auditing and improved cross checking of returns for different taxes. Revenues have also benefited from the temporary expansion of the tax base on account of the consumption boom—a harbinger of less dynamic receipts in the medium term as private consumption growth slows to more sustainable levels. Moreover, the authorities noted that the reduction in the corporate income tax rate to 32 percent in 2000 had placed them among the countries with relatively low tax rates, and that contribution rates on social security were also comparatively modest. Even so, there was some acknowledgment that growth prospects could be enhanced by a reduction in the overall revenue burden: while empirical evidence on the positive growth effects of lower tax-to-GDP ratios was mixed, *changes* in the relative tax burden are likely to have important effects on business location decisions and, ultimately, income levels. Accordingly, and subject to securing expenditure cuts that would achieve the deficit targets outlined above, the staff suggested reducing the tax-to-GDP ratio by at least 1½ percent of GDP over the next three years, broadly in step with the plans of euro partners. However, the authorities saw little room

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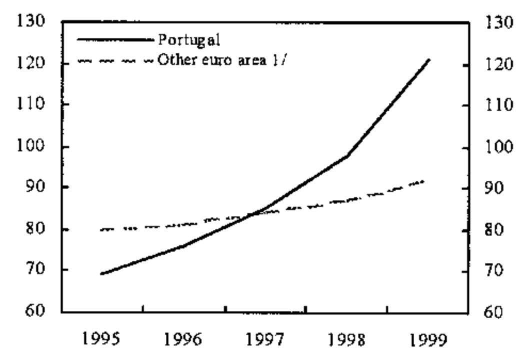
[8] To some extent, Portugal's elevated revenue-to-GDP ratio reflects a relatively high level of EU support recorded in the budget (2½ percent of GDP per annum, compared with about 2 percent of GDP and 1 percent of GDP in Spain and Ireland, respectively). Subsequent revisions to the fiscal and national accounts since the *Stability Program* (reflected in Table 3) have reduced revenues and expenditures as a share of GDP by about 3 percentage points.

in this regard in light of the government's social and investment expenditure objectives, while at the same time aiming for budget balance.

22. **The government had launched initiatives to improve the equity and efficiency of the personal income tax system, and further corporate tax reforms were under preparation**. The personal income tax reform, to take effect in 2001, was expected to be broadly revenue neutral and reduce the tax burden on low-income groups. The proposed changes included an increase in the basic deduction for dependents; more generous deductions for education and health; a tightening of tax benefits for housing; and a lowering of tax rates for the lowest brackets. Staff welcomed these initiatives, but noted that there was further room to target tax benefits to the most needy. For the corporate income tax, additional reform measures were to be introduced later in 2000, including a streamlining of tax benefits; and the authorities were considering using the revenues from tax-base widening for a further reduction in tax rates to 30 percent. Staff suggested that this could form part of a tax strategy to strengthen supply conditions, including a reform of the income tax aimed at further raising labor force participation. It also argued for eliminating the adjustable element of the petroleum tax, whose price stabilization effect distorts market-based incentives; however, political commitments were unlikely to allow early reform steps.

D. Financial Sector Issues

Bank Credit to the Private Sector
(In percent of GDP)



1/ Unweighted average; excludes Luxembourg.

23. **In the financial sector, the authorities viewed the principal challenge as safeguarding its continued soundness in the face of high debt levels and brisk credit growth** (Box 2).[9] The sector had undergone a major transformation in recent years, spurred on by liberalization, merger activity, and heightened euro-area competition. Interest spreads on private sector credit (vis-à-vis government bonds) had narrowed and, with strong competition among banks, were smaller than in many industrial countries. The authorities emphasized that there were no signs of a deterioration in the quality of banks' loan portfolios, and that all available evidence suggested the banking system was healthy—banks were well capitalized; provisioning requirements were tighter than in most euro-area countries; and nonperforming loan ratios had declined sharply, though this is a lagging indicator of financial sector fragility. Even so,

[9] For developments in major other euro-area banking systems, see the forthcoming cross-country paper "Euro-area Banking at the Crossroads"; for more background on Portugal's financial system, see SM/98/243 (10/9/98) and OECD, *Portugal 1999*.

Box 2. The Credit Boom in Portugal

Bank Credit to the Private Sector, 1999 (In percent of GDP)	
Portugal	121.3
Ireland	107.4
Spain	92.9
Other EU 1/	81.7

Sources: IMF, IFS; WEO database; and Fund staff estimates.
1/ Excludes Luxembourg.

Propelled by brisk credit growth, the ratio of private sector bank debt to GDP is now the second highest in the euro area, after the Netherlands. Credit to households—of which ¾ is for mortgages—has risen by some 25 percentage points of GDP over the past three years to about 50 percent of GDP as of end-1999. In the first half of 2000, credit to households has slowed to seasonally-adjusted, annualized quarterly growth rates of around 20 percent from rates peaking at over 35 percent in the second half of 1999. Over the same period, enterprise credit has accelerated from annualized rates of about 20 percent to 40 percent.

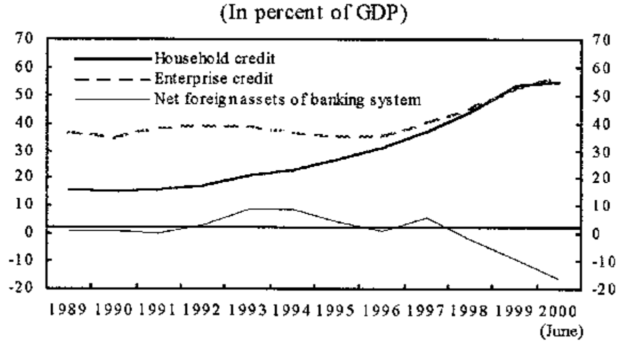
While undergoing a process of deregulation and restructuring, the **banking system's health** has improved considerably over the past decade.[1] Banks' expansion into more profitable ventures and cost cutting have mitigated the effect of competition on profitability. In addition, helped by a favorable cycle, the share of nonperforming in total loans has fallen to under 3 percent, a little over one-fourth of equity and provisions. The **regulatory framework** was strengthened further, more recently by tightening rules governing general provisions, large exposures, connected lending, and capital adequacy.

The rapid growth of credit—typically extended at variable interest rates—has raised concerns that it may have strained the **credit approval process** at a time when many banks were restructuring and expanding into new activities. Of special concern is the rapid growth of enterprise credit, about one-third of which is for construction or real estate. On the other hand, the risk stemming from the growth of household credit may be more limited given that (i) mortgage credit is almost exclusively for purchases of first homes, delinquency rates on which are likely to remain low even as interest rates rise; (ii) there is no compelling evidence of a property price bubble (Figure 6); and (iii) loan-to-value ratios—with value typically discounted below market by assessors—effectively amount to some 70 percent, according to bankers, in line with practices in other EU countries. Consistent with such an assessment, a recent ECB report[2] sees no systemic threat emanating from excessive asset prices. Nevertheless, the debt-service burden (including amortization) on households is considerable. Precise data are not yet available, but on the assumption that loans mature, on average, in 15 years the burden was at about 22 percent of disposable income in 1999 (8 percent on the assumption that maturing amounts are rolled over annually). This was higher than in the United States, where it reached 13½ percent. A concern is that in contracting new loans, agents may not take fully into account that in the new, low-inflation environment nominal incomes may no longer grow as fast as in the past, focusing instead on the immediate financial burden, which has declined dramatically as a result of lower nominal interest rates. Moreover, even the immediate burden is likely to rise when cyclically less-advanced euro-area countries hit capacity constraints and the ECB raises interest rates further—and this could coincide with cyclical weakness in Portugal. The Bank of Portugal, using end-1998 data, estimated that a 100 basis point increase in interest rates would increase household debt service payments by 6½ percent.

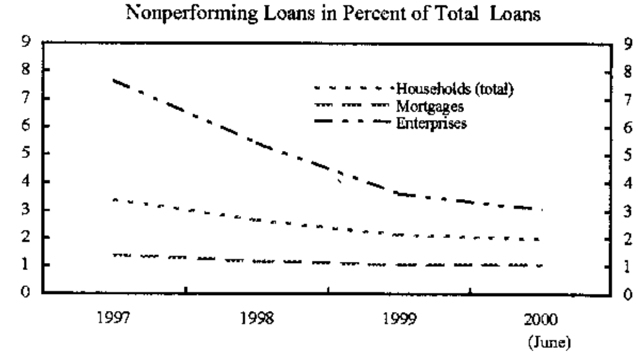
To **fund the credit expansion,** banks have reduced their holdings of government paper, contracted loans in the euro-area interbank market, and issued bonds and equity. Net foreign assets of the banking system have declined sharply and the credit-to-deposit ratio, which averaged some 60 percent during 1989–95, has climbed rapidly to over 110 percent by end-1999. While total bank capital rose about 12 percent in 1999, the capital adequacy ratio for the banking system dropped to 11.8 percent, from 12.4 percent in 1998. Also, the median capital adequacy ratio stood at 10–11 percent at end-1999, down from 11–12 percent at end-1998.

What measures should usefully be taken to **strengthen the resilience of the banking system** to an economic downturn? Close supervision remains essential and the Bank of Portugal is taking steps to strengthen its monitoring of the qualitative aspects of banks' activities, notably their credit management processes and practices. Also, it is considering a new loan loss provision based on historical loan default rates, similar to the one recently introduced in Spain. Furthermore, the discussion with the authorities covered enhancing **market discipline** through more public disclosure;[3] and setting stricter provisioning and capitalization requirements for specific financial institutions that engage in riskier lending. To help identify such institutions and lending, supervisors could require financial institutions to perform sensitivity analyses in relation to adverse events, such as rising interest rates or falling asset prices and incomes.

Credit Developments, 1989-2000
(In percent of GDP)



Nonperforming Loans in Percent of Total Loans



[1] See *IMF Staff Country Report No. 98/127* for a historical review of the Portuguese financial system.
[2] ECB, "Asset Prices and Banking Stability" (April 2000).
[3] BIS, "Sound Practices for Loan Accounting and Disclosure" (July 1999).

they expressed concern that credit growth was not slowing as expected, and staff pointed out that bank debt (as a share of GDP) had risen more sharply than elsewhere and was already among the highest in the euro area. The authorities concurred that it was critical to ensure that the financial sector could weather both rising interest rates and a cyclical slowdown in the economy—developments that could occur simultaneously under monetary union.

24. **Against this background, the authorities agreed on the need to carefully monitor banks' risk management and internal control practices and policies—and further steps were being taken in the areas of financial sector supervision and regulation**. Soon after the end of the consultation discussions in July, the Bank of Portugal announced an increase in capital requirements for housing loans with loan-to-value ratios exceeding 75 percent, and that preparations were underway for introducing provisions based on average loan performance over the cycle (similar to rules introduced recently in Spain). To help identify more broadly those banks engaged in riskier lending—and subsequently adjust capital or provisioning requirements—the authorities were considering to undertake scenario analysis and stress testing, as recently proposed by the Basel Committee on Banking Supervision (BCBS)—covering an economic or industry-wide downturn, market-risk events, or changes in liquidity conditions. Drawing further on the recommendations of the BCBS, the discussions also covered fortifying market discipline through enhanced public disclosure, including on significant concentrations of risk, and on credit risk management and control policies and practices. The Bank of Portugal cautioned, however, that these steps should probably await similar initiatives by other countries and should not expose banks' proprietary information. On supervision, the capacity of the insurance supervisory agency is to be strengthened as it becomes fully independent; and the quality of supervision, especially for financial conglomerates, would be further enhanced under the proposed council of supervisors, involving all three financial market supervisory agencies.

E. Policies to Raise Productivity and Achieve Durable Real Income Convergence

25. **Sound fiscal policies and a competitive tax environment will be necessary, but not sufficient, to achieve a more rapid convergence to average EU living standards**. In spite of the highest investment-to-GDP ratio in the euro area, Portugal's growth has exceeded the (unweighted) euro-area average by only a small margin and its per capita income level remains only about ¾ of the area average. This points to low investment efficiency—even when allowing for longer gestation lags of Portugal's (relatively high) public investment. The mission discussed selected areas considered critical for raising Portugal's lackluster productivity growth:

Investment and Growth in Portugal and the Euro Area, 1995-99

	Fixed Capital Formation (In percent of GDP)	Real GDP Growth (Annual average)
Portugal	25.5	3.4
Ireland	20.6	9.1
Spain	22.4	3.3
Euro-area average 1/	21.0	3.3

Sources: World Economic Outlook database; national authorities; and Fund staff estimates.

1/ Unweighted average excluding Luxembourg.

- **Product market reform**: A wide-ranging program of product market reform, marked by steady implementation of EU directives in key infrastructure sectors—including telecommunications, electricity, and postal services—had transformed the economic landscape and sown the seeds for a more efficient utilization of resources. Looking ahead, further liberalization of the telecommunications sector—made possible by the unbundling of the local telecommunications loop—was envisaged in 2001, facilitating more vigorous competition and possibly lower access costs to the Internet. In the electricity sector, the authorities planned to enhance competition by removing ownership of the grid from the former public monopolist; and steps were also planned with respect to the transport sector, where efforts to stem the losses of the railways and the metro company were likely to require reductions in personnel and fare increases.

- **Competition and external trade policy**: The authorities viewed competition policy as an important instrument to raise productivity and product quality, and were preparing the creation of an administratively and financially independent antitrust authority. The recent creation of separate trade courts was also expected to help resolve economic disputes more rapidly. With respect to external trade policy, they expressed reservations about accelerating liberalization for specific countries or country groups beyond the pace envisaged in existing trade agreements, and a preference for adhering to the multilateral framework agreed to under the Uruguay Round.

- **Privatization**: A bold program of privatization had reduced considerably the role of the state in the economy and enhanced economic efficiency. Over the next three years, the authorities envisaged further divestitures, including in energy, telecommunications, and transportation, with expected receipts of 2 percent of GDP per annum.

- **Education, the "new economy," and labor market reform**: Portugal's low levels of educational attainment represent a formidable obstacle to the skill- and technology-intensive growth envisaged at the March Lisbon Summit. So far, the new economy has had little discernible macroeconomic impact, and households' Internet penetration stands at less than half the EU average, hampered in the past by relatively high access costs. In education, while steps had been taken to expand the preschool network and strengthen vocational training, more fundamental reforms were needed to raise the system's efficiency and performance—as discussed in a background study for last year's consultation (SM/99/242, 9/23/99). Reforms were made all the more urgent in light of the rapid increase in spending in recent years, and the mission's discussions with social partners pointed also to a clear need to align education and training more closely with job requirements. In addition, the authorities acknowledged that productivity would benefit from an improved allocation of labor resources; this could be facilitated by increased labor mobility—among the lowest in the industrial countries and hampered by relatively strict severance pay and other dismissal requirements.

IV. Staff Appraisal

26. **Portugal's impressive economic performance since the mid-1990s owes much to the steady pursuit of stability-oriented macroeconomic policies and progress in**

implementing structural reforms. The fruits of this strategy are evident on many fronts: economic growth has exceeded the euro-area average; the unemployment rate is among the lowest in the euro area; and inflation has remained subdued.

27. **After seven years of robust growth, however, macroeconomic and financial imbalances are increasing with trends that are not sustainable**. The prolonged expansion of domestic demand in excess of incomes has pushed private sector bank credit to the second highest level in the euro area (in relation to GDP), and the rising indebtedness of domestic residents has been reflected in a sharp widening of the current account deficit. While these developments reflect to some extent the transition to the new euro environment, a considerable part of the rise in private sector indebtedness is difficult to reconcile with changing fundamentals under monetary union. Moreover, full employment has contributed to wage and unit labor cost increases above those in the euro area, exacerbating concerns about competitiveness, particularly if the euro were to appreciate considerably over the medium term. At the same time, monetary conditions remain more accommodative than warranted by the advanced stage of the domestic cycle.

28. **Against this background, more decisive fiscal adjustment is needed to achieve an appropriate policy mix and bring about a timely return to a more sustainable pattern of economic growth**. With fiscal policy carrying the burden of stabilization under monetary union, the authorities' recent decision to effectively relax the original 2000 budget target—by aiming to meet the target only *inclusive* of UMTS receipts—is inopportune. In light of macroeconomic imbalances and the cyclical strength of the economy, it would instead be desirable to accelerate deficit reduction toward the Stability and Growth Pact's target—from which Portugal is still relatively distant. Firm control over public expenditure should allow at least achievement of the original deficit target in 2000 (excluding UMTS receipts). This would lay the foundation for a path of deficit reduction to ¾ percent of GDP in 2001 and balance the following year—two years ahead of the *Stability Program* target.

29. **The government's commitment to reduce the growth of public outlays in 2001 is laudable and would present an important break from the past; nevertheless, more ambitious spending restraint than currently envisaged—preferably within a detailed program of medium-term expenditure reform—is needed**. The marked rise of Portugal's outlays in recent years stands in stark contrast to developments in the rest of the euro area; and, looking forward, Portugal's *Stability Program* is considerably less ambitious on this front than those in other euro-area countries. The government's proposed multiyear budgetary framework and "budgeting by objectives" provide potentially powerful tools for well-designed expenditure reductions, and should be implemented as soon as possible. The framework needs to involve an explicit costing of measures and specific targets for employment by ministry. Within these guideposts, reforms should be delineated in key areas of public expenditure, including the public wage bill, which is now the highest in the euro area as a share of GDP; and in health care, exploiting room for efficiency gains. On pensions, the recent framework law represents an important step forward; expeditious implementation would need to be complemented by additional measures to limit rising outlays—especially for the system covering civil servants—if these are not to jeopardize other government objectives. Savings

could also be found by further limiting public enterprise support—making all support strictly conditional on meeting specific targets—and by eliminating mortgage subsidies.

30. **Safeguarding a competitive tax environment will be instrumental for continued real income convergence**. A useful benchmark for the coming period would be to keep apace with cuts in the tax burden of other euro-area countries. Plans to streamline some income tax benefits are welcome, although there is further room to target education and health benefits to the most needy. With respect to the corporate income tax, the envisaged tightening of tax benefits should be used to reduce rates further and could become an important element of a broader, supply-side oriented tax reform strategy. The adjustable element of the petroleum tax, whose domestic price stabilization is distorting market-based incentives, needs to be reconsidered.

31. **In the financial sector, high levels of private sector bank debt and the continued rapid expansion of credit pose challenges for financial sector supervision and regulation**. The authorities have recently taken welcome steps to strengthen the safety margins of the financial system, which remains healthy by all available indicators. To better align capital and provisioning requirements with risk, it would be useful to undertake scenario analysis and stress testing, as recently proposed by the Basel Committee on Bank Supervision. Market discipline could also be enhanced by greater public disclosure, including on significant concentrations of risk, and on credit risk management and control policies and practices. The granting of full independence to the insurance supervisory agency is most welcome, as well as the improved coordination in the supervision of financial conglomerates under the proposed council of supervisors. Consideration could also be given to participating in a Financial Sector Assessment Program (FSAP) in the future.

32. **The Portuguese economy has benefited from steady progress in product market reform and the authorities' emphasis on further privatization, additional liberalization of the energy and telecoms sectors, and strengthening competition is well placed.** Future efforts in this area should also address inefficiencies in the transport sector. While progress in implementing the privatization program has been noteworthy, ex ante fiscal transparency would be enhanced if all receipts from the sale of assets were used for debt reduction. The proposed strengthening of competition through the creation of a fully independent antitrust authority would be an important step in improving the competitive environment in Portugal, and should be implemented without delay.

33. **Low levels of educational attainment threaten Portugal's prospects of participating fully in the new economy and the skill- and technology-intensive economic growth envisaged at the March Lisbon Summit**. Bold steps are needed to address pervasive inefficiencies in the education system, where high spending has coexisted with low levels of educational performance.

34. **Portugal provides data to the Fund that is generally adequate for surveillance**. With respect to the real sector, however, data quality and periodicity are relatively poor by

industrial country standards. As the conversion of the national accounts to ESA95 is completed by end-2000, these and other data deficiencies should be quickly resolved.

35. Portugal's substantial financial support for the development of East Timor has been most commendable; in addition, the authorities should strive toward raising ODA from its 1999 level of 0.2 percent of GNP toward the UN target, and for lending their support to fully liberalize imports from the least developed countries.

36. It is proposed that the next Article IV consultation with Portugal take place on the standard 12-month cycle.

Table 1. Portugal: Selected Economic Indicators, 1994–2001 1/

(Changes in percent, except as otherwise indicated)

	1994	1995	1996	1997	1998	1999	2000	2001
Domestic economy								
Real GDP	2.4	2.9	3.3	3.7	4.2	3.0	3.4	3.5
Real domestic demand	3.1	2.4	3.1	4.9	6.6	4.8	3.9	3.5
Private consumption	2.3	1.7	3.3	3.1	6.1	4.9	3.7	3.5
Gross fixed investment	3.4	4.6	4.8	11.9	10.3	5.3	4.5	4.1
Foreign sector contribution	-0.9	0.3	-0.1	-1.6	-2.8	-2.3	-0.8	-0.5
Employment	-0.1	-0.6	0.6	1.9	2.3	1.8	0.7	0.5
Unemployment rate	6.8	7.2	7.3	6.7	5.0	4.4	4.1	4.0
Output gap	-2.0	-2.0	-1.6	-0.9	0.2	0.0	0.3	0.7
Compensation per worker (manufacturing)	4.8	6.0	4.9	4.8	4.8	4.5	5.0	4.9
Unit labor costs (manufacturing)	2.8	-1.9	-5.9	2.1	2.8	3.9	2.4	2.4
Consumer prices (national index)	5.2	4.1	3.1	2.2	2.8	2.3	2.7	2.5
Consumer prices (harmonized index)	...	...	2.9	1.9	2.2	2.2	2.5	2.3
GDP deflator	6.1	7.4	3.6	3.2	4.4	3.2	2.2	3.1
External accounts								
Export volume	13.2	12.9	12.7	10.0	7.4	6.1	9.7	8.8
Import volume	11.3	9.7	8.4	13.2	15.2	10.3	7.9	7.1
Export unit value	6.5	4.2	-3.8	0.4	0.1	1.0	5.0	1.4
Import unit value	4.3	1.7	-0.3	0.3	-1.4	2.0	7.9	1.0
Trade balance (US$ billions, f.o.b.)	-8.3	-8.9	-9.1	-10.0	-12.4	-14.2	-14.9	-15.4
Current transfers (net, US$ billions) 2/	5.4	7.1	4.3	3.8	4.1	3.9	3.8	4.0
Current account (US$ billions) 3/	-2.2	-0.2	-2.2	-3.4	-5.4	-7.5	-8.6	-8.8
In percent of GDP 3/	-2.5	-0.1	-2.1	-3.2	-4.8	-6.6	-8.1	-7.8
Current account excluding capital transfers (in percent of GDP)	...	...	-4.0	-5.7	-7.1	-8.8	-10.4	-10.5
Financial account (in percent of GDP)	1.2	2.8	3.0	4.7	4.7	8.9	...	...
Of which: inward foreign direct investment	1.4	0.6	1.2	2.1	2.5	0.5	...	...
inward portfolio investment	4.5	1.9	3.6	7.6	4.6	10.7	...	...
Nominal effective exchange rate 4/	-3.4	1.7	0.2	-2.1	-1.0	-1.4	-2.2	...
Real effective exchange rate (CPI based) 4/	-1.2	2.9	0.9	-1.8	0.2	-0.4	-1.7	...
General government finances (in percent of GDP) 5/								
Revenues	39.7	40.3	41.5	41.6	42.0	43.0	45.1	45.0
Expenditures	45.8	44.9	45.2	44.2	44.1	45.0	46.6	46.1
Of which: capital expenditures	5.0	5.2	5.8	6.0	5.7	6.4	6.4	6.5
Overall balance	-6.0	-4.6	-3.8	-2.5	-2.1	-2.0	-1.5	-1.1
Excluding UMTS receipts	-6.0	-4.6	-3.8	-2.5	-2.1	-2.0	-1.9	-1.1
Public debt (Maastricht definition)	64.1	64.4	62.8	59.4	55.2	55.1	55.0	51.9
Of which: external debt	9.4	11.4	11.4	13.6	14.4	...	...	...
Privatization receipts	1.3	2.2	2.7	4.7	3.8	1.4	2.2	2.1
Financial variables (end of period)								
National contribution to euro-area M3 6/	...	8.2	6.1	6.3	6.8	9.8	9.9	...
Domestic credit 6/	13.7	11.7	12.6	11.6	16.8	19.9	23.7	...
Credit to the central government	23.1	-6.8	-4.1	-32.6	-52.6	-118.6	-25.5	...
Credit to the private sector 7/	11.0	17.6	16.8	20.7	24.9	25.9	25.9	...
Interest rates (percent) 8/								
Overnight rate	8.9	8.6	6.7	5.1	3.3	3.0	4.4	...
Deposit rate, 91–180 days	9.3	8.1	5.5	4.6	3.3	2.8	3.5	...
Lending rate, 91–180 days	14.7	12.7	11.0	8.4	6.0	5.1	6.4	...
Government benchmark bond	11.6	10.0	7.0	5.7	4.1	5.5	5.6	...

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

1/ Unless otherwise noted, 2000 and 2001 data are staff estimates or projections.

2/ Statistical break in 1996. Figures exclude transfers to finance capital expenditure for 1996–2001. These transfers equaled US$2.2 billion in 1996.

3/ Statistical break in 1996. Figures include transfers to finance capital expenditure, which equaled US$2.2 billion in 1996.

4/ Data for 2000 correspond to year-on-year rates of change through June.

5/ Figures for 2000 include receipts from sale of UMTS licenses of 0.4 percent of GDP. Figures for 2001 reflect the *Stability Program* deficit target.

6/ Data for 2000 correspond to year-on-year rates of change through July.

7/ Comprises all domestic credit except that to the central government.

8/ Data for 2000 correspond to August.

Table 2. Portugal: Balance of Payments, 1995–2000
(In percent of GDP)

	1995	1996	1997	1998	1999	2000 1/
Current account balance	-2.0	-4.0	-5.7	-7.0	-8.8	-10.4
Trade balance	-8.3	-8.3	-9.5	-11.0	-12.5	-14.0
Exports	22.4	22.7	23.4	23.0	22.6	24.6
Imports	30.8	31.1	33.0	34.1	35.0	38.6
Services balance	1.5	1.3	1.4	1.6	1.4	1.5
Exports	7.7	7.1	7.3	7.7	7.4	7.9
Tourism	4.5	4.3	4.4	4.7	4.5	4.7
Imports	6.2	5.8	5.9	6.2	6.0	6.4
Income balance	0.0	-0.9	-1.2	-1.2	-1.2	-1.4
Current transfers, net 2/	4.8	3.9	3.6	3.7	3.5	3.6
Capital account balance 2/	1.9	2.0	2.5	2.2	2.2	2.3
Current plus capital account balance	-0.1	-2.1	-3.2	-4.8	-6.6	-8.1
Financial account balance	3.1	3.1	4.8	4.7	8.9	...
Direct investment, net	0.0	0.5	0.6	0.0	-1.9	...
Direct investment - Portuguese investment abroad	-0.6	-0.7	-1.6	-2.6	-2.4	...
Direct investment - Foreign investment in Portugal	0.6	1.2	2.2	2.5	0.5	...
Portfolio investment, net	-1.0	-1.4	0.5	-0.7	6.8	...
Portfolio investment assets	-2.9	-5.1	-7.1	-5.3	-3.9	...
Portfolio investment liabilities	1.9	3.7	7.6	4.6	10.7	...
Financial derivatives	...	0.0	0.0	0.1	0.2	...
Other investment, net	3.8	4.7	4.9	5.8	4.0	...
Other investment assets	-7.1	-1.6	-6.3	-6.7	-1.9	...
Other investment liabilities	10.9	6.2	11.2	12.5	6.0	...
Reserve assets (and related items)	0.3	-0.7	-1.2	-0.5	-0.3	...
Errors and omissions	-3.0	-1.0	-1.5	0.1	-2.3	...

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

1/ Fund staff projection.
2/ For 1995, Fund staff estimates.

Table 3. Portugal: Fiscal Developments 1/ 2/
(General government, in percent of GDP)

	1996	1997	1998	1999			2000	
				Budget ESA79 3/	Actual ESA79	Actual	Budget 3/	Staff Proj.
Total revenue	41.5	41.6	42.0	42.3	43.5	43.0	45.6	45.1
Current receipts	39.4	39.2	39.5	39.5	40.6	40.8	42.5	42.2
Direct taxes	9.9	10.1	9.8	10.4	10.3	10.4	...	10.6
Social security contributions	10.3	10.3	10.6	11.2	11.8	11.5	...	12.0
Taxes on goods and services	14.4	14.3	14.6	13.9	14.5	15.0	...	15.0
Nontax revenue	4.8	4.5	4.5	4.0	4.0	3.9	...	4.6
Capital revenue	2.1	2.4	2.5	2.7	2.8	2.2	3.1	2.9
Total expenditures	45.2	44.2	44.1	44.2	45.3	45.0	47.1	46.6
Current expenditures	39.4	38.1	38.4	37.7	38.8	38.5	40.1	40.3
Public consumption	19.0	19.2	19.3	17.7	18.4	18.4	...	19.1
Compensation of employees	13.7	13.9	14.0	...	14.4	14.4	...	15.0
Other public consumption	5.3	5.3	5.2	...	4.0	4.0	...	4.1
Subsidies	1.5	1.2	1.4	0.7	0.7	1.0	...	1.2
Interest payments	5.4	4.2	3.5	3.2	3.1	3.2	3.2	3.2
Current transfers	13.6	13.6	14.3	16.1	16.6	15.9	...	16.8
Capital expenditures	5.8	6.0	5.7	6.4	6.5	6.4	7.1	6.4
Overall balance	-3.8	-2.5	-2.1	-1.9	-1.8	-2.0	-1.5	-1.5
Excluding receipts from sale of UMTS licenses	-3.8	-2.5	-2.1	-1.9	-1.8	-2.0	-1.5	-1.9
Memorandum items:								
Nominal GDP (billion escudos)	17,317	18,533	20,149	21,392	21,427	21,427	22,665	22,634
Real GDP growth (in percent)	3.3	3.7	4.2	3.5-4.0	3.0	3.0	3.3	3.4
Structural balance to potential GDP	-3.1	-2.1	-2.1	-2.3	-1.8	-2.0	-1.6	-2.0
Primary current expenditures	34.1	33.9	34.9	34.5	35.7	35.4	36.9	37.1
Primary balance	1.6	1.7	1.4	1.3	1.2	1.2	1.7	1.7
Public debt	62.8	59.4	55.2	...	...	55.1	...	55.0

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

1/ Due to recent revisions in the fiscal and national accounts, revenue and expenditure ratios are approximately 3 percentage points of GDP lower than in the Stability Program (see Table 4).

2/ Based on ESA95 unless otherwise noted. Figures for 2000 staff projection include receipts from sale of UMTS licenses of 0.4 percent of GDP in capital revenues. These receipts are excluded, however, from the calculation of the structural and primary structural balances.

3/ To account for major revisions to the national accounts, the ratios reported here are calculated on the basis of revised estimates of GDP. These estimates are based on GDP from the previous year multiplied by the nominal GDP growth assumed in the budget. Figures for revenues and expenditure for 2000 budget are staff estimates based on the deficit target in the *Stability Program*. Structural balance figures are staff estimates.

Table 4. Portugal: Comparison of Stability Programs for 2000–04
(General government, in percent of GDP) 1/

	1998	1999	2000	2001	2002	2003	2004	Change 1999–2003 2/
Revenue								
Portugal	43.0	45.9	48.0	48.2	48.1	47.9	47.8	2.0
Portugal (adjusted) 3/	42.0	43.0	45.6	45.8	45.7	45.5	45.4	2.5
Ireland	35.9	35.5	35.0	34.1	33.6	32.8	...	-2.7
Spain	39.9	40.1	40.1	40.0	39.9	39.8	...	-0.3
Other euro area 4/	46.0	46.2	45.7	45.0	44.6	44.3	...	-1.9
Expenditure								
Portugal	45.1	47.9	49.6	49.3	48.8	48.2	47.8	0.3
Portugal (adjusted) 3/	44.1	45.0	47.1	46.8	46.3	45.7	45.3	0.7
Ireland	33.8	32.3	31.7	31.3	30.7	30.4	...	-1.9
Spain	42.2	41.3	40.9	40.4	39.8	39.5	...	-1.8
Other euro area 4/	47.1	46.6	45.8	45.0	44.3	43.7	...	-3.0
Primary expenditure								
Portugal	41.5	44.5	46.4	46.0	45.6	45.2	44.9	0.7
Portugal (adjusted) 3/	40.6	41.8	43.9	43.5	43.1	42.7	42.4	0.9
Ireland	30.7	29.5	29.3	29.3	29.0	28.8	...	-0.7
Spain	37.8	37.5	37.3	36.8	36.3	36.0	...	-1.5
Other euro area 4/5/6/	40.8	40.5	40.0	39.6	39.1	38.7	...	-1.9
Overall balance								
Portugal	-2.1	-2.0	-1.5	-1.1	-0.7	-0.3	0.0	1.7
Ireland	2.1	3.2	3.3	2.8	2.9	2.9	...	-0.3
Spain	-2.3	-1.2	-0.8	-0.4	0.1	0.2	...	1.4
Other euro area 4/	-1.1	-0.5	-0.1	0.0	0.3	0.5	...	1.0
Structural balance								
Portugal	-2.1	-2.1	-1.7	-1.5	-1.3	...	...	0.8
Ireland	1.1	0.9	1.2	1.4	2.3	...	...	1.4
Spain	-1.5	-1.2	-1.1	-0.7	-0.2	...	...	1.0
Other euro area 4/5/	-0.4	0.0	0.4	0.5	0.9	...	...	0.9
Primary structural balance								
Portugal	1.5	1.3	1.5	1.8	2.0	...	...	0.7
Ireland	4.3	3.8	3.7	3.4	4.0	...	...	0.2
Spain	2.9	2.6	2.5	2.9	3.3	...	...	0.8
Other euro area 4/5/6/	4.8	4.7	4.7	4.6	4.9	...	...	0.2

Sources: National authorities; and Fund staff estimates.

1/ The nonadjusted figures for Portugal are based on the Stability Program and do not reflect recent revisions to fiscal and national accounts (see footnote 3). Figures for some years for France, Ireland, and Netherlands were estimated or projected by Fund staff. See SM 00/48 (4/27/00) for more details on individual country stability programs.

2/ Refers to 1999–2002 for structural balance and primary structural balance.

3/ Staff estimates based on revised fiscal and national accounts data for 1998–99. Figures for 2000 refer to staff estimates of the budget, and figures for 2001–04 are based on changes (in percent of GDP) indicated in the *Stability Program.*

4/ Unweighted average for euro area excluding Portugal and Luxembourg.

5/ Excludes Austria.

6/ Excludes Germany.

Table 5. Portugal: Indicators of External and Financial Vulnerability 1/
(In percent of GDP, unless otherwise indicated)

	1995	1996	1997	1998	1999	2000 Latest est.	2000 Date
External indicators 1/							
Exports (annual percent change, in U.S. dollars) 2/	28.9	6.2	-2.8	3.9	-0.2	1.6	
Imports (annual percent change, in U.S. dollars) 2/	22.1	5.9	-0.2	9.4	4.7	2.7	
Terms of trade (annual percent change)	2.5	-3.6	0.1	1.4	-0.9	-2.9	
Current account balance	...	-4.0	-5.7	-7.0	-8.8	-10.4	
Current account balance (including capital transfers) 1/	-0.1	-2.1	-3.2	-4.8	-6.6	-8.1	
Capital and financial account balance	...	5.1	7.3	6.9	11.0	10.4	
Of which: Inward portfolio investment (debt securities etc.)	...	3.7	7.6	4.6	10.7	...	
Inward foreign direct investment	...	1.2	2.2	2.5	0.5	...	
Other investment liabilities (net)	...	4.7	4.9	5.8	4.0	...	
Official reserves (in billions of U.S. dollars, end-of-period) 3/	22.0	21.7	20.3	21.6	14.1	13.9	Jun.
Broad money to reserves 3/	3.5	3.7	3.6	3.9	7.8	7.7	Jun.
Central Bank foreign liabilities (in billions of U.S. dollars) 4/	1.4	1.6	3.4	2.9	10.7	10.5	Aug.
Foreign assets of the financial sector (in billions of U.S. dollars) 5/	39.1	41.1	46.8	53.2	47.5	51.6	Jul.
Foreign liabilities of the financial sector (in billions of U.S. dollars) 5/	30.7	36.3	41.8	56.8	57.9	68.3	Jul.
Official reserves in months of imports 3/	8.0	7.5	7.0	6.8	4.2	4.0	Aug.
Total external debt 6/	30.0	27.4	37.5	37.2	...	...	
Of which: General government debt	12.7	13.1	16.2	18.7	...	...	
Total external debt to exports (ratio)	98.6	86.8	108.7	114.4	...	...	
Exchange rate (per U.S. dollars, period average)	151.1	154.2	175.3	180.1	188.2	221.8	Aug.
Financial market indicators							
Public sector debt (Maastricht definition)	64.4	62.8	59.4	55.2	55.3	55.3	
Money market rate	8.9	7.4	5.8	4.3	2.7	4.4	Aug.
Money market rate (real)	4.8	4.3	3.6	1.5	0.4	0.9	Aug.
Stock market index	100.0	132.6	219.0	253.5	259.9	321.4	Aug.
Share prices of financial institutions	100.0	116.0	168.3	297.2	266.9	324.4	Aug.
Financial sector risk indicators							
Foreign exchange loans (in billions of U.S. dollars) 7/	...	...	3.3	4.1	3.4	3.4	Jul.
Share of foreign exchange loans in total lending (percent) 7/	...	...	3.2	3.2	2.6	2.4	Jul.
Deposits in foreign exchange (in billions of U.S. dollars) 8/	...	...	13.0	17.5	15.5	15.4	Jun.
Share of foreign deposits in total deposits (percent) 8/	...	...	12.4	14.6	13.5	13.9	Jun.
Share of real estate sector in private credit	29.0	33.2	31.8	33.7	37.6	37.6	Feb.
Share of nonperforming loans in total loans 9/	5.9	5.2	4.0	2.9	2.2	1.9	Jun.
Share of nonperforming loans in total assets 9/10/	...	...	2.6	2.3	1.9	1.8	Jun.
Risk-based capital asset ratio 11/	8.5	8.4	9.1	9.1	9.8	...	
Long-term foreign currency debt rating (S&P)	AA-	AA-	AA-	AA	AA	AA	Aug.
Long-term foreign currency debt rating (Moody's)	A1	A1	Aa3	Aa2	Aa2	Aa2	Aug.

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

1/ The interpretation of some indicators is affected by the introduction of monetary union in 1999.
2/ Annual rates of change are affected by movements in the exchange rate. For real growth rates, see Table 1.
3/ Reserves and foreign liabilities refer to the Bank of Portugal, both before and after EMU. Statistical break in 1999.
4/ Ratio of reserves to M2 until 1998, and national contribution to euro-area M3 in 1999 and 2000.
5/ Banks only.
6/ Debt securities plus loans.
7/ Share of loans in noneuro currencies.
8/ Financial sector liabilities in noneuro currencies to nonresidents.
9/ For 2000, staff estimate.
10/ Assets include those of the Bank of Portugal.
11/ Capital over risk-weighted liabilities; figure refers to lowest value among the six largest banking groups (which account for 90 percent of the banking system). It should be noted that the Portuguese methodology for computing this ratio delivers lower values than the BIS standard norm.

Portugal: Fund Relations

(As of August 31, 2000)

I. **Membership Status**: Joined March 29, 1961. Portugal accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement effective September 12, 1988.

II. **General Resources Account**:

	SDR Million	Percent Quota
Quota	867.40	100.0
Fund holdings of currency	615.72	71.0
Reserve position in Fund	251.69	29.0
Operational budget transfers (net)	-1.00	

III. **SDR Department**:

	SDR Million	Percent Allocation
Net cumulative allocation	53.32	100.0
Holdings	38.84	72.8

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	10/07/83	2/28/85	445.00	259.30
Stand-by	6/05/78	6/04/79	57.35	0.00

VI. **Projected Obligations to Fund**: None.

VII. **Exchange Rate Arrangements**:

• Portugal entered the final stage of European Economic and Monetary Union on January 1, 1999, at a rate of 200.482 Portuguese escudos per 1 euro.

• Portugal has notified the Fund of the imposition of restrictions under Decision 144-(52/51) vis-à-vis Iraq and the Socialist People's Libyan Arab Jamahiriya.

VIII. **Article IV Consultation**: Portugal is on a standard 12-month consultation cycle. The last Article IV consultation discussions were concluded at EBM/99/113, 10/8/99.

IX. **Technical Assistance**

Year	**Dept.**	**Purpose**	**Date**
1991	FAD	Treasury Management	3/91
1994	FAD	Strengthening the Tax System	4/94
1998	STA	Finalize Metadata for DSBB	9/98
1998	STA	Revision of Monetary Statistics	11/98

X. **Resident Representative**: None.

Portugal: Statistical Issues

Portugal's economic data on the core variables needed for surveillance are at acceptable standards of quality, coverage, and timeliness. Portugal's publication policy is characterized by a high degree of frequency and openness, with extensive use of the Internet. The Bank of Portugal, Ministry of Finance, and National Statistics Office (INE) have several sites with long- and short-term economic indicators and data, and official documents such as the fiscal budget, the stability program, and economic laws and decrees are posted regularly. Portugal subscribed to the Special Data Dissemination Standards (SDDS), and the relevant metadata have been posted on the Dissemination Standards Bulletin Board.

Statistical weaknesses remain in several areas. INE has not yet published a full set of national accounts based on ESA95. INE's quarterly national accounts data, based on ESA79, are only available through 1998, and are built on an unrealistic seasonal pattern that precludes their use to assess quarterly developments. Separate and considerably different estimates of the national accounts are produced by the Bank of Portugal, but only on an annual basis. Thus, the analysis of current output trends is done using a range of quantitative and opinion surveys, including the Bank of Portugal's and INE's coincident economic indicators. Some improvement in this area is expected by year-end, when it is expected that INE will complete work on ESA95-based quarterly national accounts for 1995-2000:2. The lack of consistent monthly or quarterly data on output, employment, and total wage compensation hampers the monitoring of within-year developments in the labor market. Unemployment data also suffer from statistical problems caused, inter alia, by frequent revisions to the measurement of unemployment and sampling rotations.

Fiscal data have undergone a number of revisions during the transition to ESA95, sizably altering revenues and expenditures and hampering international comparisons. Data for the 2000 budget that are fully consistent with recent changes in national and fiscal accounting methodology were not yet available as of September 2000. While figures on the fiscal outturn (on a cash basis) for the central administration are available on a monthly basis, accrual data—including for autonomous funds such as the National Health Service—are only published on an annual basis, and forecasts for the yearly outturn for the general government (including autonomous funds) are only disseminated semiannually.

External sector data are now provided according to the IMF's Fifth *Balance of Payments Manual*. A number of problems remain, however, as the liberalization of capital movements and tax-induced capital transactions have complicated the interpretation of balance of payments flows. Problems stem from several sources, including (i) difficulties in obtaining data on residents' capital income from abroad, which tend to bias factor income in the current account; (ii) the likely underestimation of foreign direct investment inflows following the lifting of registration requirements; and (iii) problems in interpreting flows in the financial account because of, inter alia, the rolling-over of financial positions which generate large gross inflows and outflows.

Portugal: Core Statistical Indicators as of August 31, 2000

	Exchange Rates	Interna-tional Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Central Government Balance 1/	GDP/GNP 2/	External Debt
Date of Latest Observation	8/31/00	8/31/00	6/31/00	6/31/00	6/31/00	8/31/00	Jul. 2000	June 2000	May 2000	July 2000	1999 (annual)	June 2000
Date Received	8/31/00	3rd week of August	3rd week of August	3rd week of August	3rd week of August	8/31/00	3rd week of August	3rd week of August	3rd week of August	End-August	Mid-February	3rd week of August
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly
Source of Update 3/	Reuters, Bloomberg	BoP	BoP	BoP	BoP	Reuters, Bloomberg	INE	BoP	BoP	MoF	INE	BoP
Mode of Reporting	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic
Confidentiality	None	None	None	None	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly

1/ Estimates of the general government balance (annual basis) are updated twice during the year (February/March and August/September), and include projections for the current year.
2/ The release of quarterly GDP figures for 1999 and 2000 has been delayed while the national accounts are converted to ESA95, which is expected by end-2000.
3/ BoP = Bank of Portugal; MoF = Ministry of Finance; INE = National Statistics Office.

INTERNATIONAL MONETARY FUND

PORTUGAL

Staff Report for the 2000 Article IV Consultation
Supplementary Information

Prepared by the European I Department

Approved by Alessandro Leipold and G. Russell Kincaid

October 17, 2000

1. This supplement reports on information on economic and financial developments in Portugal since the issuance of the staff report (SM/00/219, 9/28/00) to the Executive Board. The information does not alter the thrust of the staff appraisal.

Macroeconomic developments

2. On inflation, the year-on-year increase in the harmonized index of consumer prices (HICP) remained unchanged at 3.6 percent in September. The differential vis-à-vis the euro-area average for underlying inflation (excluding energy and food) was broadly stable at around 2 percentage points.

3. Reflecting mainly higher-than-expected oil prices and revisions for partner country demand (see SM/00/212, Supplement 1), the staff has revised downward its projection for economic growth relative to the staff report—by 0.1 percentage point for 2000 and 0.3 percentage point for 2001, leaving projected GDP growth at 3¼ percent in both years. The external current account deficit (including transfers) could reach 9 percent of GDP in 2000 and 10 percent in 2001. Higher import prices, reflecting also a more depreciated euro, are expected to contribute to higher inflation. The impact would be most pronounced in 2001, with staff now projecting HICP inflation of 2.9 percent, compared with 2.3 percent in the staff report.

The 2001 budget

4. The 2001 budget (cash basis) was presented to parliament on October 16. While data on a national accounts (accrual) basis are not yet available, the authorities have explained that the cash figures are consistent with a deficit of 1.1 percent of GDP, unchanged from the *Stability Program*. This compares with a 2000 deficit, which the staff and the authorities, on current policies, estimate at 1.9 percent of GDP (excluding receipts from universal mobile telephone licenses, UMTS), unchanged from the main report. The 2001 budget envisages strong revenue growth: overall revenues (on a public accounts basis, excluding UMTS receipts) are to increase by 9.7 percent, compared to nominal GDP growth of 7 percent (Fund

staff projection: 5¾ percent); and direct and indirect tax receipts are projected in the budget to rise by 8½ and 10 percent, respectively. The authorities' estimates are based on further gains in revenue collection from improvements in tax administration—especially with respect to reducing tax evasion—and robust growth of the tax base. Petroleum tax rate increases are to be phased in gradually during 2001; this follows their marked reduction during 1999–2000, aimed at stabilizing domestic prices, and petroleum tax revenues would remain below their 1998–99 levels by about ½ percent of GDP.

5. On tax reform, the authorities have proposed several measures beyond those mentioned in the staff report, including the broader use of presumptive taxation to capture income tax from the self-employed and for small enterprises; the abolition of the deductibility of general provisions from banks' taxable income, to be phased in between 2001 and 2003; and the elimination of the double taxation of dividends. Looking ahead, the corporate income tax rate is to be reduced from the present 32 percent to 30 percent in 2002, to 28 percent in 2004, and 25 percent in 2006. For 2001, the reforms are expected to be broadly revenue neutral.

6. The 2001 budget envisages an increase in current expenditures of 7.8 percent relative to the authorities' latest estimate for 2000. The wage bill would grow by 5½ percent and fall as a share of GDP, while higher capital transfers from the EU would support an almost 15 percent increase in capital expenditures. The budget also includes a reallocation toward social spending, including for health and education.

7. On balance, these revisions do not alter the staff appraisal. Economic growth is still expected to be close to potential, indicating that the suggested fiscal adjustment called for by staff would remain well timed. A preliminary assessment of the 2001 budget points to considerable risks to the deficit target that staff, in the main report, viewed itself as insufficiently ambitious. Key risks relate to the projected large revenue increase at a time of slowing domestic demand growth; relatedly, to further high revenue yields from improvements in tax administration; and to an envisaged improvement in the revenue performance of the National Health Service, where past initiatives have often failed to achieve tangible fiscal savings. Moreover, while the growth in current primary expenditures in the 2001 budget is lower than in 2000, overall as well as current primary expenditure would still rise as a share of GDP—relative to the authorities' (and staff's) expected outturn for 2000. Finally, continued shortfalls on petroleum taxes underscore the importance of the staff appraisal's recommendation to reconsider the present energy tax policy, and allow the relative price mechanism to operate, in conjunction—and as appropriate—with targeted income support for the most needy.

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FOR IMMEDIATE RELEASE
November 20, 2000

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

IMF Concludes Article IV Consultation with Portugal

On October 20, 2000, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Portugal.[1]

Background

Portugal's economy has prospered since the mid-1990s, guided by prudent macroeconomic policies and steady progress on structural reform. The fruits of this strategy have been evident on many fronts, with strong output and employment growth; a reduction in unemployment to one of the lowest rates in the euro area; and historically low inflation. Participation in the euro area provided an anchor for expectations and facilitated a reduction in interest rates, ushering in a period of domestic-demand led growth with high rates of investment and the rapid expansion of credit to the private sector. However, after a prolonged period of economic expansion, there are signs of macroeconomic imbalances that are not sustainable. Private sector bank debt (in relation to GDP) is now the second highest in the euro area, and the rising indebtedness of domestic residents has been reflected in a widening of the external current account deficit (including transfers) to a projected 9 percent of GDP in 2000, the highest among advanced economies. Tight labor markets have contributed to wage and unit labor cost increases that are well above those in the euro area, and a differential in core inflation (excluding energy and food) of 1–2 percentage points remains.

Domestic demand has gradually decelerated in 1999/2000, but remains the engine of economic growth. With the revival of exports, GDP growth is expected to accelerate to 3¼ percent in 2000 from 3 percent in 1999. Private consumption has cooled from its blistering pace in 1998, but is still growing faster than incomes as households continue to adjust to the earlier decline in

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

interest rates with a further drop in their savings rate. As elsewhere in Europe, exports began to rebound in the second half of 1999, compensating for the slowdown in domestic demand. Monetary conditions remain expansionary from a Portuguese perspective, as the impact of rising European Central Bank (ECB) interest rates has been offset by the euro's weakness. The monetary stance has contributed to strong growth in monetary and credit aggregates. And while the year-on-year growth of credit to households decelerated to about 20 percent by mid-2000—amid high household debt levels and rising interest rates—credit to nonfinancial corporations has continued to rise strongly at above 25 percent on an annualized basis. Banks financed the expansion of credit predominantly by reducing their holdings of government paper, contracting loans in the euro area interbank market, and issuing bonds and new equity.

Fiscal consolidation stalled during 1998–99. Rapidly rising government expenditure resulted in weakening of the primary structural balance and left the overall structural deficit at the highest level in the euro area. For 2000, the budget envisaged a decline in the deficit by ½ percentage point of GDP to 1.5 percent of GDP. Successive government decisions to cut petroleum taxes to help stabilize domestic prices have lowered revenues in 2000 (by ½ percentage point of GDP) and have led to a projected deficit of 1.9 percent of GDP, excluding expected receipts of 0.4 percent of GDP from the sale of licenses for universal mobile telephone service.

Near-term prospects for economic activity point to steady GDP growth of around 3¼ percent in 2000–01, with the strength of exports likely to offset a further slowdown of domestic demand. Growth prospects benefit from accommodative monetary conditions and the weakness of the euro, which is facilitating a rebalancing of growth toward the tradables sector. Following an upward adjustment in domestic petroleum prices in late March, inflation increased to 3½ percent in early fall 2000. The main risks to growth relate, on the downside, to a slowdown in external demand and an abrupt appreciation of the euro, and to a decline in construction activity if interest rates were to increase by more than expected. On the upside, continued strong employment growth may result in a rebound in consumer spending.

Executive Board Assessment

Executive Directors commended the authorities for their stability-oriented policies and structural reforms that had led to rapid output growth, a low level of inflation, and one of the lowest levels of unemployment in the euro area. After seven years of robust economic growth, there were, however, growing signs of macroeconomic imbalances that needed to be addressed. In particular, the rapid rise in private sector credit and the widening of the external current account deficit were becoming serious concerns. Moreover, tight labor markets had contributed to labor cost increases well above the euro area average and there was a persistent inflation differential vis-à-vis the euro area.

Directors noted that these developments were, in part, indicative of the relatively advanced cyclical position of the Portuguese economy, and, against this background, Directors discussed the policy options facing the authorities in dealing with these macroeconomic imbalances. They noted that the euro area monetary policy was accommodative, given the cyclical position of the

Portuguese economy, and therefore the burden of adjustment fell on fiscal policy and supply side enhancing measures.

Directors agreed that further fiscal consolidation was necessary to slow aggregate demand. They considered that a sizable improvement in the structural fiscal balance over the coming years would be both timely and desirable. In this connection, Directors expressed concem about the slippage from the deficit target in 2000 (net of receipts from the sale of universal mobile telephone licenses), which was related in part to a lowering of petroleum taxes. Some Directors stressed that expenditure control should be tightened, with a view to limiting the size of the slippage.

Directors noted that the draft 2001 budget included a welcome deceleration in the growth of current primary expenditure. Nevertheless, several Directors pointed out that expenditures were still budgeted to rise in relation to GDP, compared to the expected outcome for 2000. As a result, fiscal consolidation continued to rely heavily on fairly optimistic revenue projections at the time of slowing domestic demand. Expenditure restraint, therefore, was seen as a key priority. Directors also viewed the recently launched initiatives to improve the equity and efficiency of personal and corporate income taxes as a step in the right direction. Generally, Directors felt that concerns about macroeconomic imbalances would have called for a more ambitious target in the year 2001.

Turning to the medium term, Directors saw the authorities' objective of budget balance over the cycle as appropriate. Most Directors thought, however, that the pace of fiscal adjustment should be accelerated. Achieving budget balance would leave sufficient room—and a useful role—for the full play of automatic stabilizers. Moreover, it would result in a sizable decline in the public debt-to-GDP ratio, an important result given the need to deal with the pending fiscal implications of an aging population.

Turning to public expenditure, Directors acknowledged the authorities' commitment to curtail the growth of public spending, particularly the wage bill, but called for a more determined effort to reduce expenditure over the medium-term. They observed that Portugal's Stability Program, as well as budget plans for 2001, were less ambitious in this area than in most other euro area countries. The desire to maintain a competitive tax environment underscored the necessity for additional cuts in primary current outlays. Directors endorsed the authorities' intention to introduce a medium-term budgetary framework, and "budgeting by objectives," which they viewed as a useful tool for guiding reforms in key areas of public expenditure, including the wage bill and health care.

In the financial sector, Directors viewed the high levels of private bank debt and continued strong expansion of credit as posing important challenges for financial sector supervision and regulation. They welcomed recent steps taken to curtail credit expansion and to strengthen the safety margins of the financial system. To better align capital and provisioning requirements with risk, Directors endorsed the implementation of stress testing and scenario analysis, as proposed by the Basle Committee on Banking Supervision. Directors welcomed the planned strengthening of insurance supervision, and noted that the proposed council of supervisors should improve supervisory coordination, particularly for financial conglomerates. Some Directors suggested that Portugal should participate in the Financial Sector Assessment Program (FSAP).

Directors noted that the central economic challenge facing Portugal over the medium-term was to secure higher productivity growth, accelerating real income convergence with the rest of the euro area. Directors welcomed the progress made in the area of structural reforms, particularly in reforming product markets and privatizing major state enterprises. Measures to enhance competition, such as the creation of a fully independent antitrust authority, would be welcome steps. Looking ahead, the authorities were urged to continue with plans regarding public sector reform, as envisaged in the Stability Program, as well as undertake reforms in the areas of health care and pensions. These reforms were desirable from the standpoint of strengthening the fiscal position as well as improving the competitiveness of the economy. Directors viewed Portugal's low levels of educational attainment as a major obstacle to the more skill- and technology-intensive growth envisaged at the European Union Summit in Lisbon, and they noted the need for improving the efficiency of spending on education and training.

Directors commended Portugal's development assistance to poorer countries, and called on the authorities to raise ODA to the UN target. They encouraged Portugal to support full European Union trade liberalization of imports from the least developed countries.

Directors expressed concern that macroeconomic surveillance and policy making were hampered by statistical weakness, notably for real sector statistics. These shortcomings needed to be addressed quickly.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. As part of a pilot project, the staff report for the 2000 Article IV consultation with Portugal is also available.

Portugal: Selected Economic Indicators

	1997	1998	1999	2000 1/	2001 1/
Real economy (change in percent)					
Real GDP	3.7	4.2	3.0	3.3	3.2
Domestic demand	4.9	6.6	4.8	3.4	3.2
CPI (year average, harmonized index)	1.9	2.2	2.2	2.7	2.9
Unemployment rate (in percent)	6.7	5.0	4.4	4.1	4.0
Gross national saving (percent of GDP)	22.0	21.4	20.0	18.2	17.9
Gross domestic investment (percent of GDP)	25.2	26.2	26.6	27.3	28.1
Public finance (percent of GDP)					
Central government balance 2/	-3.3	-2.6	-2.6	-2.3	-2.2
General government balance 2/	-2.5	-2.1	-2.0	-1.5	-1.1
Public debt	59.4	55.2	55.1	55.1	52.4
Money and credit (end-period, percent change)					
Total domestic credit 3/	11.6	16.8	19.9	25.4	...
National contribution to euro area M3 3/	6.3	6.8	9.8	9.9	...
Interest rate (period average)					
Deposit rate, 91–180 days 4/	4.9	3.9	2.8	3.2	...
Ten-year government bond yield 4/	6.4	4.9	4.8	5.6	...
Balance of payments (percent of GDP)					
Trade balance	-9.5	-11.0	-12.5	-14.5	-15.5
Current account 5/	-3.2	-4.8	-6.6	-9.0	-10.2
Net official reserves (in US$ billions, end of period) 6/	20.3	21.6	14.1	13.9	...
Exchange rate regime		Euro area member			
Present rate (November 2, 2000)		US$ .86 per euro			
Nominal effective rate (1995 = 100) 7/	98.1	97.0	95.7	93.3	...
Real effective rate (1995 = 100) 7/	99.1	99.3	98.8	97.1	...

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

1/ Staff projections unless otherwise noted.
2/ Data for 2000 includes receipts of 0.4 percent of GDP from the sale of licenses for universal mobile telephone service. Figures for 2001 reflect *Stability Program* deficit target.
3/ Data for 2000 refer to year-on-year growth rates through August.
4/ Data for 2000 correspond to average for January-September.
5/ Includes capital transfers.
6/ Data for 2000 correspond to June.
7/Data for 2000 correspond to July.