October 2005
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Portugal: 2005 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Portugal

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with Portugal, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 11, 2005, 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 20, 2005. 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 statement of October 14, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its October 14, 2005 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Portugal.

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

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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PORTUGAL

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for the 2005 Consultation with Portugal

Approved by Alessandro Leipold and G. Russell Kincaid

September 20, 2005

- Messrs. Gerson (head), Drummond, and Xiao (all EUR), and Giustiniani (MFD) visited Lisbon and Porto June 29–July 11. They met with the Ministers of Finance, Economy, and Health; the Governor of the Bank of Portugal; and other representatives of regulatory agencies, local governments, financial entities, and labor and business organizations. Mr. Saramago (OED) attended most meetings.

- A new government took office in February 2005. Parliamentary elections are due by 2009.

- Portugal has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions, except for those maintained solely for the preservation of national or international security, and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51); see Appendix 1.

- In concluding the last Article IV consultation, Directors stressed the need for further progress in addressing fiscal vulnerabilities, and for action on structural measures to increase productivity and improve competitiveness. (http://www.imf.org/external/np/sec/pn/2004/pn0424.htm)

- The authorities intend to publish this report.

- Data provision to the Fund is adequate for surveillance purposes.

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Executive Summary

Recent developments and prospects

Portugal confronts a difficult economic environment. Domestic demand is weak, external competitiveness has been eroded, and the fiscal deficit needs to be reduced substantially over the next four years. High levels of private indebtedness also cast a shadow over medium-term prospects. Growth is unlikely to exceed ½–¾ percent this year and 1¼–1½ percent in 2006. The authorities saw scope for a more robust medium-term recovery than did the staff, though it was agreed that recovery would be gradual.

Key policy requirements

There was broad agreement between the authorities and the staff on the need for deficit reduction based on credible expenditure control measures, and for structural reforms to unlock Portugal's growth potential.

Securing fiscal consolidation. The authorities plan to reduce the fiscal deficit from a baseline of about 6½ percent of GDP this year (before recent measures) to 3 percent by 2008. Medium-term adjustment would be based on three main pillars: (i) pension reform, including a convergence of the rules governing public sector pensions to those prevailing for private sector workers, which are less generous; (ii) further reforms to the pension system for private sector workers; and (iii) reforms to modify the career path for civil servants and to enhance public sector efficiency. Key elements of the strategy remain to be defined, however, and the staff stressed the need to resolve these uncertainties as soon as possible. Staff saw the overall pace of deficit reduction as being appropriate but argued for greater expenditure containment measures this year. The authorities' medium-term growth projections appear optimistic, and the staff therefore noted that additional measures may be needed to achieve the deficit targets in later years.

Strengthening competitiveness. Initiatives in this area include steps to improve general education and vocational training; encourage research and development; strengthen competition in product markets; and reduce red-tape and bureaucratic impediments to doing business. Staff and the authorities disagreed on the priority to be accorded further labor market reform, with the authorities arguing that in practice, labor markets were more flexible than standardized measures would suggest.

Safeguarding the financial sector. Available indicators suggest that the financial sector has been resilient during the slowdown. However, high indebtedness and risk concentrations, especially to the real estate sector, are potential vulnerabilities. A more in-depth financial sector review is expected under the Financial Sector Assessment Program (FSAP), to be initiated in 2005.

I. Overview and Key Issues

1. **Portugal has yet to emerge from the slump that followed the bursting of the euro-adoption bubble** (Box 1). The euro-related drop in interest rates led to substantial increases in consumption and investment, fueled by bank credit. A rise in primary fiscal spending further fanned the flames of the expansion, and the current account deficit ballooned, reaching 10 percent of GDP in 2000–01. Domestic demand growth slowed in 2001 and turned negative in 2002–03, as firms and households sought to work off the imbalances of the boom years. The resulting sharp increase in the fiscal deficit led to a violation of the SGP ceiling in 2001 that precluded a subsequent countercyclical fiscal policy response. Cyclical difficulties have been compounded by worrying medium-term developments, as productivity and competitiveness—whose weakness was masked by the boom—have continued to slide. Per capita GDP relative to the euro-area average stands barely above its level a decade earlier.

2. **The policy strategy to respond to the slowdown did not resolve underlying macroeconomic imbalances** (Box 2). Substantial one-off fiscal measures were to bring the deficit within SGP limits while buying time for longer-term reforms to pay dividends. However, the measures adopted—chiefly, an increase in the VAT rate and a freeze in public sector wage increases—did not address in a sustainable manner the source of fiscal problems: the 6 percent of GDP rise in current spending, especially social transfers and wages, over the last 10 years. In addition, progress in the structural reform agenda has been slow. As a result, Portugal confronts a difficult environment, with sizable fiscal and external imbalances; a weak competitive position, especially within an enlarged EU; and high private indebtedness that clouds macroeconomic prospects.

3. **Early elections in February 2005 led to the formation of the first single-party majority government in a decade**. The government's reform proposals have engendered strong opposition from some affected parties, however (particularly civil servants), and local elections in October will provide a test of its support. Shortly after the conclusion of the Article IV mission, Finance Minister Campos e Cunha resigned, and was replaced by Fernando Teixeira dos Santos.

II. Economic Developments And Outlook

4. **A gradual domestic-demand driven recovery started last year, but was reversed during the second half of 2004 amid ongoing concerns about competitiveness**.

- **Real GDP** rose 1.2 percent last year, but contracted in Q3 and Q4 on a quarterly basis. Preliminary data show year-on-year GDP growth of 0.3 percent in the first half of 2005.

Box 1. What Accounts for the Boom and Bust?

To some extent, the adjustment witnessed in Portugal can be interpreted as an equilibrium phenomenon: a falling risk premium leads to an increase in investment and wealth, an immediate jump in consumption, and a corresponding decline in savings. The ensuing demand boom is met by higher imports and, because of rigidities and lags in the domestic economy, a widening of the current account deficit. Self-correcting forces would drive the subsequent adjustment, with domestic demand slowing and domestic supply expanding as new investments come on-line.

However, other mechanisms were also at play that aggravated the boom and bust pattern. Specifically, fiscal policy was mostly pro-cyclical in Portugal during the upswing and relative unit labor cost growth was above the euro area average. Fagan and Gaspar (2005) [1] point to other factors that could be at work, including indivisibilities in investment and consumer durables that can make the initial burst in demand especially front-loaded, and rigidities in labor and product markets that can hinder the necessary adjustments of the real exchange rate and of real wages needed later in the transition process, making the "slow down" phase of the transition longer and more painful than otherwise.

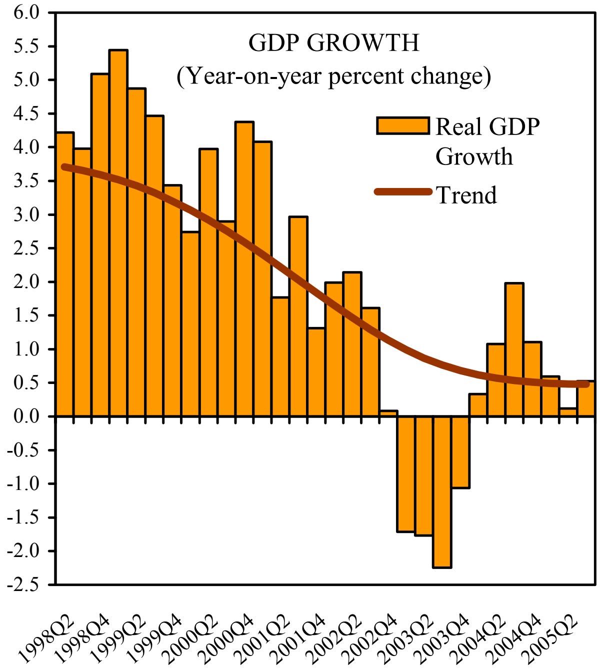
In drawing lessons for new member states, Fagan and Gaspar (2005) and Constâncio (2005)[2] point to the need to ensure that fiscal policy follows a counter-cyclical path during the upswing. While multipliers in a small open economy like Portugal are too small to fully smooth the cyclical path, fiscal policy should (as, for example, in Spain) at least avoid exacerbating upswings and downswings. Both studies also highlight the need for strong banking system oversight, to ensure that rising private indebtedness does not lead to financial sector weakness, and for sensible wage policies.

1/ Fagan, Gabriel and Vítor Gaspar, 2005, "Adjusting to the Euro Area: Some Issues Inspired by the Portuguese Experience," paper presented at a Conference organized by the ECB on "What effects is EMU having on the euro area and its member countries?" in Frankfurt am Main on June 16–17, 2005.

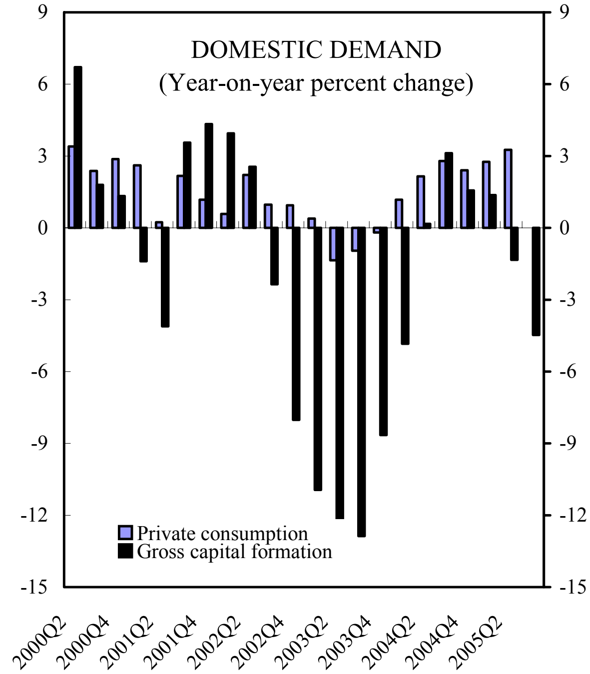
2/ Constâncio, Vítor, 2005, "European Monetary Integration and the Portuguese Case," in Carsten Detken, Vítor Gaspar and Gilles Noblet (eds.), *The New EU Member States: Convergence and Stability*, Third ECB Central Banking Conference, October 21–22, 2004, Frankfurt, European Central Bank.

Figure 1. Portugal: Output, 1998-2005

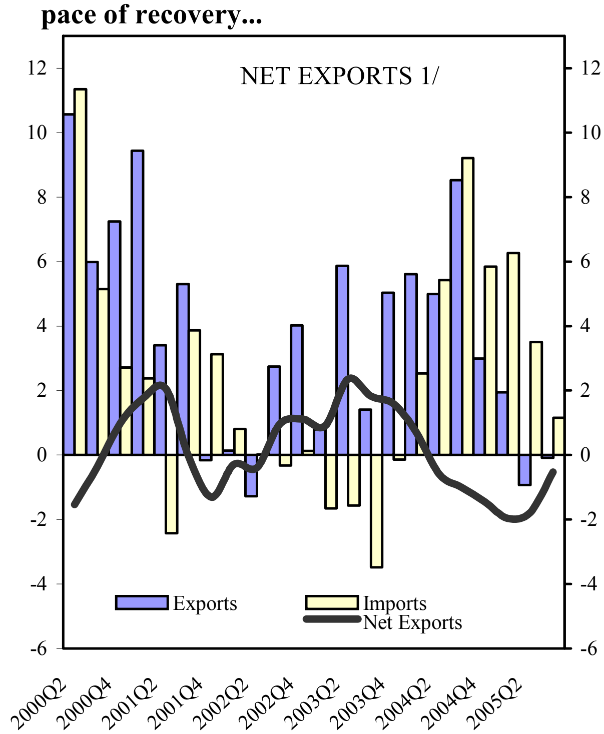
Growth turned positive in 2004...



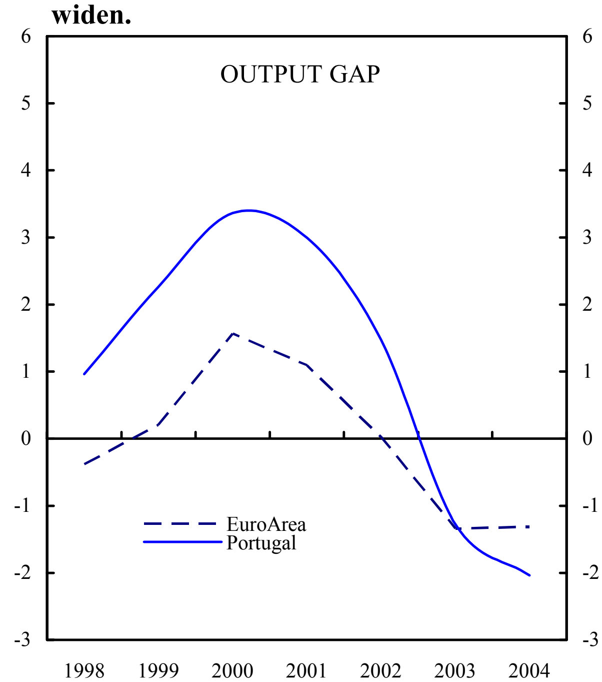
...thanks to recovering consumption and investment.



But a weak external sector has sapped the pace of recovery...



... and the output gap has continued to widen.



Source: Bank of Portugal; National Institute of Statistics (INE); and Fund staff calculations
1/ Exports and imports represented as year-on-year percent change and net export as contribution to growth.

Box 2. Fund Policy Recommendations and Implementation

Fiscal policy. The Fund has called for fiscal consolidation through structural expenditure measures, including civil service reform. While the fiscal deficit was held below 3 percent of GDP in 2002–04, this was largely through one-off measures, and the underlying deficit remained large. The Fund has also called for strengthening budget planning and control and moving toward comprehensive multi-year budget targets. Implementation has been delayed, but the authorities plan to make progress in this area (¶16).

Population aging. The Fund has emphasized the need to proceed with further reforms of aging-related spending with a view to securing fiscal solvency. Recent reforms to health care and pensions have not prevented a steady build-up of aging-related spending.

Structural policy. The Fund has called for steps to improve general education and vocational training, and to encourage R&D. It has also stressed the need to strengthen competition and flexibility in labor markets. A fully-independent competition authority was established, but red-tape and bureaucratic impediments continue to hamper investment. Reforms have improved labor market flexibility, though there is room for progress (¶23 and ¶36).

Financial sector. The Fund has supported continued supervisory vigilance in light of historically high private indebtedness and risk concentrations. The Fund has suggested a review under the Financial Sector Assessment Program (FSAP), expected to be initiated in 2005.

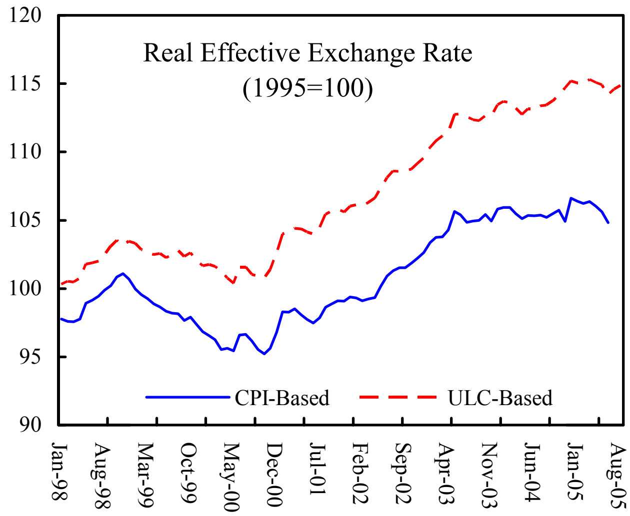
- **Private consumption** has proven resilient, reflecting low interest rates and lengthening tenors on bank lending, while **investment** and export growth remained weak.

- A variety of indicators point to continued erosion of **Portugal's competitive position**: the ULC- and CPI-based REER have appreciated steadily, the former owing both to wage growth and stagnant productivity; export shares have fallen; FDI has contracted; and employment has shifted from tradables to nontradables production. In these circumstances, the current account deficit (excluding capital transfers) widened to 7.2 percent of GDP last year.

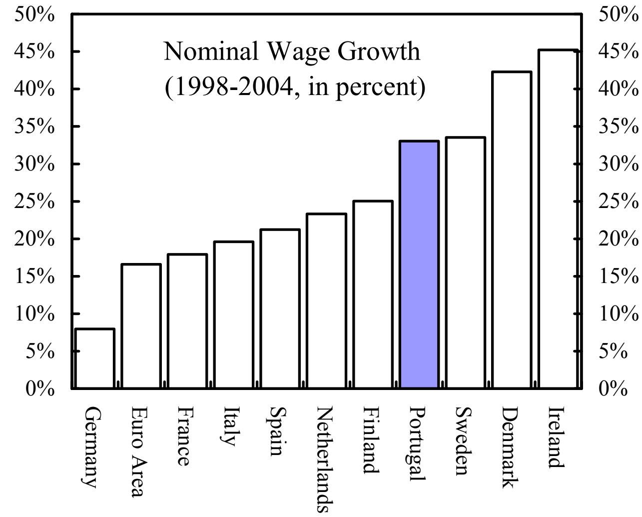
- The **unemployment** rate reached a seven-year high of 7.5 percent in 2005:Q1, falling to 7.2 percent in 2005:Q2. Due to the widening output gap—estimated by staff at

Figure 2. Portugal: Competitiveness Indicators

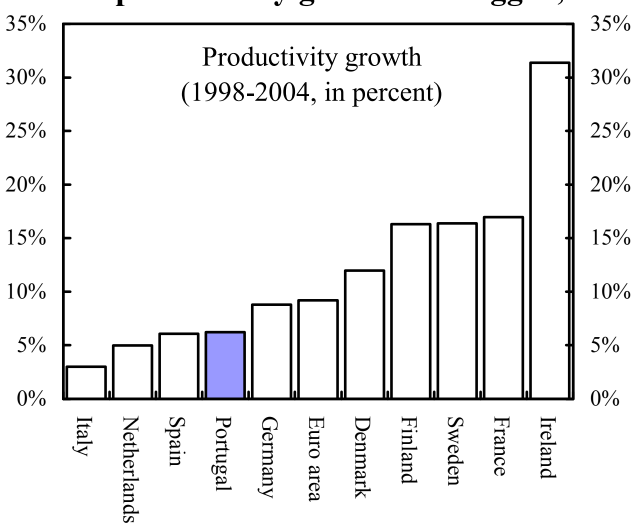
The REER continued to appreciate.



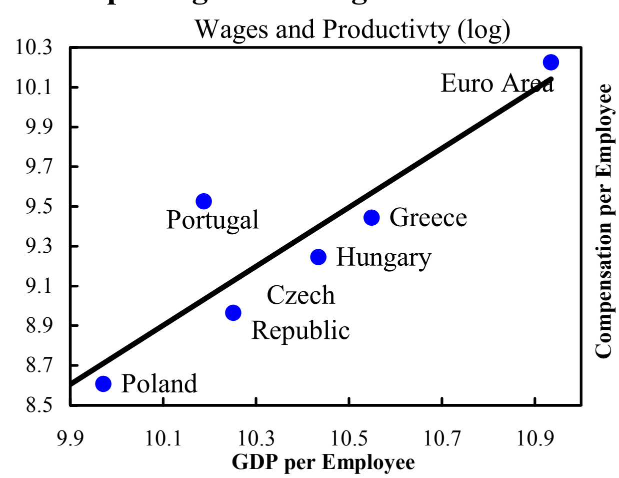
Wages grew rapidly,



while productivity growth has lagged,

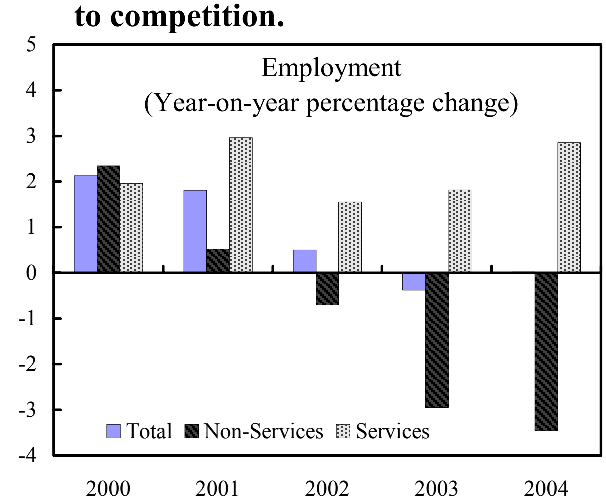


pricing out Portuguese workers.



As a result, export market share declined,

as did employment in sectors more open to competition.



Source: AMECO database; National Institute of Statistics (INE); Eurostat; and Fund staff calculations.

about 2 percent of GDP—**inflation** moderated to just over 2 percent in the first half of 2005.

5. **Short-term growth prospects were viewed as poor**. Weak domestic demand and continuing problems in the external sector meant that growth was unlikely to exceed ½–¾ percent this year and 1¼–1½ percent in 2006. Private consumption growth looked set to slow as households worked off high indebtedness in the period ahead: at end-2004, household debt stood at 118 percent of disposable income, about double its level of seven years ago and well above the EU average (80 percent). Fiscal adjustment measures were also likely to weigh on domestic demand growth. In addition, poor external competitiveness, concerns about the domestic economy, and a desire by firms to continue strengthening their balance sheets—indebtedness of the private nonfinancial corporate sector had largely stabilized as a percentage of GDP since 2001—would constrain investment growth. Meanwhile, the external sector would continue to contribute negatively to activity, with export growth remaining sluggish in the near term, given the extent of recent competitiveness losses.

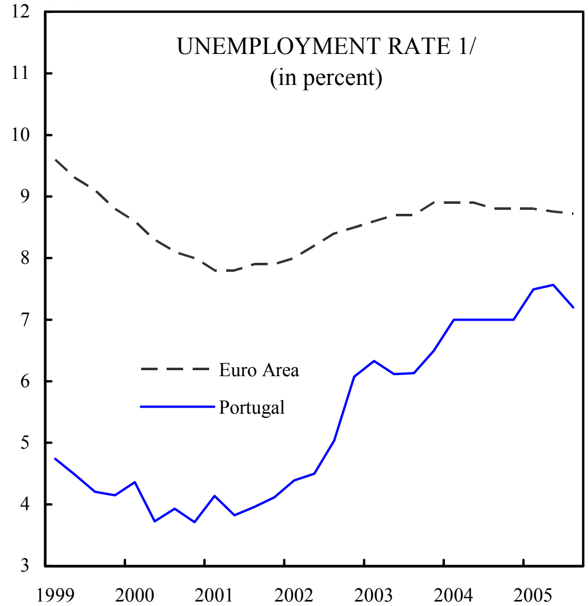
6. **Inflation in 2005–06 was expected to remain moderate**. Despite an increase in the VAT rate that had come into effect on July 1—expected to increase inflation by about ¼ percentage point this year and slightly more in 2006—inflation was projected at about 2½ percent over the coming year and half, held down both by the large output gap and by the increased penetration of imports.

7. **The external deficit was expected to widen this year**. Excluding capital transfers, staff projected the deficit would reach just over 8 percent of GDP in 2005, reflecting lower real export growth, a terms-of-trade loss from oil prices, and still-high imports. The deficit would continue to be financed by medium- and long-term bank borrowing.

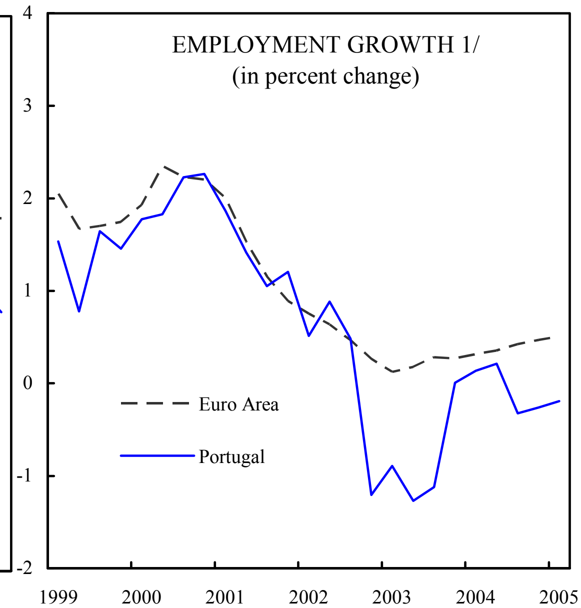
8. **Staff and the authorities differed on the medium-term outlook**. The authorities saw output growth accelerating relatively rapidly over the medium term, rising to 2½ percent by 2008, a full percentage point above estimated potential, and 3 percent by 2009. Staff took a more cautious line, forecasting growth at around 2 percent in 2008–09, noting that—as shown by experience elsewhere—reducing indebtedness and resolving competitiveness problems could be a lengthy process, and that fiscal adjustment would weigh on growth (see ¶14). Moderate investment growth and budget consolidation should lead to a narrowing of the current account deficit over the medium-term. Staff projections indicate, however, that these developments alone would be insufficient to stabilize the external debt to GDP ratio over next few years (Table 4). In addition to successful implementation of the deficit reduction program, therefore, some increase in private savings—which both the staff and the authorities anticipated—and an improvement in competitiveness will be necessary to prevent substantial rises in external indebtedness. Fiscal adjustment and productivity-enhancing structural reforms are therefore critical to ensuring long-term fiscal and external sustainability.

Figure 3. Portugal: Labor Market Conditions, 1999-2005

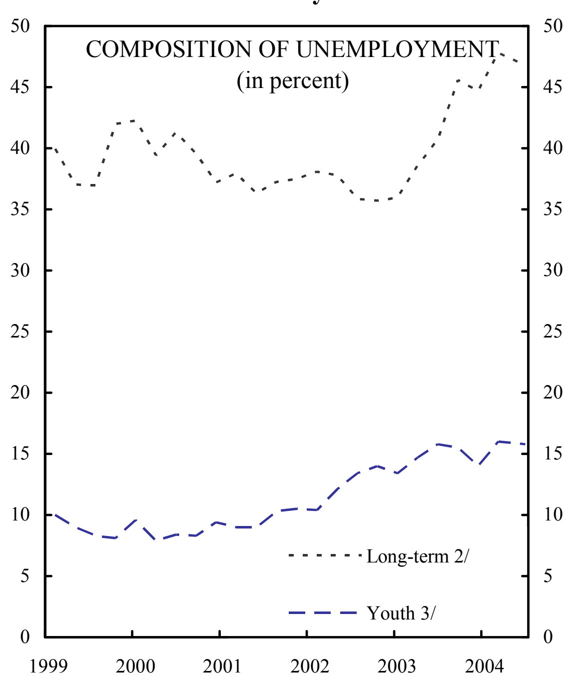
The unemployment rate stands at a record level...



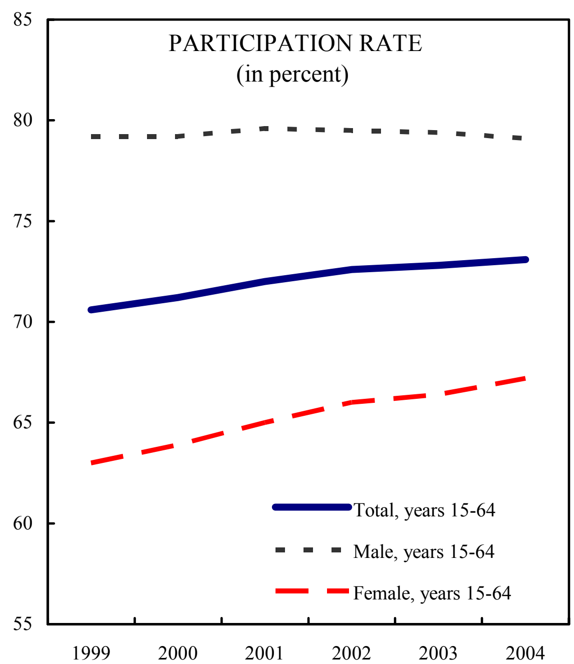
...while employment has fallen.



About half of the unemployed have been out of work for more than a year.



Rising female participation has led to some increase in the already high overall rate.

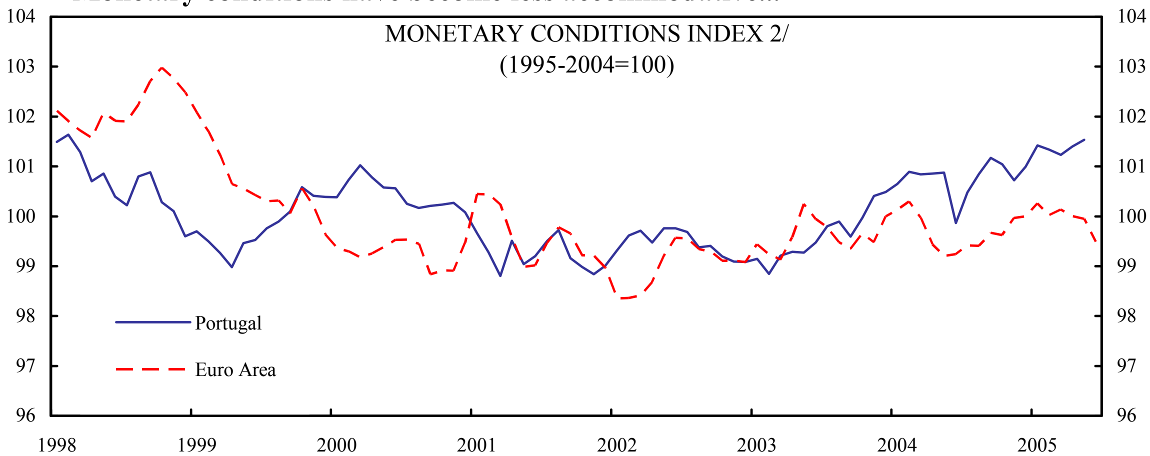


Source: Bank of Portugal; National Statistics Office (INE); and Eurostat.

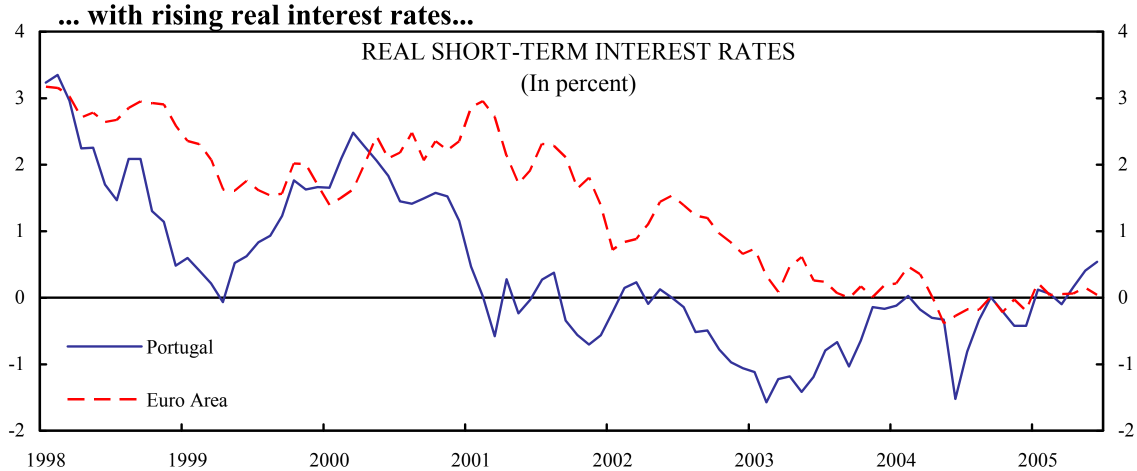
1/ Data through second quarter of 2005.
2/ Proportion of total unemployed who have been unemployed for a year or more.
3/ Proportion of those 15-24 years of age who are unemployed.

Figure 4. Portugal: Monetary Conditions, Real Interest Rates, and Inflation 1998-2005 1/

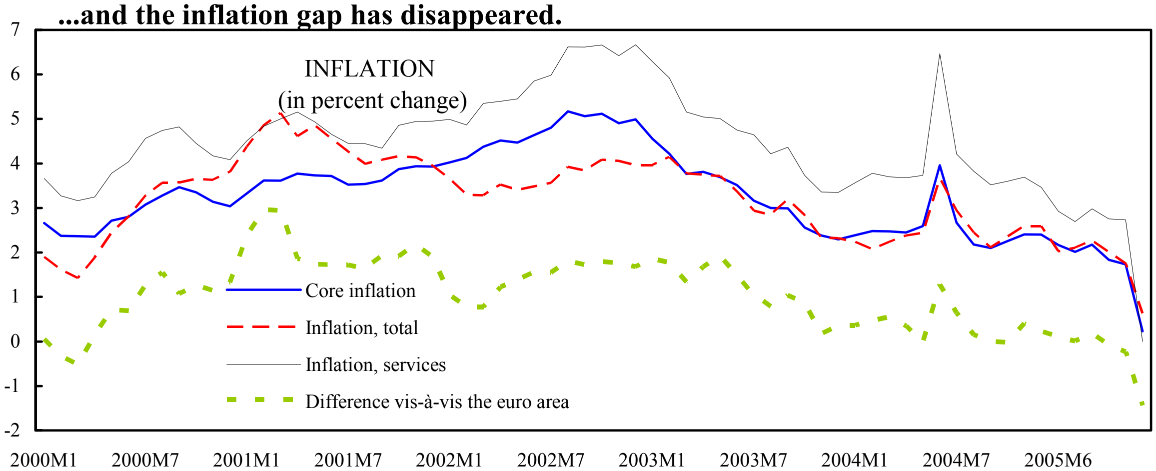
Monetary conditions have become less accommodative...



... with rising real interest rates...



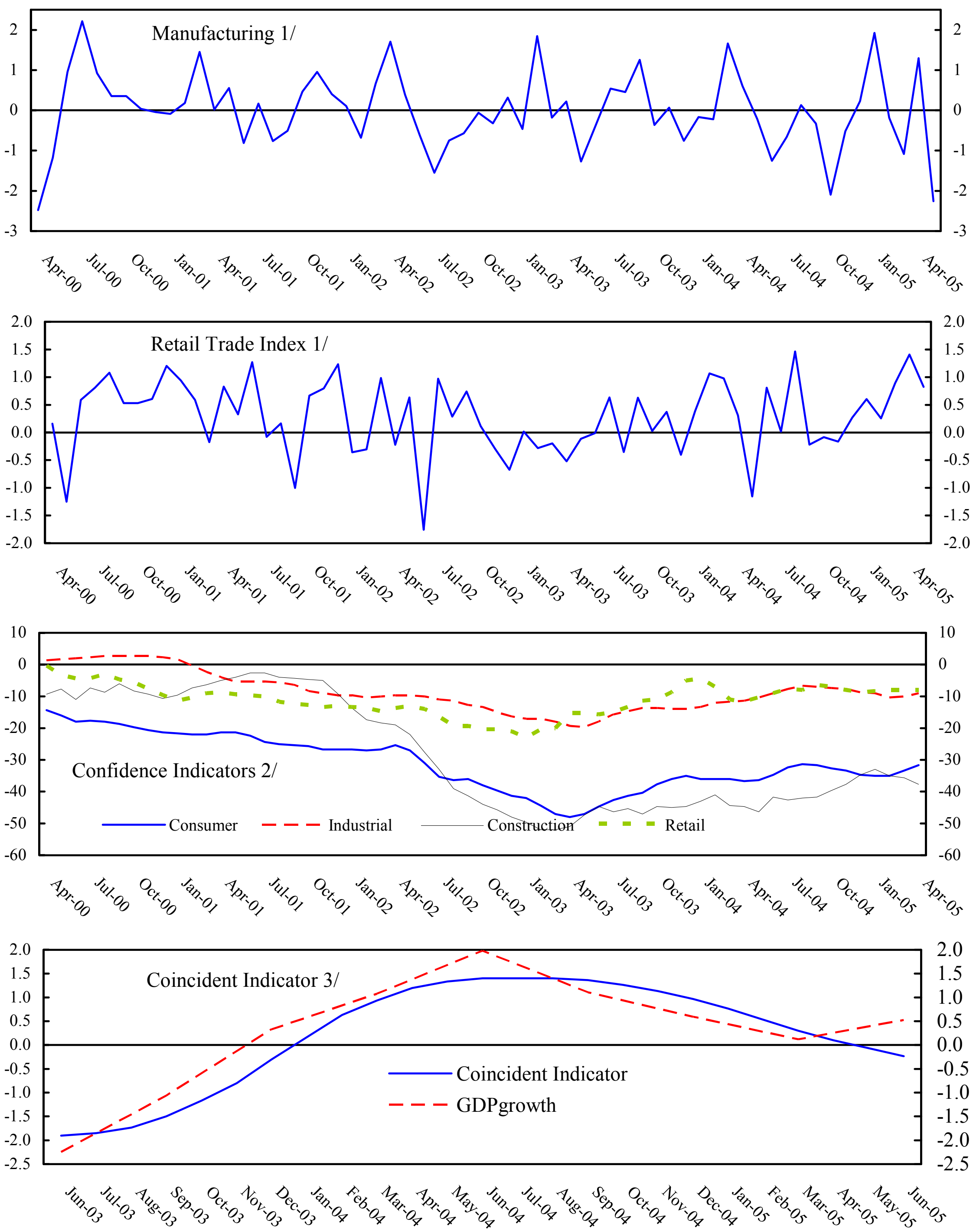
...and the inflation gap has disappeared.



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

1/ 2005 data through June, unless otherwise noted.
2/ The index is the weighted average of real short-term interest rates and real exchange rates (based on unit labor costs); data through May.

Figure 5. Portugal: High Frequency Indicators



Source : INE, Bank of Portugal, IMF staff calculations, end of period.

1/ Seasonally-adjusted data, 3-month moving average on month-to-month growth, end of period.

2/ 3-month moving average, end of period.

3/ Year-on year growth rate (3-month moving average, seasonally adjusted). The coincident indicator is a composite indicator for economic activity published by the Bank of Portugal. It combines indicators of retail sales, heavy commercial vehicle sales, cement sales, manufacturing production, household's financial situation, new job vacancies, and a consumer survey of Portugal's main trade partners.

III. Report on the Discussions

9. **Discussions focused on measures to ensure the sustainability of the fiscal accounts and improve competitiveness**. There was broad agreement on the need for deficit reduction based on credible expenditure control measures, and for structural reforms to unlock Portugal's growth potential.

A. Fiscal Policy

10. **A mid-year audit commissioned by the new government projected a 2005 fiscal deficit of about 6½ percent of GDP, absent new measures**. The significant increase in the forecast—the budget had called for a deficit of 2.8 percent—resulted in part from slower-than-budgeted growth and from the exclusion of all one-off measures (which equaled nearly 1½ percent of GDP in the budget). However, the increase also reflected more realistic estimates for certain expenditures (including health care, pensions and personnel) and non-tax revenues than in the original budget, implying an increase in the structural deficit (net of one-offs) of about 1¾ percent of GDP relative to the original budget and about 1¼ percent of GDP relative to the 2004 outturn.

11. **In response, the authorities had announced a series of measures, mostly on the revenue side, that are intended to reduce the deficit to 6.0 percent of GDP this year**. In July, the authorities increased the top VAT rate by 2 percentage points (to 21 percent), which was expected to increase revenues by about 0.3 percent of GDP this year. Measures to reduce tax evasion were also forecast to yield revenues of about 0.3 percent of GDP this year. The authorities have also announced plans to introduce a new income tax bracket on annual incomes exceeding €60,000 (bringing the top marginal rate to 42 percent) and increase fuel and tobacco taxes, all with effect from 2006.

12. **The authorities and staff agreed that these measures would not address the roots of Portugal's fiscal difficulties.** The authorities believed that previous consolidation efforts had failed because they had not targeted the underlying causes of fiscal weakness: persistent increases in spending on wages, pensions, and health care. Even when measures had focused on these spending items, they had generally been ineffective. The authorities pointed, for example, to recent public sector wage freezes, which had not prevented wage drift arising from the system of automatic promotions in force in the civil service and—because they did not apply to lower-paid workers—had contributed to increased compression of the wage scale. Similarly, past pension reforms have had limited impact on the budget because of generous grandfathering. Given the need for measures to ensure early progress in reducing the deficit and limiting the growth of the debt stock, and the fact that expenditure control measures would take time to yield benefits, the balance of adjustment measures in the short term would tilt toward the revenue side. However, these measures were not intended to substitute for more fundamental reforms on the spending side.

13. **Accordingly, measures to control the growth of spending—especially on pensions and wages—would over time take on increasing prominence in the consolidation effort**. The authorities' plan—which was endorsed by the Ecofin Council of the EU—seeks to reduce the deficit to 3 percent of GDP by 2008, without one-off measures. Based on the staff's growth projections, this would imply annual underlying adjustment of 1 percent of GDP in the next three years, somewhat front loaded in 2006 (text table). Medium-term adjustment would be based on three main pillars, though some key elements remained undefined:

(In percent of GDP)

	2004	2005	2006	2007	2008
	Est.	Proj.			
Overall balance 1/	-3.0	-6.0	-4.5	-3.8	-2.7
Structural balance 2/	-2.2	-4.8	-3.2	-2.5	-1.6
Net of all one-off measures 3/	-4.4	-5.0	-3.5	-2.7	-1.8
Memorandum items:					
GDP growth (in percent)	1.2	0.5	1.2	1.7	1.9
One-off measures 2/	2.2	0.2	0.3	0.2	0.2
Revenues (net of one-off measures)	41.3	41.3	42.2	42.4	42.6
Primary expenditures	43.8	44.5	43.6	43.0	42.1
Public Sector Debt	59.4	65.6	66.6	67.7	67.8

1/ Authorities' fiscal deficit targets.
2/ In percent of staff's estimate of potential GDP.
3/ Includes asset sales and the transfer of pension funds.

- A convergence of the rules governing public sector pensions to those for private sector workers, which are less generous. The system for public workers has been closed to new entrants, and the retirement age for public employees would be raised by six months annually over the next decade until it reached 65, the age for private workers. Pension benefits for civil servants hired before 1993, which had been exempted from a previous reform, would also be reduced.

- Further reforms to the pension system for private sector workers to reduce costs and ensure its long-run viability. A working group had been formed to evaluate options, and its report is to be issued before end-year.

- Reforms to enhance public sector efficiency and to modify the career path for civil servants. As a temporary measure, the authorities had frozen the system of automatic promotions, with the expectation that by end-2006 new rules would be in place that would streamline career paths, allow for greater flexibility in allocating staff, and link pay and promotions to performance. In addition, a policy of replacing only half of departing civil servants would gradually reduce the size of the workforce. The authorities were also planning to conduct ministry-level audits over the coming months that would identify measures to enhance efficiency and reduce costs.

14. **The staff saw the overall pace of adjustment as broadly appropriate, but argued for greater spending restraint in 2005 and noted that additional measures might be needed in later years**. Based on staff analytical work,[1] deficit reductions of 1 percent of GDP annually could reduce short-term growth by as much as ¾ percent. However, staff and the authorities agreed that a rapid pace of deficit reduction would still have lower output

[1] See the Selected Issues Paper.

costs than a more protracted adjustment, including through credibility effects (Box 3). Staff also concurred that the proposed adjustment path, and the front-loading of revenue measures, was a reasonable compromise between more rapid deficit reduction and the fact that pension and civil service reforms would take time to yield significant savings. The staff noted, however, that the structural deficit net of one-off measures would still increase by about ¾ percent of GDP this year, and that the authorities' revenue projections were based on a relatively optimistic growth forecast (0.8 percent) and assume significant returns from tax administration measures whose yield is difficult to predict. The mission therefore called for greater expenditure control efforts this year, to contain the deterioration in the deficit and/or provide a cushion against possible revenue shortfalls. From a medium-term perspective, the staff argued that the program's growth forecasts could prove optimistic, and that additional measures (of up to ¾ percent of GDP by 2008) could therefore be needed to achieve the deficit targets in later years.

15. **The authorities doubted there was scope for further expenditure containment in 2005, but were prepared to take additional measures as needed to achieve their deficit targets.** They believed that the expenditure ceilings in this year's revised budget were already quite tight, limiting the room for additional spending cuts. In any case, they thought the main risk to the 2005 outcome came neither from central government spending nor from lower revenues but from higher spending by regional and local governments, particularly in light of elections scheduled for later this year. Reforming the system of local government finances—which currently relieved local governments of the political burden associated with increasing taxes and thus contained a significant inducement to spend—was therefore a high priority, although changes would not be implemented this year. Staff noted that the introduction of binding expenditure limits on local governments could be a viable reform option. The authorities agreed with the mission that achieving the program's headline nominal deficit targets was critical to maximizing credibility, and they were therefore prepared to take additional measures should they prove necessary.

16. **The mission also underscored the need to move quickly to clarify the unspecified expenditure measures needed to achieve the 2006 deficit target to enhance the credibility of the adjustment effort.** About 0.9 percentage points of the targeted 1.5 percent of GDP in deficit reduction will come from revenue measures already implemented or announced, but spending cuts totaling about 0.6 percent of GDP are also called for in the program, including from the pension and public administration reforms currently under study. The authorities agreed that progress in these studies sufficient to ensure that the impact of the reforms was incorporated in the 2006 budget would be critical. They also agreed that anchoring the deficit targets in a multiyear budget framework would help

Box 3. Minimizing the Output Costs of Fiscal Adjustment

A number of studies have examined the link between the structure of fiscal adjustment and its short-term impact on growth (see WP/02/208 and the Selected Issues paper). These studies have found that so-called expansionary contractions have some common characteristics:

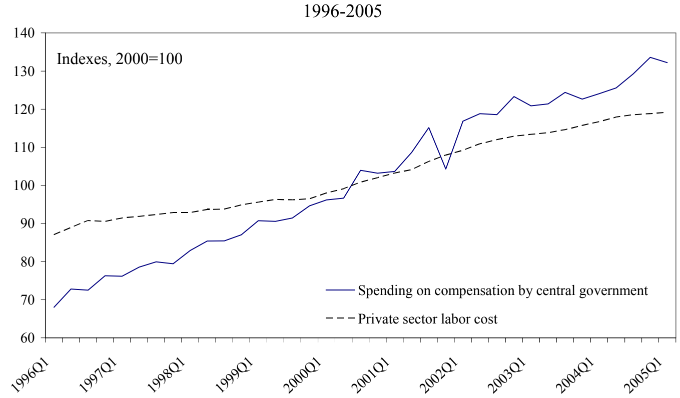
- **Initial conditions matter.** These include a large and persistent fiscal deficit, high public debt, and difficult economic circumstances.

- **The pace and balance of measures also matter.** Large and front-loaded contractions and expenditure-based adjustments are less damaging to growth than are backloaded, protracted, or revenue-based ones, as the former are more effective in altering agents' expectations.

- **Not all spending measures have the same impact.** Cuts in current spending are less damaging to growth than those to investment, in general. In particular, cuts in the public wage bill—through wage restraint or reductions in employment—can enhance external competitiveness by putting downward pressure on private sector wages.

What does this literature tell us about the likely output costs of Portugal's fiscal adjustment? First, Portugal shares some initial conditions with countries that have experienced expansionary contractions. However, Portugal's participation in monetary union means that two important channels, through which expansionary effects could apply—interest and exchange rates—are not operative. High levels of private indebtedness could also inhibit any expansionary effects of fiscal consolidation. On the other hand, the intended structure of the adjustment, with a focus on controlling expenditure, could help limit its output costs. In order to maximize any confidence effects, however, it is critical that the remaining elements of the adjustment package be clarified as rapidly as possible. Finally, the argument that plans to address the public sector wage bill could have a positive impact on competitiveness is supported by the strong correlation between public and private wages in Portugal.

Portugal: Government Compensation and Private Sector Labor Cost
1996-2005



Sources: Portuguese authorities, and Eurostat.

strengthen fiscal discipline. As a first move, they planned to introduce with the 2006 budget spending goals for the remainder of the legislature. To protect investment in public infrastructure, they were seeking ways to increase Public-Private Partnerships in some projects. The authorities were hesitant to prejudge the findings of the pension reform commission, but the staff noted there could be scope to further reduce options for early retirement and to limit the indexation of pension benefits.

17. **The authorities recognized that planned fiscal adjustments would be only the first stage of a longer process to ensure sustainability**. In particular, they agreed that over the medium term a position of near budget balance was needed to create a cushion to absorb the costs associated with population aging: staff simulations show that without additional deficit reduction beyond 2009, the public debt would rise sharply over the medium term (Box 4). An additional 3 percentage points of GDP of fiscal adjustment would therefore be needed after 2008. The authorities noted, however, that some of this adjustment could come from pension reforms to be undertaken as part of their current program, reducing the need for new measures.

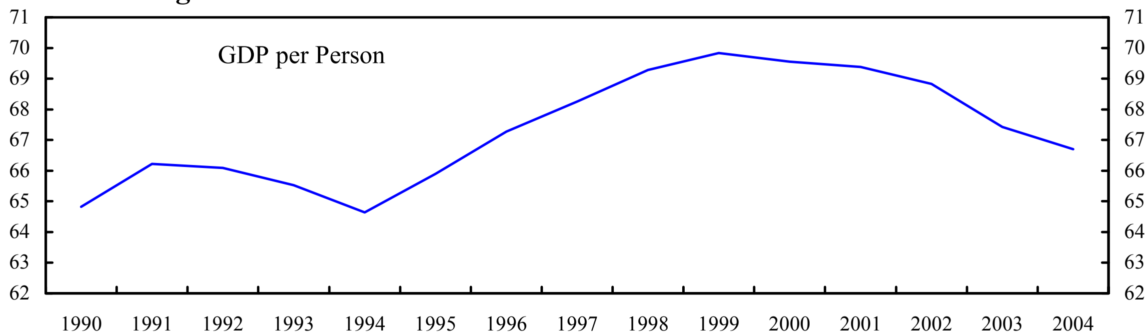
B. Enhancing Growth and Competitiveness

18. **The authorities and mission agreed that increasing labor productivity was key to resuming income convergence and improving competitiveness**. Labor utilization is relatively high, as the employment rate and hours per worker are above the euro-area average, but labor productivity has fallen to only 55 percent of that of the euro area over the last few years. Some of the decline in labor productivity growth could reflect sectoral shifts in the economy, a slowdown in capital deepening, or cyclical factors. Nonetheless, structural reforms to correct deficiencies in product markets and the business environment were recognized as being critical to restart the convergence process (Box 5).

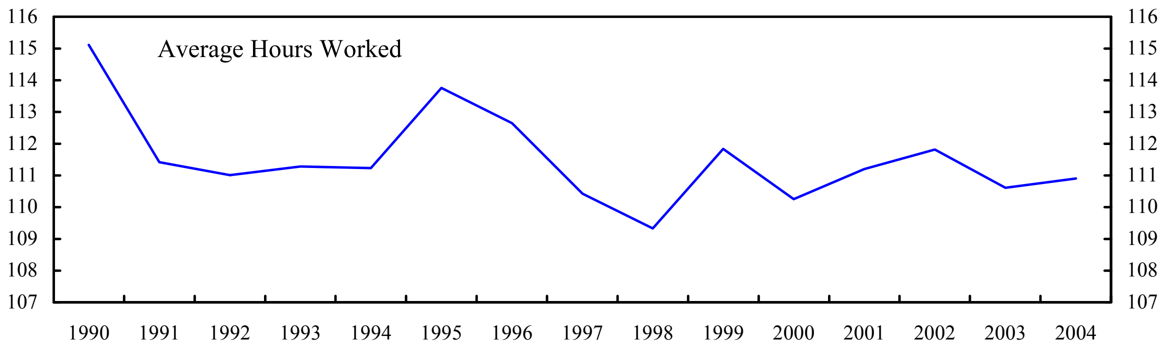
19. **The promotion of R&D and IT was the centerpiece of the authorities' program to boost growth, but the need for more fundamental reforms was recognized**. The authorities noted that spending on R&D and IT was well below European averages and believed that greater private investment in these areas could therefore stimulate growth. Staff saw more fundamental reforms to enhance human capital and the returns to innovation as a greater priority. Staff and the authorities agreed, however, that initiatives to promote technological development were in any case unlikely to yield the maximum benefits without measures to improve education, training, and the business environment.

Figure 6. Portugal: Growth Components, 1990-2004
(As percentage of the Euro Area)

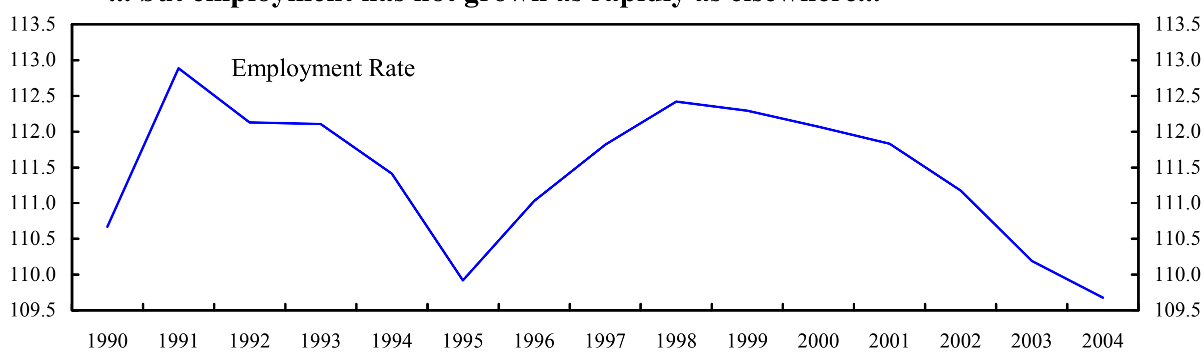
Convergence has come to a halt since 2000.



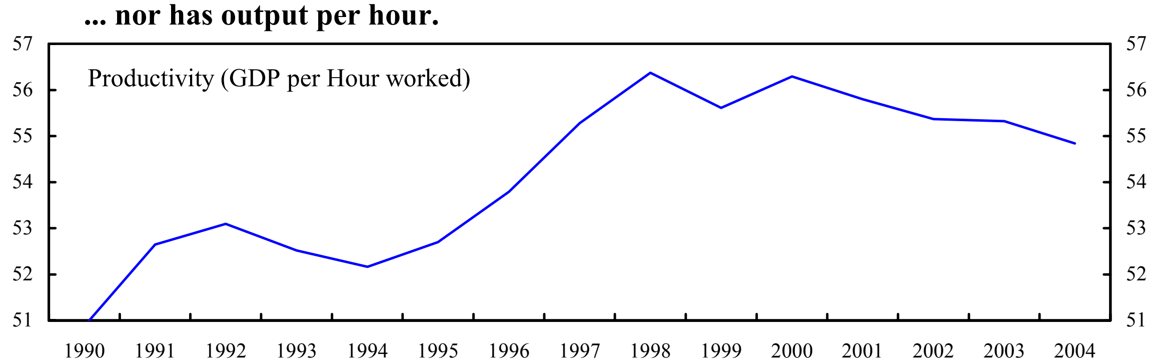
Hours per worker are high and steady...



... but employment has not grown as rapidly as elsewhere...

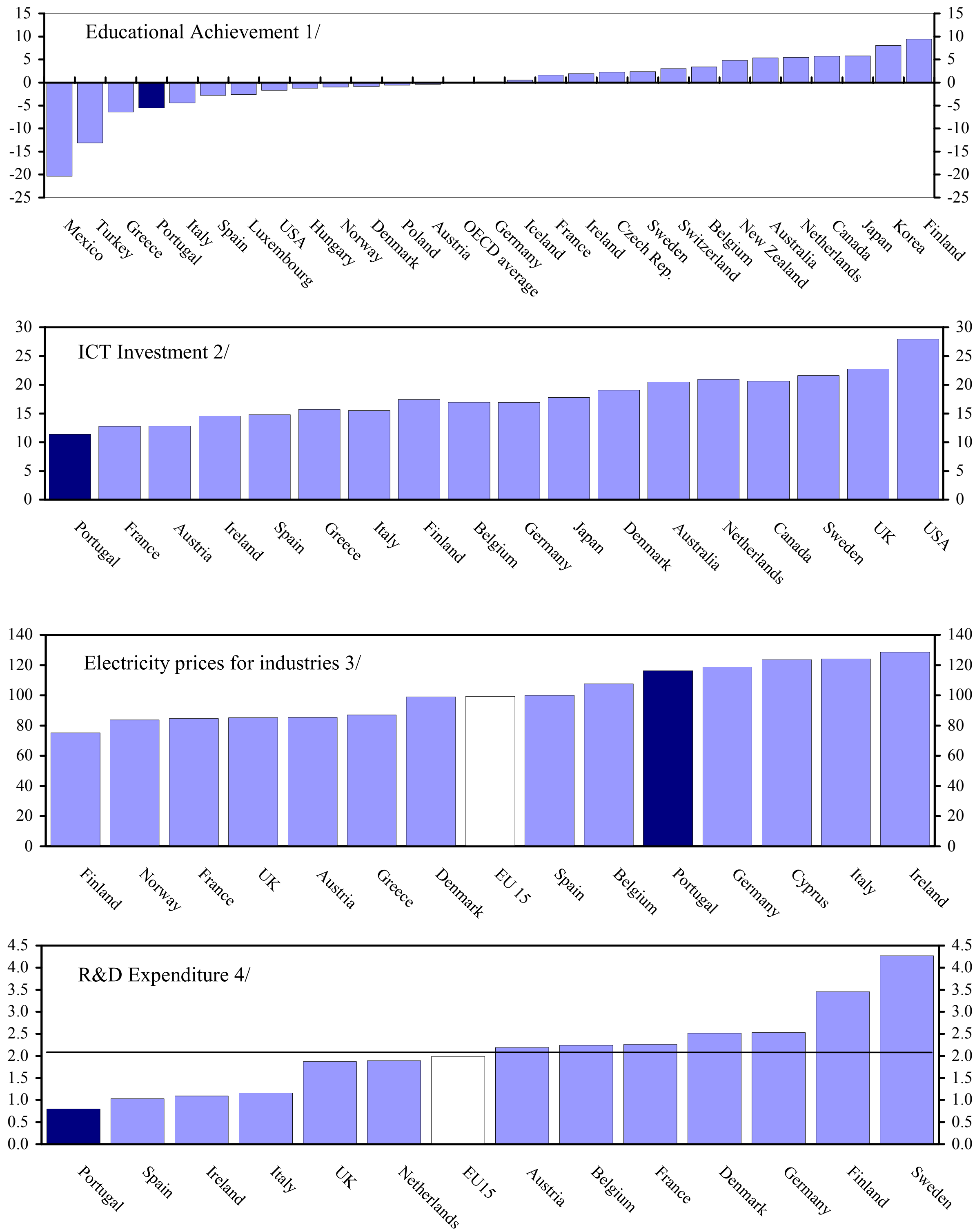


... nor has output per hour.



Source: Ameco

Figure 7. Portugal: Structural Indicators



Source: OECD, EUROSTAT; Fund staff calculations.

1/ Average of PISA scores in reading, mathematics and science, 2003.

2/ Percent of non-residential gross fixed capital formation, total economy, 2001.

3/ Index EU15=100, 2005 (1st half).

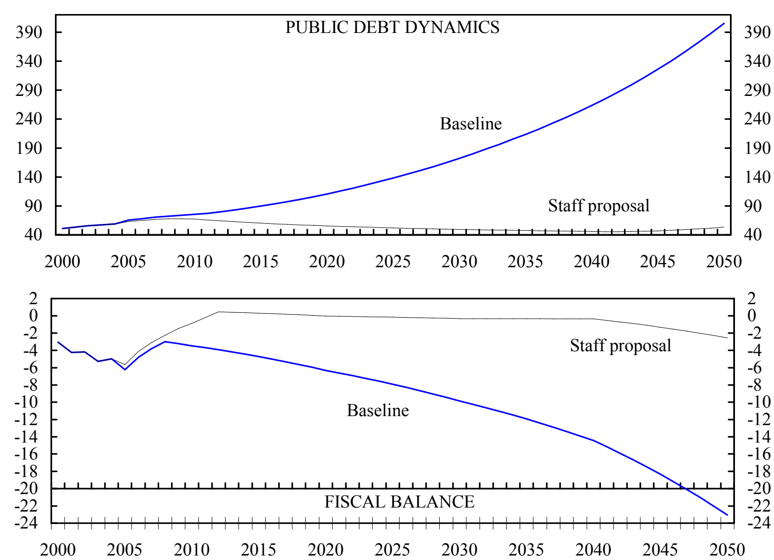
4/ In percentage of GDP, 2002, end of period.

Box 4. Fiscal Sustainability

By the staff's estimate, even if the authorities' current deficit-reduction targets are realized, reforms equivalent to an additional 3 percent of GDP in budgetary savings after 2008—enough to return the budget to structural balance before age-related spending begins to accelerate rapidly early in the next decade—will be required to ensure debt sustainability.

Under a baseline scenario in which the deficit is reduced to 3 percent of GDP by 2008, but with no subsequent fiscal adjustment, simulations show the debt ratio more than doubling to 140 percent of GDP over the next two decades and continuing to rise thereafter. In an alternative scenario where structural balance is achieved by 2012, following which non-age related spending is kept constant as a percentage of GDP, the debt ratio declines steadily over the next four decades before beginning to rise modestly near the end of the projection period. These scenarios do not, however, include the impact of any pension reforms to be introduced as part of the authorities' current adjustment program.

Portugal: Long-Term Aging-Related Fiscal Projections, 2000-50
(In percent of GDP)

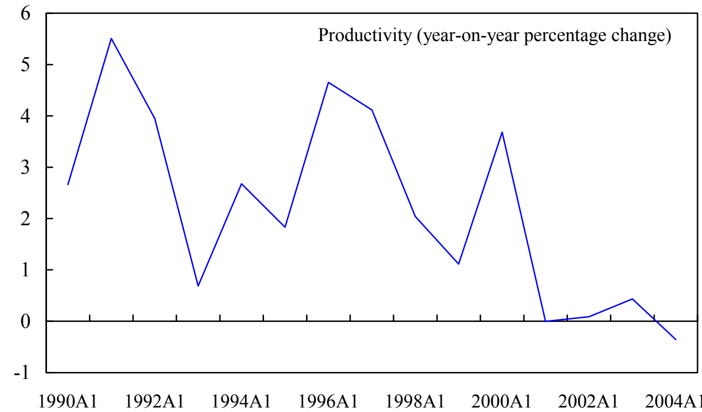


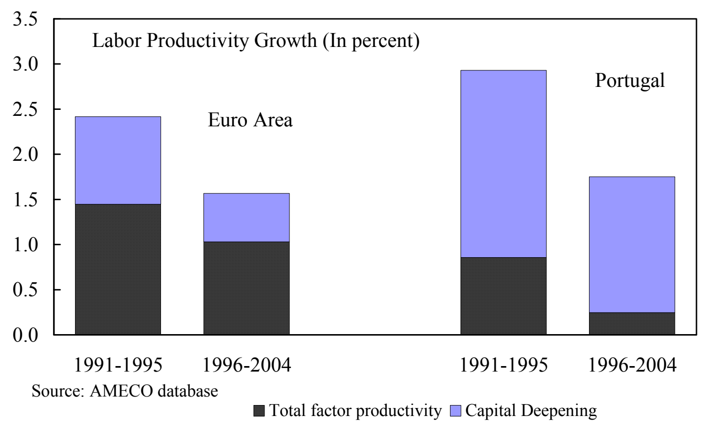
Sources: Portuguese authorities; and Fund staff calculations.

20. **The authorities concurred that there was clear scope to increase the efficiency of education spending.** Standardized test (OECD-PISA) results rank Portugal among the bottom six countries in the OECD in students' math, science and reading literacy, even though public spending per student is above the EU average. Recent reforms had introduced

Box 5. The Productivity Slowdown

Since the mid-1990s productivity growth—the annual increase in output per labor hour—has trended downward. Part of this decline reflects sectoral shifts in the economy: the weight of the services sector—where productivity growth has been relatively low—has increased in recent years at the expense of the manufacturing sector, where productivity growth has been more rapid. In addition, some of the decline in labor productivity growth during the second half of the 1990s can be traced to a slowdown in capital deepening. Nevertheless, TFP growth has also slowed, eventually turning negative since 2000. The very poor productivity performance of the last few years could reflect cyclical factors, but also possibly a decline in the efficiency of investment, particularly given the rising share that has been dedicated to real estate.





Source: AMECO database

new curricula, increased emphasis on technical training, and closed (and consolidated) very small schools. Reforms were also planned to increase teachers' classroom time and to reduce teacher rotation across schools. In addition, the authorities planned to increase incentives for worker training, which is low by OECD standards.

21. **A number of initiatives were also underway to enhance competition, as high costs in some key sectors were seen as a significant drain on the economy**. The new competition authority, created in March 2003, has begun operations, although its effectiveness was constrained by Portugal's slow legal system (see below). Introduction of the unified electricity market with Spain had been delayed, but the authorities remained committed to the project. Over time, this was expected to lead to a significant reduction in

electricity costs. Portugal was granted a derogation until 2007 to implement EU directives for liberalizing the natural gas market, but the government has pledged to complete the process before this deadline. Following the substantial privatization efforts over the last two decade, the authorities saw limited room for further progress in this area.

22. **Problems with Portugal's business environment were also seen as a major impediment to investment**. The World Bank's *Doing Business Indicators* point to a number of shortcomings, and the Bank's recent review of governance ranked Portugal in the bottom third of the EU in terms of both the market-friendliness of its regulatory environment and the efficiency of its public service. The authorities pointed to a number of measures that had been introduced to reduce bureaucratic impediments to investment, making it now possible to create a new firm in only one day. In addition, the costs of compliance with the corporate tax system had been reduced, including through enhanced use of the internet. Nevertheless, investors continue to report concerns about considerable delays in the granting of permits and licenses for new plants and products. The authorities acknowledged that the slow pace of Portugal's legal system was a concern, and they were working to address this issue.

Portugal: Business Climate

	Portugal	Finland	Estonia	Euro-area 2/
Cost of Starting a Business (in pct of per capita GDP)	13.5	1.2	7.5	11.6
Rigidity of Employment Index 1/	58	44	41.8	48.2
Firing Cost (weeks of wages)	98	24	38.3	55
Cost of Enforcing Contracts (in pct of debt)	17.5	7.2	10.6	10.7
Cost of Foreclosing a Business (in pct of estate value)	8	1	8	7.4

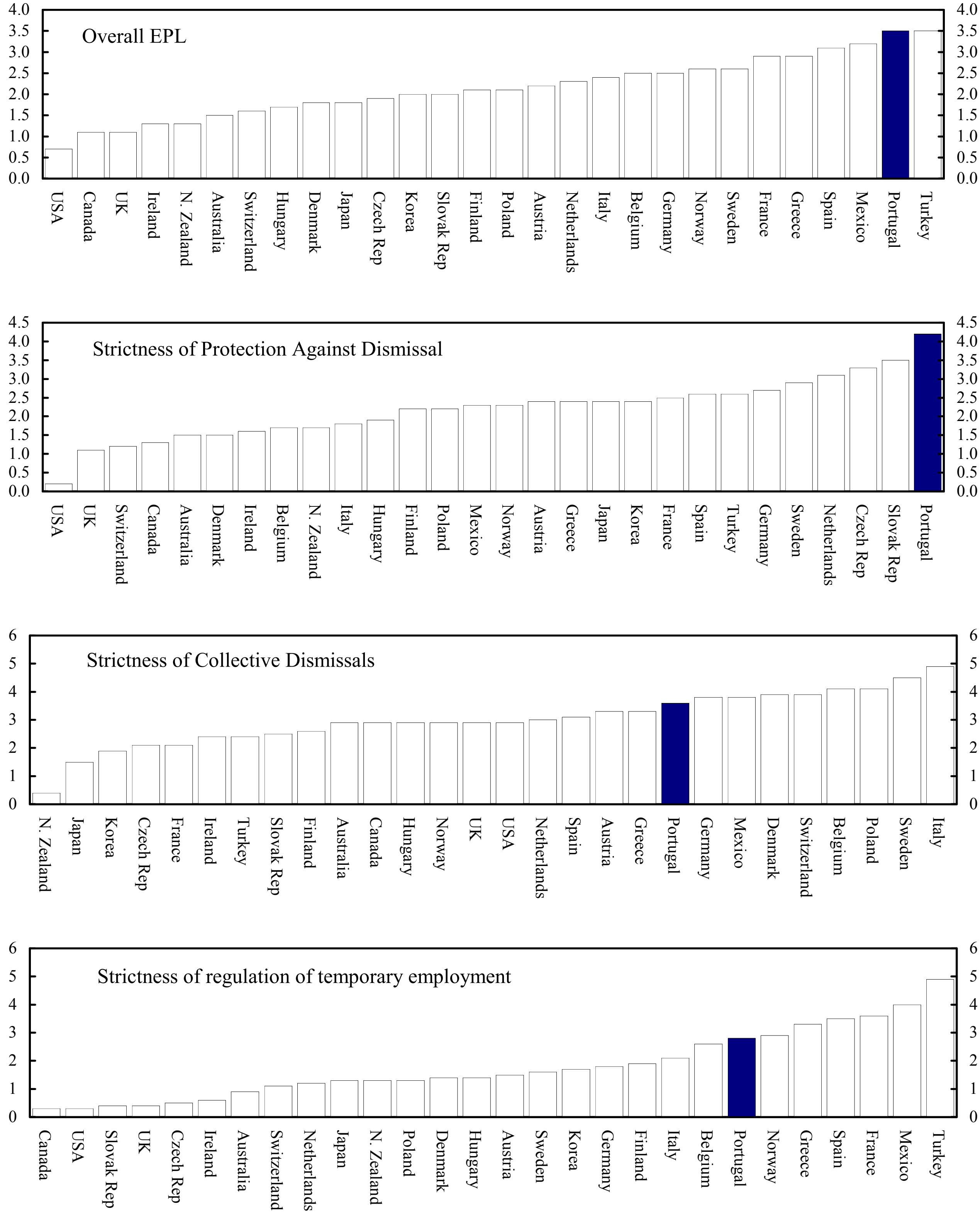
Source: World Bank (2004) *Doing Business Indicators.*

1/An overall measure that captures rigidity of hours worked. A higher number indicates a more rigid environment.

2/ Excludes Portugal.

23. **The authorities disputed international indicators pointing to high labor market rigidities, arguing that markets displayed considerable de facto flexibility**. A new labor code adopted at end-2003 allowed for more flexible working hours, facilitated the reallocation by firms of labor across regions, and revised collective bargaining procedures (with the introduction of expiry clauses, and more flexibility at the firm level with respect to rules for fixed-term contracting and dismissal). Experience with the new code was, however, too limited to allow definitive statements about its effectiveness. They stressed that while legal restrictions on individual dismissals might be relatively strict, restrictions on collective dismissals—which they felt were more important for facilitating the flow of workers to more productive sectors and achieving a restructuring of the economy—were less burdensome (though, the staff noted, still above average). Moreover, extensive use of fixed-term contracts and self-employment allowed firms to adjust employment in response to economic developments. Accordingly, further labor market flexibilization was not a priority. The staff argued, however, that fixed-term contracts and questionable self-employment were poor substitutes for fundamental reform, creating a segmented labor market and likely contributing to the low level of on-the-job training.

Figure 8. Portugal: Employment Protection Legislation (EPL) Strictness Indicators, 2003



Source: OECD Employment Outlook 2004, end of period.

C. Financial Sector Issues

24. **Private sector loan growth continued to outpace income growth in 2004**. While growth of bank credit to enterprises slowed, loans to households continued to expand at a rapid pace, with mortgage lending rising at double-digit rates. As a result, the private sector credit-to-GDP ratio continued to increase, reaching about 144 percent—the highest value in the EU.[2] The authorities noted, however, that owing to low interest rates and the extension of tenors by banks, the debt service burden for households had remained moderate. They also emphasized that the increase in indebtedness reflected in large part improved access to mortgage credit for a growing number of households, particularly younger ones and those with lower levels of formal education.

25. **The financial sector has proven resilient to the economic downturn**. Bank profitability has remained solid, as the declining contribution of net interest income has been partially offset by other sources of income (such as fees and commissions) and cost-cutting. Capitalization has improved, reflecting higher growth of own funds, although the Tier I ratio is lower than elsewhere in the euro area. Liquidity has improved, with assets exceeding liabilities at tenors up to three months (on a remaining maturity basis) and gaps narrowing at other short-term maturities, owing to securitization transactions and greater reliance on international capital markets, instead of the interbank market, for funding. Despite the economic slowdown, NPLs (both as a percentage of gross loans and in levels) have remained low, due to favorable interest rates, significant write-offs, and improved risk management. Notwithstanding significant consolidation over the last decade, competition remains strong (Box 6). The financial soundness of the insurance sector has strengthened, owing to a combination of higher premiums in some categories, positive investment yields, slower growth in claims, and rationalization of personnel costs.

26. **The authorities nevertheless recognized vulnerabilities arising from the high levels of corporate and household debt.** In addition, a high share of loans was at floating interest rates, and loans were concentrated across sectors (real estate loans account for about 60 percent of banks' total loan portfolio) and enterprises (about 6 percent of borrowers holds about 80 percent of bank credit). Therefore, a sharp drop in growth or rise in unemployment or interest rates could impair loan quality and hamper bank profitability.

27. **Progress has been achieved in preparing the financial system for changes in accounting and prudential frameworks**. The impact of the application of IFRS standards will be significant but smoothed over time. According to preliminary estimates by the Bank of Portugal, unrealized losses in the investment portfolio of the four largest banking groups, calculated by applying the IFRS rules, amounted to €445 million in 2004 (2.9 percent of their

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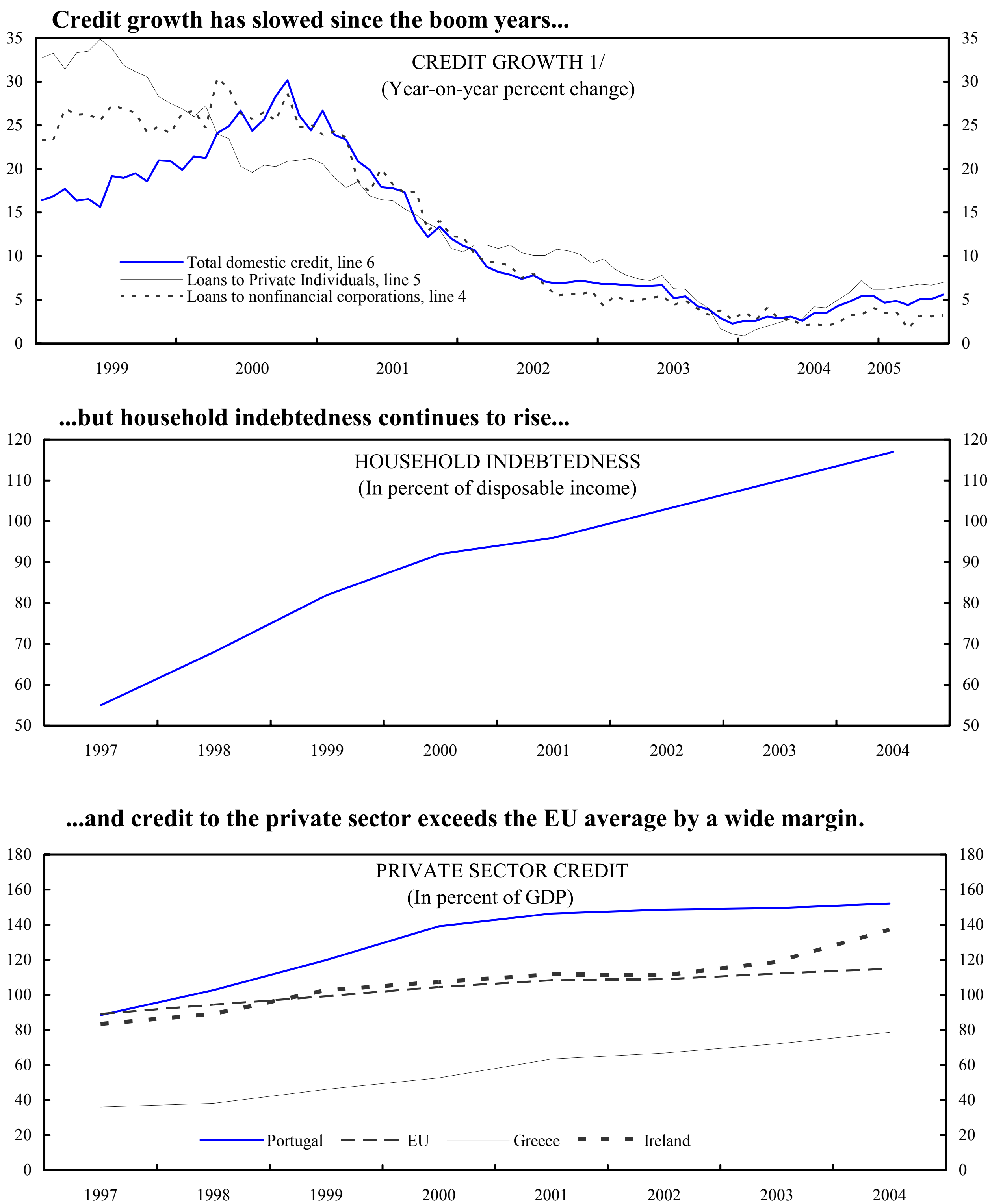
[2] At end-2004, household debt was 118 percent of disposable income, well above the EU average of 80 percent, and non-financial enterprises' debt was 98 percent of GDP.

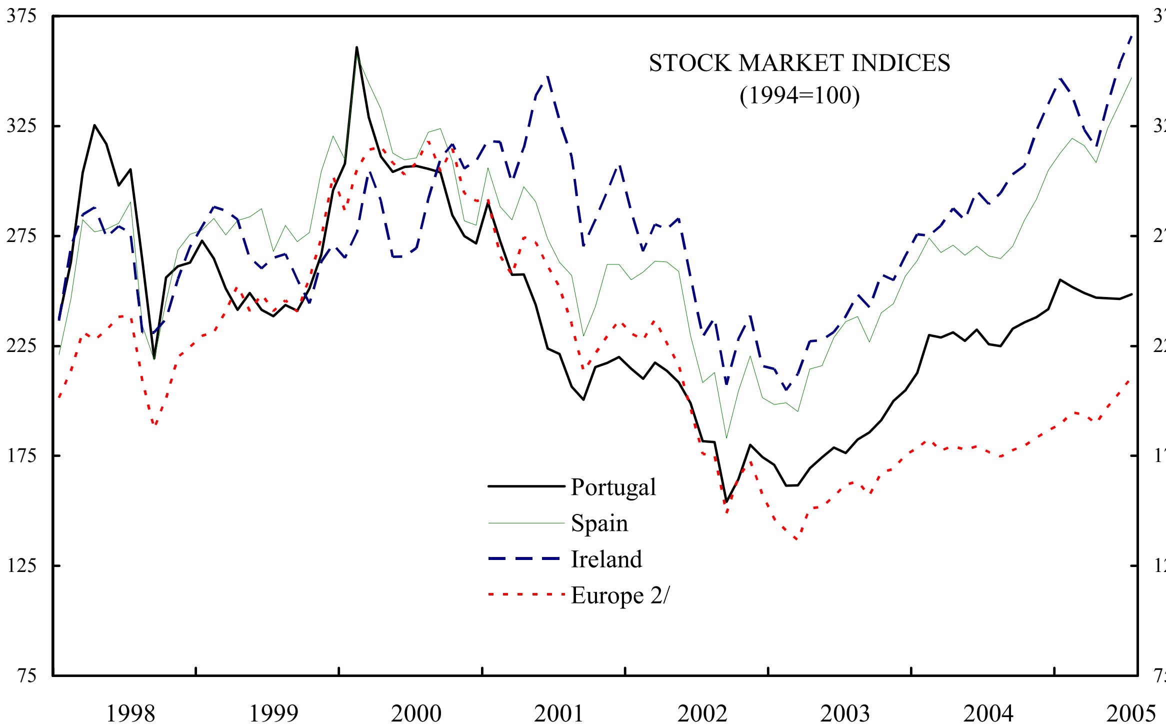
Figure 9. Portugal: Credit Developments, 1998-2005

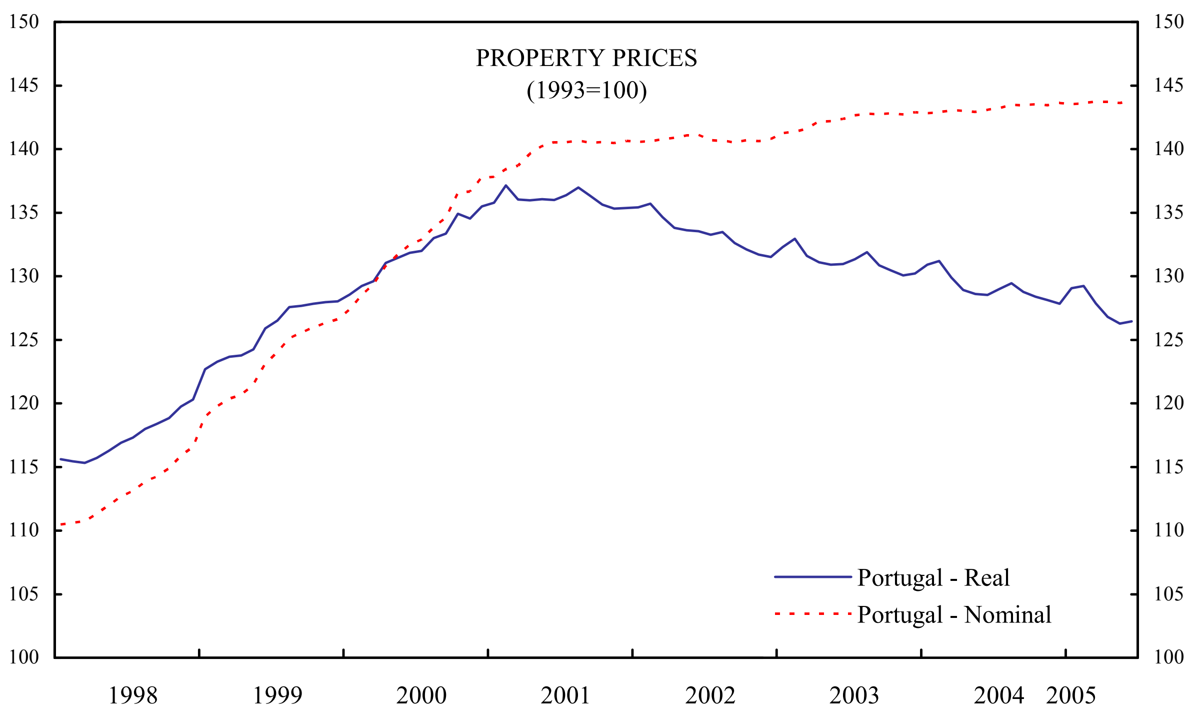


Source: Bank of Portugal, INE and Eurostat.

1/ 2005 data refers to June.

Figure 10. Portugal: Asset Market Indicators, 1998-2005 1/





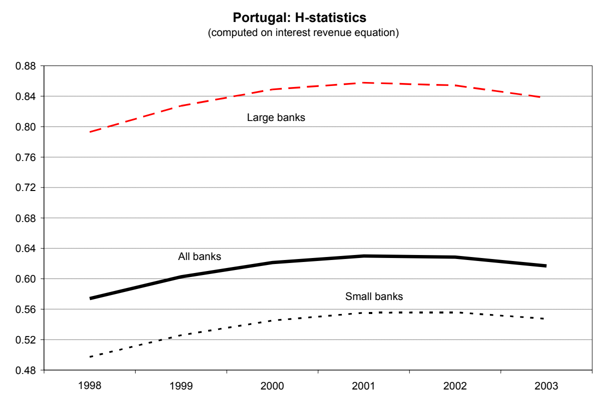
Sources: Bank of Portugal; Ministry of Finance, *Monthly Note on Conjecture;* Datastream; and Fund staff calculations.

1/ 2005 data through July.
2/ FTSE Eurotop 100 (in euros).

own funds). These losses, however, can in some cases be recognized for prudential purposes over a period up to 2010. In preparation for Basle II, the central bank has intensified its oversight of risk management practices by banks.

Box 6. The Portuguese Banking Sector

Portugal experienced significant bank consolidation over the last decade. Between 1995 and 2004, the number of credit institutions declined from 233 to 197, mainly due to mergers and acquisitions. [1] Typical market structure indicators, such as the market share of the largest institutions or the Herfindhal-Hirshman index suggest a concentrated market structure for the Portuguese banking industry.



Yet, as discussed in a Selected Issues paper, competitive conditions in the banking sector do not seem to have been adversely affected. The Panzar and Rosse H statistic, which relates changes in a firm's revenues to changes in input costs—shows that, although conditions of monopolistic competition prevail, there is some evidence that competition improved over 1998–2003 period. In particular, competition seems to be more intense among larger banks, as smaller ones may have been able to carve out niches for themselves. Cross-country studies suggest bank competition in Portugal compares favorably with other euro-area countries.

1/ ECB *Monthly Bulletin* (May 2005).

D. Other Issues

28. **As a relatively small, open economy, trade issues are of considerable importance to Portugal.** The textile sector has been significantly affected by the elimination of quotas under the Multi Fiber Agreement. The authorities noted, however, that liberalization had occurred in a context of a significant restructuring of the textile industry that had been ongoing for some time: between 2000 and 2004 employment in the industry had already fallen by about 70,000. The authorities stressed that putting the Doha round of trade negotiations firmly on track remained a high priority. Portugal's **official development assistance** as a percentage of GNI has remained lower than in the majority of advanced economies.

29. **According to the authorities, the AML/CFT legislation is consistent with EU directives and FATF recommendations**. A mutual evaluation by FATF will take place in January 2006.

30. **A number of innovations are underway to improve the quality of statistical data (Appendix II)**. Revisions of quarterly employment data are being undertaken that will facilitate the assessment of productivity developments. In addition, the authorities were in the process of rebasing the national accounts data to 2000. Improvements were also underway in the series on industrial production prices and import prices.

IV. Staff Appraisal

31. **In an unfavorable context marked by large fiscal and external imbalances, slow growth, and a weak competitive position, the challenge is to create the conditions to restart Portugal's per capita income convergence as soon as possible**. Doing so will require sustainable fiscal adjustment and measures to improve product and labor markets, enhance the business environment, and strengthen human capital development. The authorities' policy outlines in these areas point in the right direction, but early action in implementing them will be key to building confidence and credibility.

32. **The authorities' fiscal strategy correctly emphasizes medium-term expenditure containment and sets an appropriate pace of adjustment**. Steady rises in the public wage bill and in pension spending in recent years are at the heart of current fiscal difficulties, and the authorities' intention to focus on these items is well-founded. The decision largely to abandon one-off measures is also appropriate, as they have tended to obscure the true state of the public finances and to add to budget pressure in subsequent years. The planned pace of adjustment, with the deficit falling to 3 percent of GDP by 2008, strikes a balance between the need to make rapid progress in reducing the deficit and the focus on longer-term reforms. However, the authorities should seek to contain spending in 2005, both to limit the deterioration in the fiscal balance this year and to provide a cushion should revenues fall short of projected levels. Over the medium term, the growth forecasts underlying the authorities' plans may be optimistic. The authorities' willingness to take additional measures—ideally on the expenditure side—if needed to achieve the deficit targets, including the objective of observing the Maastricht deficit criterion by 2008, is therefore welcome.

33. **Nevertheless, one consequence of the focus on medium-term measures is that adjustment in 2005 has come from revenue measures, while expenditure consolidation has yet to commence**. This is true in part because a number of key elements of the authorities' program are still being defined, including reforms of the public administration and of the retirement system for private sector workers. The definition and implementation of these bedrock spending reforms is essential to distinguish the current adjustment effort from previous, unsuccessful attempts at durable fiscal consolidation, and to maximize the credibility of the government's program. Progress in these areas sufficient to allow them to be reflected in the 2006 budget will therefore be critical.

34. **The fiscal adjustment planned for the next four years is but the first—albeit critical—stage of a longer process of deficit reduction**. The looming rise in pension and health care spending from population aging underscores the need to find durable measures to improve the quality and efficiency of public expenditure. Greater use of Public-Private Partnerships could help raise spending efficiency, but care will be needed to ensure that these transactions involve an appropriate transfer of risk to the private sector, that contracts and associated liabilities are recorded transparently (including in budget documents), and that commitments to make payments over time to private partners do not unduly constrain future budget flexibility. Reforms to local government financing arrangements—possibly including binding expenditure limits—could also help reduce medium-term fiscal pressures.

35. **Planned structural reforms to improve labor productivity are essential to income convergence**. The impact of initiatives to promote R&D and IT spending is likely to be enhanced by ongoing and planned reforms to the education and training system, to the business environment, and to the competitive environment. In this regard, recent measures to reduce the time required to open a new business are welcome, but reducing delays in the legal system and accelerating the process of granting licenses and permits should be a high priority. There is also a need to enhance competition in key sectors like telecommunications and transportation, where relatively high costs undermine competitiveness.

36. **Additional steps to raise labor market flexibility are also needed**. Restrictions on collective dismissals exceed the EU average, and those on individual dismissals are the tightest in the OECD. Extensive use of temporary contracts and dubious self-employment to evade the restrictions creates a segmented labor market, with one class of workers enjoying strong employment protection and a second subject to considerable job instability. Not only do such conditions raise equity concerns, they also hamper productivity growth by slowing the movement of protected workers from low-growth sectors to higher-growth ones. They may also contribute to the low level of on-the-job training.

37. **The financial sector has proven resilient to the slowdown, but high debt levels and concentrated bank lending remain a risk**. Banks have remained adequately capitalized and liquid, profitability has been solid, and the quality of banks' loan portfolios has remained broadly stable. Potential vulnerabilities arise mainly from high household and corporate debt and the concentration of loans across sectors and enterprises. The authorities should continue to monitor developments carefully. The authorities' decision to undertake a Financial Sector Assessment Program this year is welcome, as it will afford an opportunity for a more detailed review of the financial sector.

38. Portugal is encouraged to actively support progress under the Doha round and to increase its ODA toward the UN target level.

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

Table 1. Portugal: Selected Economic Indicators, 2000–06
(Changes in percent, except as otherwise indicated)

	2000	2001	2002	2003	2004	2005 Proj.	2006 Proj.
Domestic economy 1/							
Real GDP	3.8	2.0	0.5	-1.2	1.2	0.5	1.2
Real domestic demand	3.2	1.7	-0.1	-2.6	2.2	1.7	1.3
Private consumption	3.6	1.1	1.2	-0.4	2.5	2.1	1.2
Gross fixed investment	3.5	1.3	-5.0	-10.1	0.6	-0.6	2.8
Foreign sector contribution	0.2	0.1	0.7	1.6	-1.3	-1.4	-0.2
Employment	1.9	1.8	0.5	-0.4	0.1	0.1	0.6
Unemployment rate	3.9	4.0	5.0	6.3	6.7	7.4	7.7
Output gap	3.4	3.0	1.5	-1.3	-2.0	-3.0	-3.3
Compensation per worker (whole economy)	6.6	5.6	3.9	2.6	2.6	2.8	3.0
Unit labor costs (whole economy)	4.9	5.6	3.9	3.3	1.6	2.5	2.1
Consumer prices (national index)	2.9	4.4	3.6	3.3	2.4	2.3	2.5
Consumer prices (harmonized index)	2.8	4.4	3.7	3.3	2.5	2.3	2.5
GDP deflator	2.8	4.1	4.2	2.7	2.7	2.5	2.7
External accounts							
Export volume (goods)	8.4	-0.2	2.0	4.7	4.0	1.6	4.4
Import volume (goods)	6.1	1.2	-0.4	-0.6	6.4	6.3	2.3
Export unit value (goods and services)	5.2	1.2	0.2	-2.6	1.2	0.8	3.1
Import unit value (goods and services)	8.3	0.2	-1.9	-2.3	2.0	1.6	1.7
Trade balance (in percent of GDP) 1/	-12.5	-11.9	-10.0	-8.7	-10.3	-12.0	-11.3
Capital transfers (net, € billions)	1.7	1.2	2.0	2.7	2.2	2.3	2.4
Current account including capital transfers (€ billions)	-10.3	-11.2	-7.7	-4.3	-8.0	-9.5	-8.8
(in percent of GDP) 1/	-8.6	-8.8	-5.8	-3.2	-5.6	-6.5	-5.8
Nominal effective exchange rate	-2.9	0.6	0.8	2.8	0.5	...	...
Real effective exchange rate (CPI based)	-2.4	2.5	2.4	4.0	0.7	...	...
General government finances (in percent of GDP) 1/ 2/							
Revenues	40.6	40.2	41.5	42.9	43.5	41.5	42.5
Expenditures	43.3	44.4	44.1	45.7	46.5	47.5	47.0
Of which : capital expenditures	4.8	5.2	4.0	4.4	4.5	4.1	3.6
Overall balance	-2.9	-4.2	-2.8	-2.9	-3.0	-6.0	-4.5
Structural balance, excluding asset sales	-4.5	-5.4	-4.5	-4.6	-4.5	-5.0	-3.5
Primary balance	0.3	-1.2	0.1	-0.1	-0.3	-3.2	-1.3
Government debt, Maastricht definition	51.2	53.6	56.1	57.7	59.4	65.6	66.6
Financial variables 3/							
National contribution to euro area M3 4/	6.2	6.8	-1.1	4.2	5.7	...	...
Credit to the private sector 5/	24.4	13.8	10.0	6.2	6.5	...	...
Interest rates (percent)							
Overnight rate	5.2	3.9	3.4	2.3	2.2	...	...
Deposit rate, up to 2 years 6/	4.4	3.3	2.9	2.0	2.0	...	...
Loans granted to non-financial corporations 7/	6.4	5.2	4.6	4.4	4.3	...	...
Government benchmark bond	5.3	5.0	4.5	4.5	3.6	...	...

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

1/ GDP figures and ratios use revised GDP series with base year 2000.
2/ Asset sales, including UMTS receipts, the transfer of the postal pension fund and securitization are netted out for purposes of calculating structural balances.
3/ End-of-period data.
4/ Excludes the currency in circulation held by non-bank private sector.
5/ Includes securitized loans. 2001 onwards it is also corrected for loan write-offs and reclassifications.
6/ Data refer to new deposits before 2003 and to the stock of outstanding deposits thereafter. Before 2003 deposit rate with 91-180 days maturity.
7/ Average rates on outstanding amounts of loans, denominated in Euros to residents in the Euro Area, for each sector and/or purpose, weighted by the corresponding outstanding amounts at the end of the month in each original maturity. Before 2003 lending rate with 91-180 days maturity.

Table 2. Portugal: Balance of Payments, 2000–10 1/

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
								Proj.			
					(In billions of euros)						
Current account	-12.0	-12.4	-9.7	-7.0	-10.2	-11.8	-11.2	-10.5	-10.0	-9.7	-9.5
Trade balance	-15.0	-15.3	-13.4	-11.8	-14.6	-17.4	-17.0	-16.5	-16.2	-16.0	-15.8
Exports fob	27.3	27.5	28.1	28.7	30.0	30.7	33.1	34.8	36.7	38.8	41.5
Imports fob	42.3	42.8	41.5	40.6	44.6	48.2	50.1	51.3	52.9	54.8	57.4
Services, net	2.2	2.9	3.3	3.5	4.1	4.1	4.5	4.9	5.3	5.7	6.1
Exports	9.8	10.5	10.9	10.8	11.9	12.3	13.1	13.7	14.4	15.2	16.0
Imports	7.6	7.6	7.6	7.3	7.7	8.2	8.6	8.8	9.1	9.5	9.9
Of which:											
Tourism	3.3	3.8	3.8	3.7	4.0	4.2	4.5	4.8	5.0	5.3	5.5
Exports	5.7	6.1	6.1	5.8	6.3	6.5	6.9	7.2	7.6	7.9	8.3
Imports	2.4	2.4	2.2	2.1	2.2	2.3	2.4	2.5	2.6	2.7	2.8
Income	-2.7	-3.8	-2.6	-1.5	-2.5	-1.3	-1.7	-2.0	-2.4	-2.8	-3.2
Current transfers, net	3.6	3.7	2.9	2.9	2.8	2.9	3.0	3.1	3.2	3.4	3.4
Private remittances, net	3.5	3.6	2.6	2.3	2.3	2.3	2.4	2.5	2.6	2.8	2.8
Official transfers, net	0.2	0.2	0.3	0.6	0.5	0.5	0.5	0.6	0.6	0.6	0.6
Capital account	1.7	1.2	2.0	2.7	2.2	2.3	2.4	2.5	2.6	2.6	2.7
Current account (including capital transfers)	-10.3	-11.2	-7.7	-4.3	-8.0	-9.5	-8.8	-8.0	-7.4	-7.2	-6.8
Financial account	10.9	11.3	7.0	4.7	9.4	9.5	8.8	8.0	7.4	7.2	6.8
Direct investment	-1.6	0.1	1.7	-0.7	-4.1	-0.1	-0.4	-0.5	-0.6	-0.7	-0.7
Portuguese investment abroad	-8.8	-7.0	-0.2	-6.5	-5.0	-1.0	-1.4	-1.5	-1.6	-1.8	-1.9
Foreign investment in Portugal	7.2	7.0	1.9	5.8	0.9	0.9	1.0	1.0	1.0	1.1	1.1
Portfolio investment, net	-2.1	2.1	3.1	-5.1	1.2	0.3	0.5	0.5	0.5	0.6	0.6
Equity securities	-0.7	1.5	2.4	7.7	3.9	0.7	1.0	1.1	1.2	1.3	1.4
Long-term debt securities	-2.3	-2.5	-0.2	-9.1	-8.9	-1.8	-2.1	-1.8	-1.9	-3.0	-2.3
Money market instruments	0.9	3.0	0.8	-3.8	6.1	1.4	1.5	1.2	1.3	2.3	1.5
Financial derivatives	0.3	0.4	0.0	0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Other investment, net	14.6	9.7	3.3	4.6	10.8	9.3	8.8	8.1	7.5	7.3	7.0
Of which:											
Monetary financial institutions	11.9	14.8	8.8	9.8	2.0	...	...	...	...	...	...
Of which:											
Short-term	8.7	6.0	-1.2	-2.3	-1.6	...	...	...	...	...	...
Long-term	3.2	8.8	10.0	12.2	3.6	...	...	...	...	...	...
Reserve assets	-0.4	-1.0	-1.1	5.8	1.5	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	-0.6	-0.1	0.8	-0.3	-1.5	0.0	0.0	0.0	0.0	0.0	0.0
					(In percent of GDP)						
Memorandum items:											
Current account	-9.9	-9.7	-7.3	-5.2	-7.2	-8.1	-7.4	-6.7	-6.1	-5.7	-5.3
Current account (including capital transfers)	-8.6	-8.8	-5.8	-3.2	-5.6	-6.5	-5.8	-5.1	-4.5	-4.2	-3.8
Net international investment position 2/	-38.0	-42.1	-46.5	-51.4	-57.2	-62.2	-65.7	-68.2	-70.0	-71.2	-71.9

Sources: Bank of Portugal; and Fund staff calculations.

1/ Scenario assumes an improvement in competitiveness through structural reform, and thus differs from the constant policies scenario in Table 4.

2/ End-of-period data.

Table 3. Portugal: General Government Accounts, 2000–06

	2000	2001	2002	2003	2004	2005 1/	2006 1/
				(In millions of euros)			
Total revenues	49,045	51,810	55,979	58,775	61,365	60,328	64,211
Current receipts	47,388	49,630	53,641	55,102	56,245	58,154	62,102
Tax revenue	28,506	29,599	31,796	32,444	32,739	34,710	37,434
Social security contributions	13,682	14,738	15,872	16,750	17,576	17,907	18,612
Other current revenues	5,200	5,294	5,972	5,909	5,930	5,536	6,056
Capital revenue	1,657	2,180	2,338	3,672	5,120	2,174	2,109
Total expenditures	52,512	57,229	59,741	62,658	65,594	69,069	71,039
Primary current expenditures	42,845	46,425	50,076	52,763	55,536	59,053	60,780
Interest payments	3,670	3,882	3,894	3,808	3,832	4,125	4,892
Capital expenditures	5,997	6,923	5,770	6,088	6,226	5,891	5,367
Overall balance	-3,467	-5,420	-3,762	-3,884	-4,229	-8,741	-6,828
Excluding one-off measures 2/	-3,866	-5,420	-5,583	-7,141	-7,280	-9,073	-7,281
				(In percent of GDP) 2/			
Total revenues	40.8	40.6	41.8	43.3	43.5	41.5	42.5
Current receipts	39.4	38.8	40.1	40.6	39.9	40.0	41.1
Tax revenues	23.7	23.2	23.8	23.9	23.2	23.9	24.8
Social security contributions	11.4	11.5	11.9	12.3	12.5	12.3	12.3
Other current revenues	4.3	4.1	4.5	4.4	4.2	3.8	4.0
Capital revenue	1.4	1.7	1.7	2.7	3.6	1.5	1.4
Total expenditures	43.7	44.8	44.6	46.1	46.5	47.5	47.0
Primary current expenditure	35.6	36.3	37.4	38.8	39.4	40.6	40.2
Interest payments	3.1	3.0	2.9	2.8	2.7	2.8	3.2
Capital expenditures	5.0	5.4	4.3	4.5	4.4	4.1	3.6
Overall balance	-2.9	-4.2	-2.8	-2.9	-3.0	-6.0	-4.5
Excluding one-off measures 3/	-3.2	-4.2	-4.2	-5.3	-5.2	-6.2	-4.8
Memorandum items:							
Structural balance 4/	-4.5	-5.4	-4.5	-4.6	-4.4	-5.0	-3.5
Primary balance	0.2	-1.2	0.1	-0.1	-0.3	-3.2	-1.3
Primary structural balance 4/	-1.5	-2.4	-1.6	-1.8	-1.7	-2.2	-0.3
Public debt (Maastricht definition)	51.2	53.6	56.1	57.7	59.4	65.6	66.6
Nominal GDP (in millions of euros)	120,302	127,767	133,826	135,822	141,115	145,366	151,082
Change in nominal GDP (in percent)	6.7	6.2	4.7	1.5	3.9	3.0	3.9
Real GDP growth (in percent)	3.8	2.0	0.5	-1.2	1.2	0.5	1.2

Sources: Ministry of Finance; and Fund staff estimates.

1/ Staff estimates based on Authorities' targets.
2/ Ratios based on new GDP series with 2000 as base year.
3/ Includes the transfer of the postal pension fund in 2003, the state enterprises pensionfunds in 2004, securitization and asset sales.
4/ Structural balances are calculated using the staff's estimates of potential output. Asset sales, including UMTS receipts, the transfer of pension funds and securitization are netted out for purposes of calculating structural balances.

Table 4. Portugal: External Debt Sustainability Framework, 2000-10
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	**Debt-stabilizing noninterest current account** 7/
1 **Baseline: External debt** 1/	120.3	135.5	140.1	147.7	154.0	**159.1**	**163.1**	**166.6**	**169.8**	**173.0**	**176.0**	**-1.3**
2 Change in external debt	20.0	15.1	4.6	7.6	6.3	5.1	3.9	3.5	3.2	3.2	3.0	
3 Identified external debt-creating flows (4+8+9)	6.1	5.0	-5.1	-6.6	-0.6	1.5	-0.4	-1.1	-1.3	-1.2	-1.1	
4 Current account deficit, including capital transfers and excluding interest payments	4.2	3.4	1.4	-0.6	1.8	2.4	1.5	0.9	0.4	0.2	-0.1	
5 Deficit in balance of goods and services	10.7	9.7	7.6	6.1	7.4	9.2	8.3	7.8	7.4	7.1	6.7	
6 Exports	30.8	29.8	29.1	29.1	29.7	29.6	30.6	30.5	30.5	30.6	30.8	
7 Imports	41.5	39.5	36.7	35.3	37.1	38.8	38.9	38.3	37.9	37.7	37.5	
8 Net nondebt creating capital inflows (negative)	1.6	2.7	-4.0	-5.6	0.6	-0.5	-0.6	-0.6	-0.6	-0.6	-0.6	
9 Automatic debt dynamics 2/	0.3	-1.2	-2.6	-0.4	-2.9	-0.3	-1.3	-1.4	-1.1	-0.8	-0.4	
10 Contribution from nominal interest rate	4.3	5.4	4.4	3.8	3.9	4.2	4.4	4.6	4.9	5.1	5.4	
11 Contribution from real GDP growth	-4.2	-2.3	-0.6	1.4	-1.5	-0.7	-1.9	-1.9	-1.9	-1.8	-1.8	
12 Contribution from price and exchange rate changes 3/	0.2	-4.2	-6.3	-5.6	-5.2	-3.7	-3.8	-4.2	-4.0	-4.1	-4.0	
13 Residual, incl. change in gross foreign assets (2-3)	13.9	10.2	9.8	14.2	6.9	3.6	4.4	4.6	4.5	4.4	4.2	
External debt-to-exports ratio (in percent)	390.2	454.9	481.3	507.2	518.9	537.3	533.5	545.5	556.1	564.9	571.2	
Gross external financing need (in billions of U.S. dollars) 4/	42.3	43.6	46.1	48.3	58.3	63.5	64.5	67.6	71.0	75.1	78.8	
in percent of GDP	38.1	38.1	36.4	31.4	33.3	35.0	35.2	35.5	35.8	36.5	36.9	
Scenario with key variables at their historical averages 5/						**159.1**	**156.4**	**158.3**	**160.0**	**161.3**	**162.2**	**-4.1**
Key macroeconomic assumptions												
Real GDP growth (in percent)	3.8	2.0	0.5	-1.2	1.2	0.5	1.2	1.2	1.2	1.1	1.1	
GDP deflator in U.S. dollars (change in percent)	-11.0	0.9	9.9	23.0	12.9	2.9	-0.3	2.8	2.8	2.7	2.5	
Nominal external interest rate (in percent)	4.0	4.6	3.6	3.3	3.0	2.8	2.8	3.0	3.0	3.1	3.2	
Growth of exports (U.S. dollar terms, in percent)	-1.2	-0.6	8.0	21.6	16.4	3.2	4.2	3.9	4.0	4.1	4.2	
Growth of imports (U.S. dollar terms, in percent)	-0.8	-2.2	2.6	16.8	20.2	8.2	1.1	2.6	2.8	3.3	3.1	
Current account balance, excluding interest payments 6/	-4.2	-3.4	-1.4	0.6	-1.8	-2.4	-1.5	-0.9	-0.4	-0.2	0.1	
Net nondebt creating capital inflows	-1.6	-2.7	4.0	5.6	-0.6	0.5	0.6	0.6	0.6	0.6	0.6	

1/ Refers to gross external debt and assumes growth at historical (2000-2005) average.
2/ Derived as $[r - g - r(1+g) + ea(1+r)]/(1+g+r+gr)$ times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
3/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Assuming no improvements in external competitiveness and private savings over the projection period.
7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and both noninterest current account and nondebt inflows in percent of GDP) remain at their levels of the last projection year.

Table 5. Portugal: Public Sector Debt Sustainability Framework, 2000-10
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
						Baseline Projections					
1 **Public sector debt** 1/	51.2	53.6	56.1	57.7	59.4	**65.6**	**66.6**	**67.7**	**67.8**	**67.1**	**65.0**
o/w foreign-currency denominated	3.8	3.4	4.0	2.0	2.1	2.3	2.4	2.4	2.4	2.4	2.3
2 Change in public sector debt	-0.9	2.4	2.6	1.5	1.7	6.3	1.0	1.0	0.2	-0.7	-2.1
3 Identified debt-creating flows (4+7+12)	-2.3	1.0	0.0	1.6	1.6	5.7	2.0	1.0	0.2	-0.8	-2.1
4 Primary deficit	-0.3	1.2	-0.3	-0.1	0.3	3.2	1.3	0.5	-0.2	-1.1	-2.4
5 Revenue and grants	40.6	40.2	41.9	43.1	43.5	41.5	42.5	43.0	43.0	43.2	43.0
6 Primary (noninterest) expenditure	40.3	41.4	41.6	43.0	43.8	44.7	43.8	43.6	42.8	42.1	40.6
7 Automatic debt dynamics 2/	0.4	0.2	0.3	1.6	0.4	1.1	0.7	0.5	0.4	0.3	0.3
8 Contribution from interest rate/growth differential 3/	-0.2	0.1	0.5	2.0	0.6	1.1	0.7	0.5	0.4	0.3	0.3
9 Of which contribution from real interest rate	1.7	1.1	0.7	1.3	1.2	1.4	1.5	1.6	1.7	1.7	1.9
10 Of which contribution from real GDP growth	-1.9	-1.0	-0.3	0.7	-0.7	-0.3	-0.8	-1.1	-1.2	-1.4	-1.6
11 Contribution from exchange rate depreciation 4/	0.6	0.1	-0.2	-0.3	-0.2	...	...	...	...	...	...
12 Other identified debt-creating flows	-2.4	-0.3	0.0	0.0	1.0	1.4	0.0	0.0	0.0	0.0	0.0
13 Privatization receipts (negative)	-2.4	-0.3	0.0	0.0	-0.4	0.0	0.0	0.0	0.0	0.0	0.0
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	1.4	1.4	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3) 5/	1.4	1.4	2.6	0.0	0.0	0.6	-1.0	0.0	-0.1	0.1	0.0
Public sector debt-to-revenue ratio 1/	126.0	133.3	134.2	133.9	136.5	158.1	156.7	157.3	157.7	155.3	151.1
Gross financing need 6/	17.0	18.4	19.5	21.7	22.3	26.6	26.3	25.9	25.4	24.4	22.6
in billions of U.S. dollars	18893.8	21077.2	24621.1	33394.7	39115.8	48350.5	48244.2	49553.7	50777.2	51141.2	49758.4
Scenario with key variables at their historical averages 7/						**65.6**	**65.4**	**66.1**	**66.9**	**67.7**	**68.5**
Scenario with no policy change (constant primary balance) in 2005-2010						**65.6**	**65.6**	**66.4**	**67.1**	**67.7**	**68.2**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline											
Real GDP growth (in percent)	3.8	2.0	0.5	-1.2	1.2	0.5	1.2	1.7	1.9	2.2	2.5
Average nominal interest rate on public debt (in percent) 8/	6.4	6.4	5.7	5.0	4.9	4.9	5.1	5.1	5.0	5.0	5.1
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.6	2.3	1.5	2.3	2.2	2.5	2.4	2.5	2.6	2.7	3.0
Nominal appreciation (increase in US dollar value of local currency, in percent)	-13.4	-3.1	5.4	19.7	9.9	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	2.8	4.1	4.2	2.7	2.7	2.5	2.7	2.6	2.4	2.3	2.1
Growth of real primary spending (deflated by GDP deflator, in percent)	3.7	4.8	1.0	2.3	3.0	2.6	-0.8	1.1	0.1	0.6	-1.1
Primary deficit	-0.3	1.2	-0.3	-0.1	0.3	3.2	1.3	0.5	-0.2	-1.1	-2.4

1/ The public sector refers to general government. Uses the Staff's growth scenario for 2005-10.
2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as αε(1+r).
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.

Table 6. Portugal: Indicators of External and Financial Vulnerability, 2000–05
(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005 Est.	Date
External indicators							
Exports (goods, annual percent change in U.S. dollars)	-0.8	-2.1	7.5	22.4	14.9	7.1	May
Imports (goods, annual percent change in U.S. dollars)	-0.2	-2.0	2.3	17.0	20.9	12.5	May
Terms of trade (goods and services, annual percent change)	-2.8	1.0	2.2	-0.4	-0.8	...	
Current account balance	-9.9	-9.7	-7.3	-5.2	-7.2	-9.5	Q1
Current account balance (including capital transfers)	-8.6	-8.8	-5.8	-3.2	-5.6	-8.6	Q1
Capital and financial account balance	10.4	9.8	6.7	5.4	7.2	11.6	Q1
Of which: Inward portfolio investment (debt securities, etc.)	2.5	8.5	8.0	10.1	7.4	2.4	Q1
Inward foreign direct investment	6.0	5.5	1.4	4.3	0.6	3.2	Q1
Other investment liabilities (net)	12.2	7.6	2.5	3.4	6.6	13.3	Q1
Official reserves (in billions of U.S. dollars, end-of-period) 1/	14.1	15.3	15.9	11.5	10.7	11.0	March
Broad money to reserves 1/	7.5	7.2	7.1	12.4	15.4	11.8	May
Central Bank foreign liabilities (in billions of U.S. dollars) 1/	7.5	7.3	8.9	2.8	10.9	17.7	May
Foreign assets of the financial sector (in billions of U.S. dollars) 2/	52.9	53.2	60.8	73.0	93.4	93.2	May
Foreign liabilities of the financial sector (in billions of U.S. dollars) 2/	73.2	84.3	105.1	121.8	149.1	151.3	May
Official reserves in months of imports 3/	4.3	4.8	4.9	3.0	2.3	2.2	March
Exchange rate (per U.S. dollars, period average)	1.08	1.12	1.06	0.88	0.80	0.79	August
Financial market indicators							
Public sector debt (Maastricht definition)	51.2	53.6	56.1	57.7	59.4	65.6	
Money market rate (period average in percent)	4.4	4.3	3.3	2.3	2.1	2.1	August
Money market rate (real, in percent)	1.4	-0.1	-0.3	-0.9	-0.3	-0.2	April
Stock market index (PSI 20, 1992=3000)	10,404	7,832	5,825	6,747	7,600	7,699	August
Share prices of financial institutions (2000=100)	100	90	73	61	74	82	August
Spread of 10-year benchmark bond with euro yield (percentage points)	0.2	0.2	0.1	0.0	0.0	0.0	August
Financial sector risk indicators							
Foreign exchange assets (in billions of U.S. dollars) 4/	7.0	8.0	5.7	3.9	3.4	4.6	June
Share of foreign exchange loans in total lending (percent) 4/	2.6	2.6	2.1	1.7	1.5	1.8	June
Deposits in foreign exchange (in billions of U.S. dollars) 5/	5.3	6.1	3.5	3.9	4.0	4.1	June
Share of foreign deposits in total deposits (percent) 5/	3.8	4.0	2.8	3.5	3.7	3.3	June
Share of real estate sector in private credit 6/	47.3	47.9	49.5	51.4	53.1	54.0	June
Share of nonperforming loans in total loans 2/ 7/	2.1	2.1	2.1	2.1	1.8	1.9	June
Risk-based capital asset ratio 8/	9.2	9.5	9.8	10.0	10.4	...	
Return on equity for the banking system	15.1	14.9	11.7	13.9	12.8	...	
Household Debt							
In percent of disposable income 9/	91	97	104	110	118	...	
In percent of GDP	61	65	69	75	79	...	
Non-financial corporate debt (in percent of GDP)	86	93	94	97	98	...	

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

1/ Reserves and foreign liabilities refer to the Bank of Portugal.
2/ Banks only.
3/ Ratio of reserves to harmonized M3.
4/ Non-euro area currencies assets vis-à-vis the resident and non-resident non monetary sector.
5/ Deposits in non-euro area currencies by the resident non-monetary sector and liabilities in non-euro area currencies by the non-resident non-monetary sector.
6/ Real estate defined as the sum of total credit by monetary financial institutions to individuals for housing and to nonfinancial corporations for construction; private credit defined as total domestic credit excluding the general government. Stocks adjusted for securitization operations.
7/ NPL concern households and non-financial corporations.
8/ Capital over risk-weighted assets. Consolidated data for the banking system.
9/ Based on disposable income data prior to the revision of the national accounts.

Table 7. Portugal: Selected Financial Indicators of the Banking System, 2000-04

	2000	2001	2002	2003	2004
Capital Adequacy					
Regulatory capital to risk-weighted assets (*)	9.2	9.5	9.8	10.0	10.4
Regulatory Tier I capital to risk-weighted assets (*)	7.6	7.3	7.1	7.1	7.3
Capital (net worth) to assets 1/	5.8	5.5	5.6	5.8	6.1
Asset composition and quality					
Sectoral distribution of loans to total loans (*)					
Households	47.5	46.7	47.3	47.2	48.1
of which: Housing	35.0	35.3	36.9	37.0	37.7
Construction	7.9	8.4	8.3	8.6	8.5
Manufacturing	7.8	7.6	7.4	7.4	6.6
Agriculture	0.6	0.5	0.6	0.6	0.6
Services	24.5	26.2	26.9	28.0	27.2
NPLs to gross loans (*) 2/	2.2	2.2	2.3	2.4	2.0
Specific provision to NPLs 2/	67.7	66.8	62.8	73.0	83.4
NPLs net of provisions to capital (*) 2/	7.9	8.4	10.5	7.5	3.6
Large exposure to capital (*) 2/	...	...	110.0	82.0	83.1
Earnings and Profitability					
ROA (*)	0.9	0.9	0.7	0.8	0.8
ROE (*)	15.1	14.9	11.7	13.9	12.8
Interest margin to gross income (*)	62.9	65.8	65.0	60.0	58.1
Noninterest expenses to gross income (*)	51.1	50.7	51.8	50.5	50.5
Personnel expenses to noninterest expenses	61.8	59.5	59.3	59.3	58.6
Trading and fee income to total income	29.5	25.5	26.1	27.7	29.1
Spread between reference loan and deposit rates 3/	4.5	3.9	3.5	3.2	3.1
Stock price index of bank shares 4/	107.9	92.2	69.3	72.1	80.7
Liquidity					
Liquid assets to total assets (*) 5/	...	15.3	12.5	17.1	15.4
Liquid assets to total short-term liabilities (*) 5/	...	89.1	85.7	108.6	115.2
Customer deposits to total (non-interbank) loans	86.2	81.5	77.2	77.4	77.9
FX liabilities to total liabilities 6/	9.7	9.0	8.2	8.1	7.2
Sensitivity to market risk					
Net open position in FX to capital (*)	...	...	8.0	5.2	4.3
Net open position in equities to capital	...	...	6.0	7.1	4.7

Sources: Bank of Portugal; and Fund staff estimates.
(*) Core Financial Sector Indicators.
1/ On accounting basis; consolidated.
2/ On a consolidated basis. NPLs are defined as credit to customer overdue.
3/ Based on weighted averages of lending rates to households and to non financial corporations and of deposit interest rates for the two sectors.
4/ PSI Financial Services (Euronext Lisbon); 01/03/2000 =100.
5/ 3-month residual maturity horizon.
6/ FX liabilities include foreign currency deposits and deposit-like instruments of resident non-monetary sector and claims of non-resident vis-à-vis resident monetary financial institutions (excluding Bank of Portugal).

Portugal: Fund Relations

(As of July 31, 2005)

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	100.00
Fund holdings of currency	638.86	73.65
Reserve position in Fund	228.55	26.35

III. **SDR Department**:

	SDR Million	Percent Allocation
Net cumulative allocation	53.32	100.00
Holdings	69.16	129.71

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

V. **Latest Financial Arrangements**: None

VI. **Projected Payments 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. The official currency was changed to the euro on January 1, 2002.

Portugal maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for exchange restrictions with respect to: Burma/Myanmar; Mr. Milosevic and persons associated with him; certain persons and entities with a view to combating terrorism; Zimbabwe; certain persons and entities associated with Osama bin Laden, the Al-Qaida network, and the Taliban; and certain specific restrictions on economic and financial relations with Iraq, pursuant to European Council Regulations (EC) Nos. 1081/2000, 2488/2000, 2580/2001, 310/2002, 881/2002, and 1210/2003 solely for the preservation of national or international security; those restrictions have been notified to the Fund in accordance with Executive Board Decision No. 144-(52/51).

VIII. **Article IV Consultation**: Portugal is on a standard 12-month consultation cycle. The last Article IV consultation discussions were concluded at EBM/03/29, 03/26/03.

IX. **Technical Assistance**:

Year	**Dept.**	**Purpose**	**Date**
1998	STA	Finalize Metadata for DSBB	9/98
1998	STA	Revision of Monetary Statistics	11/98

X. **ROSCs**:

Standard Code Assessment	**Date of Issuance**	**Country Report No.**
Fiscal Transparency	December 1, 2003	03/373

XI. **Resident Representative**: None

Portugal: Statistical Issues

1. Data provision to the Fund is adequate for surveillance purposes. Portugal subscribes to the Special Data Dissemination Standard (SDDS), and the relevant metadata have been posted on the Dissemination Standards Bulletin Board. Portugal has taken a flexibility option regarding the timeliness of reporting wages. Portugal's publication policy is characterized by a high degree of openness and with extensive use of the Internet. The Bank of Portugal, Ministry of Finance, and National Statistics Office (INE) have several websites with long- and short-term economic indicators and data.

2. Notwithstanding some recent improvements, considerable statistical weaknesses continue to hamper an assessment of economic developments.

3. **Real sector** statistics were improved in the fall of 2000, when INE published a full set of national accounts based on *ESA95* methodology, including quarterly GDP estimates. The authorities are in the process of rebasing national account statistics to 2000. However, statistical weaknesses remain and the Bank of Portugal continues to produce separate estimates of the annual national accounts. Shortcomings in timely and high quality monthly and quarterly data on output, employment, and total wage compensation hamper 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.

4. **Fiscal sector** data have undergone a number of revisions during the transition to *ESA95*, sizably altering revenues and expenditures and hampering comparisons across years. Some progress was made and the 2001–04 budgets were presented fully consistent with recent changes in national and fiscal accounting methodology. Intra-year budget data is available only on a cash basis. In 2002 INE started to publish data for the Social Security Fund on a monthly basis with 45 days delay and in 2003 for Autonomous Funds on a quarterly basis with 75 days delay. Except for the local and general government, data broadly meet the SDDS timeliness standards. A project is underway concerning quarterly general government statistics on an accrual basis, but no firm timetable is in place for publication of the data.

5. **Trade and balance of payments** data are provided according to the IMF's Fifth Edition of the *Balance of Payments Manual*. Although the external trade data meet the timeliness standards, frequent and sizeable revisions hamper their usefulness. The portfolio investment collection system has a simplified threshold of €500 million, which is relatively high in comparison with many EU countries. The authorities estimate however, that only about 2 percent of transactions are not captured on a monthly basis by this threshold, and that this reporting simplification does not significantly hamper the quality of the monthly balance of payments. Moreover, they indicated that all transactions below this threshold are included in the first release of the annual balance of payments data, and the monthly numbers are revised accordingly.

Portugal: Table of Common Indicators Required for Surveillance

As of August 29, 2005

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	8/29/05	08/05	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	06/05	08/05	M	M	M
Reserve/Base Money	06/05	08/05	M	M	M
Broad Money	06/05	08/05	M	M	M
Central Bank Balance Sheet	07/05	08/05	M	M	M
Consolidated Balance Sheet of the Banking System	07/05	08/05	M	M	M
Interest Rates[2]	06/05	08/05	W	W	W
Consumer Price Index	06/05	08/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	06/05	08/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	06/05	08/05	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	06/05	08/05	M	M	M
External Current Account Balance	2005 Q2	08/05	Q	Q	Q
Exports and Imports of Goods and Services	2005 Q2	07/05	Q	Q	Q
GDP/GNP	2005 Q1	07/05	Q	Q	Q
Gross External Debt[6]	2005 Q1	07/05	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Although overall gross external debt is not available, public sector gross external debt is available on a monthly basis, with the last release for 2/05 on 3/24/05.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA)

Statement by the IMF Staff Representative
October 14, 2005

1. **This statement provides information that has become available since the issuance of the Staff Report for the 2005 Article IV Consultation**. The new information does not change the thrust of the staff appraisal.

2. **Short-term indicators are mixed, but give no indication that a sustained recovery is in the works**. Consumer confidence posted its fourth consecutive monthly decline in September, although confidence indicators for the manufacturing industry and the services sector were stable (albeit at low levels). Industial production rose a surprising 1.9 percent in August (month-on-month, seasonally adjusted), but the Bank of Portugal's coincident indicator of economic activity for that month deteriorated slightly.

3. **According to preliminary estimates, harmonized consumer prices rose 2.5 percent year-on-year in August**. Core inflation, which excludes energy components and fresh unprocessed food products, was 1.8 percent. The gap between the Portuguese and the euro-zone annual inflation rates was 0.3 percentage points in August.

4. **Portugal's governing Socialist party was defeated in countrywide local elections held October 8.** The opposition Social Democrats won a majority of municipalities (158) compared to 109 won by the Socialists, and 41 won by other parties. The government has pledged to continue with its reform program despite the setback.

Statement by Arrigo Sadun, Executive Director for Portugal and Luis Saramago, Advisor to Executive Director October 14, 2005

We would like to start by thanking staff, on behalf of the authorities, for their comprehensive analysis and constructive attitude during these consultations. The well-balanced report stands broadly in line with the authorities' own views and priorities, while the Selected Issues paper is always welcome as a thought-provoking exercise.

Key points

- The Portuguese economy has been going through a period of slower growth and higher unemployment for the last few years, as it adjusts to the aftermath of a boom induced by first-wave EMU accession and to enhanced external competition.

- Recovering the growth momentum and thus advancing the long-term goal of real convergence towards the EU average will critically hinge on two major challenges: sustained fiscal consolidation and increased competitiveness.

- The new government, backed in Parliament by a strong single-party majority, stated its commitment to address those issues, through an appropriate medium-term fiscal strategy and a vast array of structural measures, already taken or under preparation.

- Fiscal policy, put forward in the Stability and Growth Program recently endorsed by the EU Council, aims for a deficit below 3 percent of GDP in 2008 and further less beyond, focusing on expenditure restraint and refraining from one-off measures.

- Structural action on several fronts – from the business environment to education and IT use – will seek to improve the country's competitive position, building on pillars such as the robust banking system, further strengthened in recent years.

Overview

After a recession in 2003, the Portuguese economy recovered somewhat in 2004, although with declining impetus from mid-year onwards. Accordingly, unemployment rose further, while inflation abated and macroeconomic imbalances intensified. Indeed, the contribution of net external demand to growth was negative, reversing the favorable trend of previous years and leading to an increase of external indebtedness. The recovery was therefore based on domestic demand, particularly private consumption, fueled by an increase of disposable income and a rise in private indebtedness, as real interest rates remained very low.

Developments in 2005 confirm a pattern of slow expansion, with subdued export growth, in a context of enhanced competition from inside the enlarged EU and other emerging countries. Such a pattern tends to be reinforced by the rise and increased volatility of world oil prices, as well as by the need for fiscal consolidation. This latter, together with wage moderation, is critical to lay the foundations for future sustained growth, which hinges also on structural reforms to enhance productivity and potential output – thus further allowing for the correction of imbalances.

Turning to staff's assessment of the current slowdown as "the slump that followed the bursting of the euro-adoption bubble", it does not seem to be appropriate. In fact, the idea of "bubble bursting" applies to very steep corrections, typically in asset prices, which occur in a short period of time and lead also to sharp adjustments to the real side of the economy. No such events have occurred in Portugal. Moreover, given the current economic regime shaped by monetary union, the correction of past excesses is likely to be rather prolonged.

Going for sound public finances

Rapid expansion over an extended period pushed current primary expenditures from 28.1 percent of GDP in 1990 to 39.4 percent in 2004[1]. As the EMU-induced effect of falling interest payments tended to wear-off, while that expansionary trend kept going, a sizeable deficit became apparent in 2001 (4.2 percent of GDP). In subsequent years, weakening economic activity weighed on revenues, prompting the authorities to use one-off measures of significant magnitude in order to keep the deficit below 3 percent of GDP, as required by the Stability and Growth Pact.

After taking office, last March, the new single-party majority government appointed an independent commission, headed by the Governor of the Bank of Portugal, to estimate the likely fiscal outcome for 2005. This commission concluded that, without policy changes, the deficit would reach 6.5 percent of GDP. That assessment reflected several corrections to the original budget, including more realistic assumptions and the rejection of one-off measures. These latter are perceived by the authorities as a palliative that masks the true dimension of problems, promoting a misguided sense that the worst has been overcome.

The authorities are determined to address the root causes of fiscal imbalances and have accordingly committed to refrain from one-off measures and to address the unsustainable level of current primary expenditures. However, in view of their high rigidity – about 87 percent of such expenditures could not be tackled without cumbersome changes to the legal framework – action on the revenue side became inevitable to get immediate results, as deemed imperative. Several measures were thus introduced – including a rise of the top VAT rate and a freezing of automatic civil service promotions – in order to bring the deficit down to 6 percent of GDP. According to available figures, this goal is within reach, benefiting among other factors from the significantly increased efficiency of tax administration.

Looking ahead, the authorities have pledged to reduce the deficit below 3 percent of GDP in three years, taking it further to 1.5 percent by 2009, as stated in the revised Stability and

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[1] As part of regular methodological reviews at the European level, the Portuguese Statistics Office recently issued a new series for the country's National Accounts. Ratios presented in this statement are based on the higher GDP figures resulting` from that review.

Growth Program endorsed by the EU Council on September 20. Fiscal targets for 2006 will benefit from the full effect of the VAT rate rise – together with a new income tax top rate and increases in fuel and tobacco taxes. Efforts will nevertheless focus on expenditures, particularly as regards social transfers and the wage bill, which accounted for most of past expenditure increases.

Measures in this context include, among others, an alignment of the social security regime for public servants with the general regime, a review of this latter, an audit-based reform of public administration, several efficiency-enhancing measures directed to the National Health System, a reform of local finances, preparation of a multi-year budget framework and heightened efficiency criteria for public investment, which is to be preserved. Finally, the authorities stand ready to take additional measures as necessary to abide by the deficit targets in case macroeconomic assumptions embedded in the Program do not materialize – as regards for instance GDP projections over the medium term.

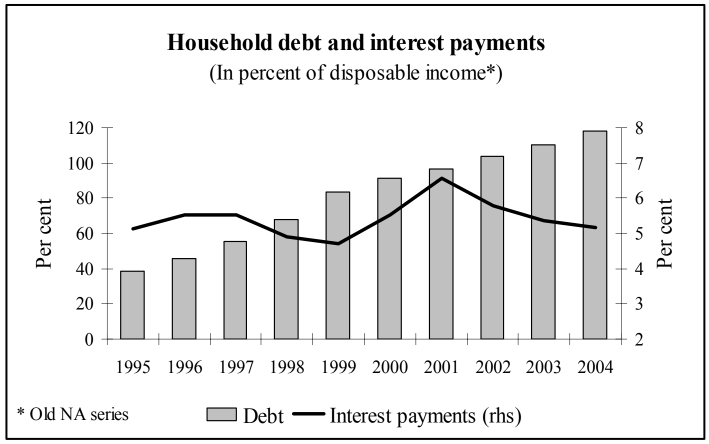
Tackling structural risks and weaknesses

Developments in the Portuguese economy since EMU was launched in 1999 illustrate the importance, for countries participating in a monetary union, of ensuring that fiscal policy is consistently able to play a counter-cyclical role. Such developments further demonstrate the cost, in terms of lost competitiveness and thus eventually output loss and unemployment, if wage increases are too much out-of-line with developments in other monetary union members. Indeed, that can only be sustained if productivity grows at a sufficiently strong pace to compensate for the wage differential, which is why the agenda for structural reforms currently envisaged by the authorities turns out to be so critical.

Although quite diverse in nature, as they encompass a vast array of relevant subjects, those reforms share a common focus on fostering productivity and potential output, by removing undue barriers to business, fostering capabilities and providing appropriate incentives to private agents. They touch upon education, the legal system, the energy sector, R&D, ICT use and the broad business environment, among other areas. Several specific measures have already been implemented, including the possibility of creating a firm in one hour, an increase in classroom time for teachers, enhanced competition to promote broadband internet use and simplified legal proceedings for low-value debt claims.

Staff rightfully points to inefficiencies in the business environment identified by the World Bank's *Doing Business Indicators* and its recent review of governance. That analysis is valued by the authorities but it should be seen together with other appraisals, such as for instance the *Global Competitiveness Index* recently published by the World Economic Forum for 2005. This ranked Portugal 22nd among 117 countries, up two places from last year and well positioned within the EU context.

Current levels of indebtedness in the Portuguese economy are a concern taken very seriously by the authorities, either in their capacity as policymakers or as financial regulators. Nevertheless, the issue must be put into perspective, on several grounds. **Public debt** rose from 51.2 percent of GDP in 2000 to 59.4 percent in 2004 and is only expected to start



declining by 2008. However, it is just now breaching the Maastricht criterion, stands below the euro area average and its spreads to relevant benchmarks remain at historically low levels. **Household debt** tripled as a percentage of disposable income in the last ten years, reaching one of the highest levels for OECD countries. And yet, household wealth stands at about 500 percent of the same disposable income and there is no evidence of significant asset price overvaluation. Credit growth slowed down markedly since 2001 and is overwhelmingly long-term and housing-related. Moreover, reflecting historically low rates, the interest burden is now about as heavy as it was a decade ago (see chart). **External debt** also rose steadily in the last few years, standing above 150 percent of GDP since 2004, in gross terms. Still, it is overwhelmingly expressed in euros, the Portuguese currency, and does not go beyond 40 percent of GDP in net terms.

Indeed, it should be stressed that participation in the euro area represented a fundamental regime change for the Portuguese economy regarding its external constraint and financing channels. The external imbalance is now financed in the common currency and therefore not constrained by the possibility of an exchange rate crisis. However, the solvency conditions arising from intertemporal budget constraints faced by individual agents remain as valid as before euro adoption. Thus, a persistent gap between the growth of domestic expenditure and that of income, financed by ever rising external indebtedness, is obviously unsustainable. This said, the unwinding of existing imbalances may take quite some time under the current regime. If the appropriate structural reforms are implemented and succeed in increasing the economy's growth potential, external imbalances may essentially be corrected through rising exports. Otherwise, the domestic savings rate will inevitably have to rise and domestic expenditure will need to be curbed, so as to serve a growing stock of external debt.

The above considerations suggest two additional remarks regarding the staff report. First, we believe that the exercises on external and public debt sustainability (Tables 4 and 5 of the report) are complementary and so should share the same baseline assumptions – which is not the case for GDP growth. Second, we further believe that several conventional indicators of external and financial vulnerability, adequate for small open economies with monetary sovereignty, become irrelevant or misleading for EMU members like Portugal. This is notably the case for such indicators as official reserves and external liabilities of the central bank, presented in Table 6 – one which would be better excluded from the report.

The Bank of Portugal remains alert, in the context of its responsibilities as supervisor of the banking system, to issues such as the concentration of credit risk in the housing sector. Yet, it should be stressed, as staff acknowledges, that broad developments in the banking sector continued to be rather positive. Indicators of solvability, liquidity and credit quality improved again in 2004, while profitability remained comfortable, amid an environment of strong competition. A similarly favorable pattern could be observed as regards the insurance sector, where cost-cutting, an improved balance of premiums to risk and the recovery of capital markets allowed for enhanced profitability. As the overall financial system stands solid, and preparations for regulatory changes such as the new IFRS and Basle II are on-track, the authorities look forward to receiving the first FSAP mission by year-end.

Portugal has endured sizeable shocks over the last decades, and yet managed to develop at a pace matched by few other countries in the world. There certainly seems to be no reason to think it will be different this time.

INTERNATIONAL MONETARY FUND
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October 19, 2005

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

IMF Executive Board Concludes 2005 Article IV Consultation with Portugal

On October 14, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Portugal.[1]

Background

Portugal has yet to emerge from the downturn that followed the bursting of the euro adoption bubble. A gradual domestic demand-driven recovery started in 2004, but activity weakened during the second half of last year amid ongoing concerns about competitiveness. Preliminary data show year-on-year GDP growth of 0.3 percent in the first half of 2005. Private consumption has proven resilient, reflecting low interest rates and lengthening tenors on bank lending, while investment and export growth remained weak. Meanwhile, the unemployment rate reached a seven-year high of 7.5 percent in the first quarter of 2005, before moderating slightly to 7.2 percent in the second quarter. Due in part to weak demand, inflation fell to just over 2 percent in the first half of 2005. Poor productivity growth has weakened external competitiveness. As a result, export shares shrank and the current account deficit (excluding capital transfers) widened to 7.2 percent of GDP last year.

[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.

High private indebtedness, especially among households, weak competitiveness, and planned significant fiscal consolidation are expected to constrain growth in the near future. Real GDP is projected to grow by about ½ percent in 2005 and 1¼ percent in 2006.

Extensive use of one-off measures kept the budget deficit within the SGP ceiling of 3 percent of GDP over the last few years. These measures, however, did not address the underlying source of fiscal problems: the steady rise in current expenditure over the last decade. After an independent audit forecasted a deficit of about 6½ percent of GDP this year without one-off measures, the authorities announced their intention to reduce the deficit below 3 percent of GDP without one-off measures by 2008. In July, a series of revenue measures—including an increase in the VAT rate—were introduced, with a view to reducing the 2005 deficit to 6 percent of GDP. Over time, expenditure measures, especially pension and civil service reforms, are expected to constitute the bulk of the adjustment effort. Some key elements of the consolidation effort remain to be defined, however.

Strong growth of bank lending to households, especially for mortgages, led to a continued increase in the private sector credit-to-GDP ratio, which reached about 144 percent by the end of 2004 (well above the EU average). The banking sector has, however, proven resilient to the economic downturn: indicators point to improved capitalization, solid profitability and low levels of Non-Performing Loans.

Executive Board Assessment

Executive Directors concurred that in an unfavorable context marked by large fiscal and external imbalances, slow growth, and a weak competitive position, the challenge confronting the Portuguese government is to create the conditions to restart Portugal's per capita income convergence toward the euro area average as soon as possible. Accordingly, Directors underscored the need to pursue sustainable fiscal adjustment and measures to improve product and labor markets, enhance the business environment, and strengthen human capital development. Directors welcomed the authorities' policy outlines in these areas, but called for early action in implementing them to build confidence and credibility.

Directors agreed that short-term growth prospects are not auspicious, owing to weak competitiveness, high private debt ratios, and the need for significant fiscal adjustment to reduce the public sector deficit. Most Directors welcomed the authorities' commitment to proceed with fiscal adjustment despite the weak economic outlook, agreeing that a determined consolidation effort is essential to lay the foundation for a resumption of growth and a reduction of the current account deficit.

Directors therefore commended the authorities' fiscal strategy, which emphasizes medium-term expenditure containment and sets an appropriately ambitious pace of adjustment. Directors noted that steady rises in the public wage bill and in pension spending in recent years have been at the heart of current fiscal difficulties; they thus supported the authorities' intention to focus measures on these items. Directors also supported the decision to largely abandon one-off measures, which they agreed have tended to create uncertainty about the true state of the public finances and to complicate future budget execution. They underscored that bringing the deficit below 3 percent of GDP by 2008 would strike an appropriate balance between the need to make rapid progress in reducing the deficit and the focus on longer-term reforms. Directors were encouraged by the authorities' willingness to take additional measures—ideally on the expenditure side—if needed to achieve the deficit targets.

Directors noted, however, that adjustment in 2005 has come primarily from revenue measures. They recognized that this is true in part because a number of key expenditure-side elements of the authorities' program are still being defined, including reforms of the public administration and of the retirement system for private sector workers. They stressed, however, that early definition and implementation of these bedrock spending reforms will be essential to distinguish the current adjustment effort from previous fiscal consolidation efforts, which had failed to produce durable gains. They considered that sufficient progress to allow these reforms to be reflected in the 2006 budget will be critical for the credibility of the consolidation effort.

Directors cautioned that the fiscal adjustment planned for the next four years is but the first stage of a longer process of deficit reduction that should aim at achieving overall budget balance. They noted that the looming rise in pension and health care spending from population aging underscores the need to find durable measures to improve the quality and efficiency of public expenditure. Directors agreed that greater use of Public-Private Partnerships could help raise spending efficiency, but cautioned that care will be needed to ensure that these transactions involve an appropriate transfer of risk to the private sector, that contracts and associated liabilities are recorded transparently (including in budget documents), and that commitments to make payments over time to private partners do not unduly constrain future budget flexibility. Directors supported the government's intention to consider reforms to local government financing arrangements—including possible binding expenditure limits—as these could help reduce medium-term fiscal pressures.

Directors stressed the need to pursue structural reforms that improve labor productivity and enhance competitiveness, and, ultimately, speed income convergence. In this respect, while recognizing that initiatives to promote research and development and information technology spending could play an important role in stimulating growth, they also praised ongoing and planned reforms to the education and training system and to the business environment. Directors stressed the important complementarities among these reforms. They were encouraged by recent measures to reduce the time required to open a new business, while noting that reducing delays in the legal system and accelerating the process of granting licenses and permits should remain a high priority. Directors stressed the need to enhance competition in key sectors like telecommunications and transportation, where relatively high costs undermine competitiveness.

Directors called on the authorities to pursue additional steps to raise labor market flexibility and improve the responsiveness of wages to productivity and skill differentials. They observed that restrictions on collective dismissals exceed the EU average, and those on individual dismissals are the tightest in the OECD. While recognizing that these restrictions are less binding in practice because of extensive use of temporary contracts and self-employment, Directors cautioned that such mechanisms can create a segmented labor market, with strong protection for some workers and considerable job instability for others. They noted that such conditions raise equity concerns and can hamper productivity growth by slowing the movement of protected workers from low-growth sectors to higher-growth ones.

Directors' welcomed the resiliency of the financial sector to the economic slowdown. They noted that banks have remained adequately capitalized and liquid, that profitability has been solid, and that the quality of banks' loan portfolios has remained broadly stable. Directors cautioned, however, about potential vulnerabilities arising from high household and corporate debt and the concentration of loans across sectors and enterprises. They therefore welcomed the authorities' commitment to continue to monitor developments carefully, to intensify oversight of risk management practices, and to undertake a Financial Sector Assessment Program this year.

Directors encouraged the authorities to actively support progress in multilateral trade liberalization under the Doha round, and to increase Portugal's overseas development assistance toward the UN target level of 0.7 percent of gross national income.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report for the Article IV consultation with Portugal may be made available at a later stage if the authorities consent.

Portugal: Selected Economic Indicators, 2001–06

	2001	2002	2003	2004 1/	2005 1/	2006 1/
Real economy (change in percent)						
Real GDP	2.0	0.5	-1.2	1.2	0.5	1.2
Domestic demand	1.7	-0.1	-2.6	2.2	1.7	1.3
CPI (year average, harmonized index)	4.4	3.7	3.3	2.5	2.3	2.5
Unemployment rate (in percent)	4.0	5.0	6.3	6.7	7.4	7.7
Gross national saving (percent of GDP)	17.8	18.2	17.9	15.9	14.7	15.4
Gross domestic investment (percent of GDP)	27.5	25.5	23.0	23.1	22.8	22.9
Public finance (percent of GDP)						
General government balance	-4.2	-2.8	-2.9	-3.0	-6.0	-4.5
Primary balance	-1.2	0.1	-0.1	-0.3	-3.2	-1.3
Public debt	53.6	56.1	57.7	59.4	65.6	66.6
Money and credit (end-period, percent change)						
Total domestic credit	11.6	6.5	1.7	4.5	...	...
National contribution to euro area M3 2/	6.8	-1.1	4.2	5.7	...	...
Interest rates (end-period)						
Deposit rate, up to 2 years 3/	3.3	2.9	2.0	2.0	...	...
Ten-year government bond yield	5.0	4.5	4.5	3.6	...	...
Balance of payments (percent of GDP)						
Trade balance	-11.9	-10.0	-8.7	-10.3	-12.0	-11.3
Current account (including capital transfers)	-8.8	-5.8	-3.2	-5.6	-6.5	-5.8
Net official reserves (in US$ billions, end of period)	15.3	15.9	11.5	10.7	...	...
Exchange rate						
Exchange rate regime	Euro-area member					
Present rate (August, 2005)	US$1.23 per €1					
Nominal effective rate (2000 = 100)	100.6	101.4	104.2	104.8	...	...
Real effective rate (2000 = 100)	102.5	105.0	109.1	109.9	...	...

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

1/ 2004 is estimate and 2005 and 2006 are staff projections.
2/ Excludes currency in circulation held by non-bank private sector.
3/ Data refer to new deposits for 2001–02 and to the stock of outstanding deposits thereafter. Before 2003 deposit rate with 91-180 day maturity is reported.