INTERNATIONAL MONETARY FUND

IMF Country Report No. 13/324

PORTUGAL

EIGHTH AND NINTH REVIEWS UNDER THE EXTENDED ARRANGEMENT AND REQUEST FOR WAIVERS OF APPLICABILITY OF END-SEPTEMBER PERFORMANCE CRITERIA

November 2013

In the context of the Eighth and Ninth Reviews Under the Extended Arrangement and Request for Waivers of Applicability of End-September Performance Criteria, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on November 8, 2013, following discussions that ended on October 3, 2013, with the officials of Portugal on economic developments and policies underpinning the IMF Extended Arrangement. Based on information available at the time of these discussions, the staff report was completed on October 25, 2013.
- **Press Release** including a statement by the Chair of the Executive Board.
- **Statement by the Executive Director** for Portugal.

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

Letter of Intent sent to the IMF by the authorities of Portugal*
Memorandum of Economic and Financial Policies by the authorities of Portugal*
Technical Memorandum of Understanding*

*Also included in Staff Report

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

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Price: $18.00 a copy

International Monetary Fund
Washington, D.C.

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October 25, 2013

EIGHTH AND NINTH REVIEWS UNDER THE EXTENDED ARRANGEMENT AND REQUEST FOR WAIVERS OF APPLICABILITY OF END-SEPTEMBER PERFORMANCE CRITERIA

EXECUTIVE SUMMARY

Discussions for the combined eighth and ninth reviews were delayed by a political crisis and marked by new adverse Constitutional Court rulings. Reflecting in part austerity and reform fatigue, tensions within the ruling coalition led to two prominent cabinet members tendering their resignations. The crisis triggered a government reshuffling, but uncertainty was compounded by concerns about the predictability of policymaking following new unfavorable Court rulings against an important public expenditure reform as well as steps to soften strict employment protection rules. These developments led to elevated sovereign yields, delaying the government's plans to follow up on successful bond issues earlier this year.

The near-term economic outlook has nevertheless improved somewhat, and progress has been made toward the program objectives. Recent economic data signal that the economy may have bottomed out. Remedial actions were taken to address delays in reforms due to the reorganization of the government. All end-June performance criteria and all but one structural benchmarks underpinning the review have been met.

Program review discussions focused on measures needed to keep the program on track. It was agreed that, in view of the now narrow path to full market access, adhering to the program strategy was critical to signal commitment to reforms and boost confidence. The fiscal targets were reaffirmed and fiscal measures were identified to underpin the targeted adjustment. Discussions also focused on steps to strengthen supervision in view of the still challenging conditions facing banks and on the structural agenda to boost competitiveness and growth.

Nonetheless, implementation risks are high, and political cohesion remains critical. Renewed tensions within the government need to be avoided, as they would delay the recovery and increase downside risks to the program. There is also a risk that new Constitutional Court rulings will further complicate policy making and heighten economic uncertainty. Decisive policy responses in case this risk materializes will be essential since the room for maneuver under the program has become limited.

Staff supports the authorities' request for completion of the combined eighth and ninth reviews and for waivers of applicability of the end-September PCs. The purchase released upon completion of this review would be in an amount equivalent to SDR 1679 million.

Approved By
Poul M. Thomsen and Kalpana Kochhar

Discussions took place over two visits to Lisbon during June 24–29 and September 16–October 3. The staff team comprised S. Lall and A. Selassie (heads), S. Ahmed, D. Gershenson, M. Goretti, H. Lin, and S. Roudet (all EUR); Y. Miao and R. Vermeulen (SPR); M. Poplawski-Ribeiro (FAD); C. Verkoren and E. Kopp (MCM); W. Bergthaler and H. Pham (LEG); and A. Jaeger and M. Souto (Res. Reps). I. Lopes (OED) also participated in meetings. J. Manning, U. Niman, S. Abebe and C. Piatakovas (all EUR) assisted the mission from headquarters.

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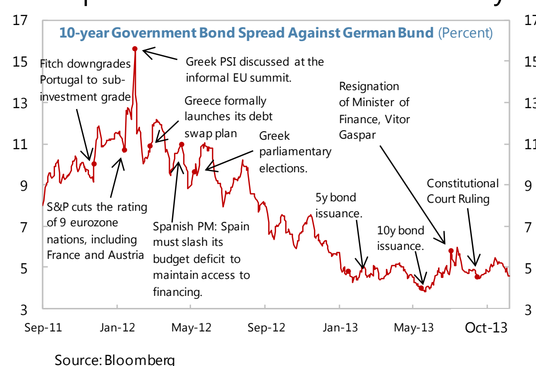
BACKGROUND

1. Discussions for the combined eighth and ninth reviews took place over June–October 2013 against the backdrop of some improvement in the macroeconomic environment but punctuated by a political crisis and Constitutional Court setbacks to key reforms:

- Reflecting in part disagreements with regard to the direction of economic policy under the economic assistance program, in early July tensions within the ruling coalition culminated in both the Finance Minister and the head of the junior coalition partner and Foreign Minister tendering their resignations. Avoiding general elections, a reshuffled government took office in late July, with the Foreign Minister elevated to the position of Deputy Prime Minister in charge of economic policymaking and program negotiations.

- In its third adverse decision on fiscal measures over the past year and a half, the Constitutional Court in August ruled against a key public expenditure reform, effectively limiting the government's scope to dismiss public sector employees. More recently, the Court also overturned labor reforms that had softened at the margin Portugal's rigid employment protection rules for dismissing individual workers with permanent contracts.

- Together with elevated global market volatility, heightened political and economic uncertainty drove government bond yields higher—with the 10-year sovereign yield peaking above 7½ percent. Despite some recent retrenchment in yields, markets remain wary of Portugal's ability to exit the current arrangement in May 2014 without further official support.



Source: Bloomberg

- Despite these adverse developments, progress has been made towards program objectives in the context of a somewhat improved near-term macroeconomic outlook. Output and employment surprised strongly on the upside in the second quarter, and recent high frequency indicators point to stabilization in activity and confidence, signaling that the economy may be turning the corner. Regarding the program, all end-June performance criteria were met.[1] The reorganization of the government generated some delays for which remedial steps were taken, and all but one of the six structural benchmarks underpinning the eighth and ninth reviews have now been met.[2] While some budgetary overruns and revenue slippages have emerged, corrective actions are underway, and the 2013 fiscal deficit target of 5.5 percent of GDP is within reach.

[1] The controlling PCs for the combined reviews are the end-September ones (originally, end-June) for which a waiver of applicability is requested.

[2] Progress has been made toward completion of the last structural benchmark on the public administration reform (see MEFP Table 2), but submission of the Public Administration Labor Law is expected to take place by end-October.

2. Against this background, discussions focused on measures needed to keep the program on track. There was agreement that adhering to the program strategy was a necessary pre-condition towards regaining full market access. Although the authorities initially were of the view that further loosening the programmed fiscal path—beyond what was already agreed at the time of the seventh review—could strengthen the tentative recovery underway, they eventually agreed that adherence to previously agreed program targets was critical to signaling their continued commitment to reforms. In light of this, fiscal measures were identified to underpin the targeted adjustment, and the draft 2014 budget together with supporting legislations were submitted to Parliament as prior actions for completion of the combined reviews. Beyond fiscal issues, discussions focused on actions to strengthen supervisory efforts in view of the still challenging conditions facing the banking system, and on the program's broad structural agenda to boost competitiveness and growth.

3. In the face of difficult tradeoffs, reasserting political cohesion will be critical to managing the high implementation risks under the program:

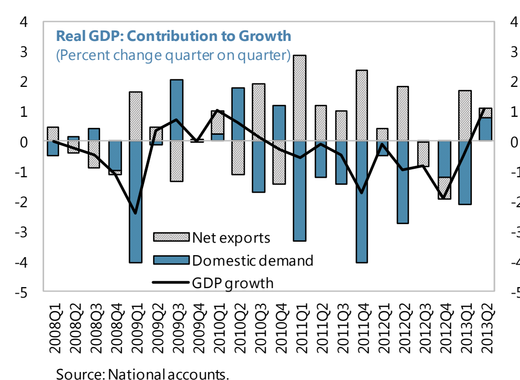
- *Political pressures*. The political crisis of the summer and recent local elections were reminders of the increased opposition to further consolidation and reforms. However, advancing politically and socially sensitive expenditure reforms remains essential to meeting the program's objectives and putting public debt on a firmly declining trajectory.

- *Challenges by the Constitutional Court*. Should critical fiscal measures once again be ruled unconstitutional, the government will need to reformulate the draft budget to meet the agreed deficit target. Given the limited room for maneuver, this will be extremely difficult and may imply again adopting lower-quality measures. These may in turn increase the risks to the recovery of output and employment, including by weighing on investment and confidence, but also lead to renewed political instability.

ECONOMIC DEVELOPMENTS AND OUTLOOK

A. Recent Developments

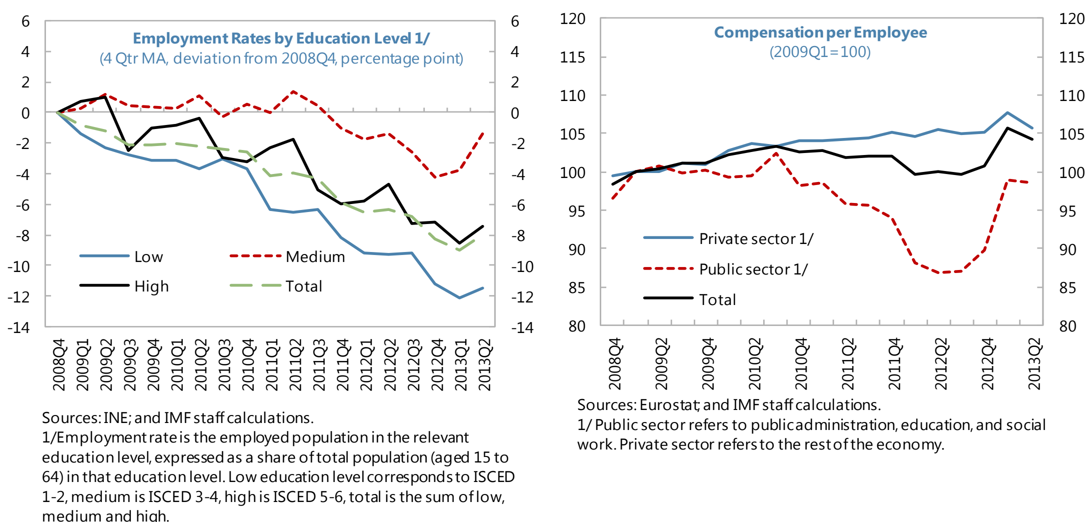
4. There are tentative signs that economic activity may have troughed. Output in the second quarter of 2013 expanded by 1.1 percent over the preceding quarter, against a projected contraction of 0.1 percent. This was underpinned by a pick-up in private consumption and investment, stock-building and strong export growth offset in part by imports. Consistent with this, employment increased by 0.8 percent on the previous quarter and the unemployment rate fell from 17.7 to 16.4 percent. Notwithstanding some one-off factors (e.g. early Easter and inclement weather in Q1), the better-than-expected performance was broad-based across



Source: National accounts.

demand components and came against the backdrop of a euro area-wide rebound. These patterns have been reinforced by more recent high-frequency indicators that point to a stabilization in activity, and suggest that the positive momentum of the second quarter may signal a bottoming out of the economic contraction.

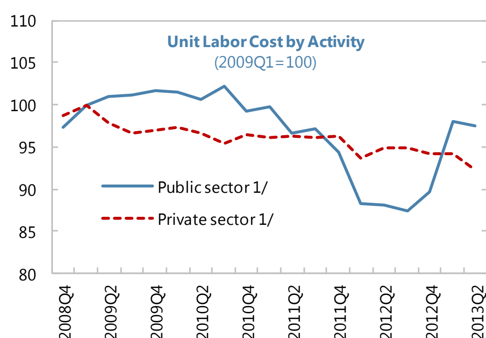
5. Notwithstanding the recent decline in the unemployment rate, its level remains high. Indeed, the level and duration of unemployment in Portugal remains one of the highest in the euro area despite a significant pick-up in outward migration. Labor market adjustment has to a large extent taken place through labor shedding, with employment 13 percent below its 2008 peak. The job retrenchment has been particularly concentrated in the lower-skilled segment of the labor market (see chart). The overall nominal wage reduction achieved so far has been mainly driven by developments in the public sector, most of which is being reversed this year due to the constitutional rulings, while overall wage flexibility in the private sector remains limited (see chart).



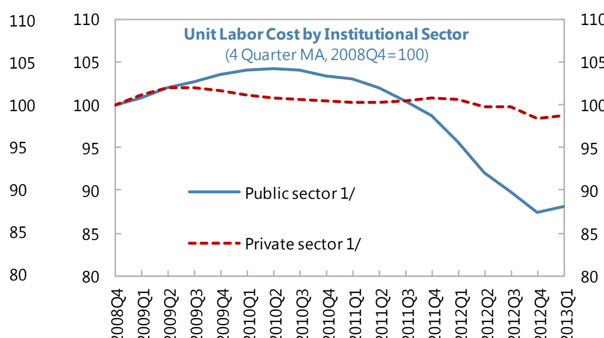
Sources: INE; and IMF staff calculations.
1/Employment rate is the employed population in the relevant education level, expressed as a share of total population (aged 15 to 64) in that education level. Low education level corresponds to ISCED 1-2, medium is ISCED 3-4, high is ISCED 5-6, total is the sum of low, medium and high.

Sources: Eurostat; and IMF staff calculations.
1/ Public sector refers to public administration, education, and social work. Private sector refers to the rest of the economy.

6. The correction of the external flow imbalance continues to take place at a faster pace than envisaged under the program. Export growth since the beginning of the year has been robust (over 4¼ percent year to date). This has been due to continued strong growth of exports of goods (3½ percent)—particularly for exports to non-EU countries (7½ percent) and exports of fuel and lubricants (6½ percent), the latter reflecting additional refining capacity—and an increase in the growth of exports of services (6¾ percent) underpinned by buoyant tourism receipts. With strong exports and stable imports over the first half of the year, the current account has continued to adjust more rapidly than envisaged under the program and is now projected to turn into a surplus of about 1 percent of GDP this year (previously projected at 0.3 percent of GDP) and stabilize at that level next year. The cumulative adjustment during 2009–14 would amount to some 12 percent of GDP.

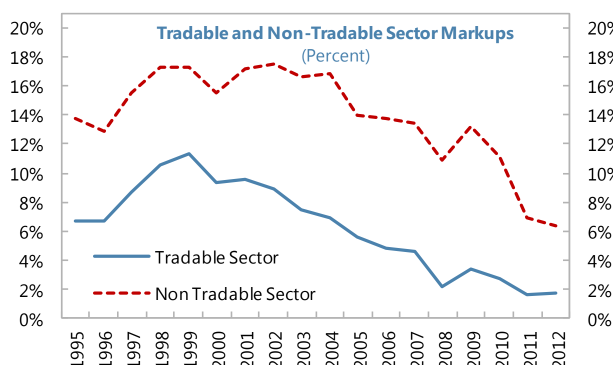


Sources: INE; DGAEP; Eurostat; and IMF staff calculations.
1/ Public sector refers to public administration, education, and social work. Private sector refers to the rest of the economy. Productivity for public sector and private sector is gross value added divided by employment.



Sources: INE; DGAEP; Eurostat; and IMF staff estimates.
1/ Public sector is defined as general government, and private sector is the rest of the economy. Productivity is real gross value added divided by employment.

7. **The improvement in cost-competitiveness indicators has lagged the current account adjustment.**[3] Economy-wide unit labor cost (ULCs) have decreased by about 4¼ percent since the peak in Q1 2009. However, this reflects mainly developments in the public sector, particularly the cuts in the 13th and 14th month salaries, which are now being reversed (see chart). Staff estimates that ULC adjustment in the private sector has been limited—although less so in the tradable sector, reflecting mainly labor shedding (see Box 1). Tradable sector profitability still needs to recover from relatively low levels (see chart), which in part reflect higher cost of capital and sticky network and other domestic input prices.



Sources: INE; Eurostat; and IMF staff estimates.

B. Outlook

8. **Activity is projected to remain stable for the remainder of this year before picking up gradually in 2014.** For this year as a whole, the economy is now expected to contract by 1.8 percent (0.5 percent of GDP less than projected earlier), with unemployment now projected at 17.4 (against 18.2 percent previously). The recovery is expected to gather momentum very gradually over the course of next year, driven by continued positive contribution of net exports and strengthening private investment, conditioned on the continued alleviation of uncertainty and a sustained improvement in confidence. Average growth is projected at 0.8 percent for 2014 as a whole and unemployment peaking at 17.7 percent.

9. **The medium term outlook remains broadly unchanged, with growth gradually increasing to near its underlying potential of 2 percent by 2017.** The contribution from the net foreign balance is now projected to be some 0.2 percentage point higher over the medium term, in

[3] See also Appendix IV in IMF Country Report No. 13/160.

light of the solid export market share gains—especially outside the European Union—in recent years, and given the sustained headwinds to domestic demand expected as public and private sector balance sheets continue to deleverage.

10. The risks to the revised baseline remain significant. On the domestic front, a renewal of political uncertainty or further Constitutional Court rulings against key reforms could complicate reform efforts and undermine confidence. In addition, there remains a risk that deleveraging of private and public balance sheets could curtail growth even more than projected under the baseline. Externally, there remains considerable uncertainty surrounding the strength and durability of the recovery in Europe, which has first-order implications for Portuguese exports. Changes in the U.S. monetary policy stance could also put upward pressure on long-term sovereign yields—as already experienced at the end of May—and tighten domestic financing conditions further. Finally, with only modest improvement in external cost-competitiveness indicators, there remains a risk that ongoing reforms will not provide sufficient impetus to reallocate resources from the nontradable to the tradable sector to avoid a return to slow growth and rising external stability risks.

ADVANCING FISCAL CONSOLIDATION

A. Recent Fiscal Developments

11. The end-June fiscal performance criteria were met comfortably, but achieving the 5½-percent of GDP deficit target in 2013 required additional measures.[4]

- Although the end-June performance criteria on government deficit and debt were met by a comfortable margin, a number of budgetary execution challenges have since emerged, generating a fiscal gap of about 0.8 percent of GDP (see text table). These reflect a combination of one-off factors—the postponement of the Lisbon port concession and shortfalls in EU structural funds—and permanent pressures, including higher contributions to the EU budget and overruns on wages and intermediate consumption, as well as lower-than-budgeted contributions to the public pensions scheme (CGA).

Projected Budget Execution, 2013 1/
(Percent of GDP)

Shortfalls and pressures	-0.8
Temporary	-0.2
Port of Lisbon concession	-0.1
EU funds	-0.1
Permanent	-0.6
EU budget	-0.2
CGA contributions	-0.1
Expenditure overruns	-0.1
Other	-0.1
Measures	0.8
Temporary	0.7
Provisional allocation	0.3
Debt recovery scheme	0.4
Permanent	0.1
Reduction of funds	0.1

Sources: Portugal Authorities; and IMF staff calculations.
1/ Excluding the increase in the share capital of BANIF (€700 milion).

- To reach the 5½-percent program deficit target, funds available to line ministries during the remainder of the year have been reduced, a permanent measure that will save 0.1 percent of GDP. In addition, the deployment of the provisional allocation—a standard

[4] The increase in share capital of BANIF bank (for €0.7 billion or 0.4 percent of GDP), an operation carried out as part of the bank's recapitalization under the program's banking sector support strategy, is excluded from the program definition of deficit (see TMU ¶7).

budgetary buffer—of 0.3 percent of GDP, and a one-off tax and social security contribution debt recovery scheme, which is expected to generate 0.4 percent of GDP in revenue, are projected to close the gap.[5]

12. The debt peak has been revised up, and the debt outlook remains precarious (see Annex). Debt will now peak earlier (in 2013) and at a higher level (close to 128 percent of GDP) than was initially projected. The decline in the debt-to-GDP ratio in 2013 envisaged in the seventh review was underpinned by two large one-off transactions and by extensive use of the government's cash reserves. One of those transactions, the transfer of the shares of public bank CGD to Parpública (a state-owned enterprise that is outside the general government perimeter), has been suspended, while the other, the reallocation of the Social Security portfolio from foreign assets to government securities, has been postponed. In addition, the government now intends to maintain a larger cash buffer than was projected in the seventh review. Looking forward, and as in other EU countries, the upcoming introduction of the ESA 2010 accounting rules in 2014 may lead to the inclusion of certain state-owned enterprises that are currently outside the general government perimeter. However, this is not expected to lead to a large increase in debt owing to offsetting factors.

13. Some delays were encountered in the implementation of the Public Expenditure Review (PER) reforms, reflecting the adverse Constitutional Court ruling over the summer as well as the difficulty of building political consensus around some measures. Some of the related structural benchmarks were met on time (see MEFP, table 2), and others were delayed by the reconfiguration of the government. Nonetheless, all but one have now been met. The Constitutional Court ruling in August against the dismissal of public employees under a requalification scheme also forced the government to alter the proposed scheme.[6] The direct fiscal impact (0.1 percent of GDP) of the changes is estimated to be relatively limited, but there is a risk that they could reduce incentives for dismissals under the voluntary separation scheme.

14. The authorities have launched a comprehensive Corporate Income Tax (CIT) reform. Following the limited CIT tax credit extended to new investments earlier this year, a comprehensive CIT reform has been announced. The key objective is to boost investment and growth. The reform consists in simplifying the CIT regime through a broadening of the tax base, the gradual lowering of the rate from 31 to around 18 percent by 2018, and the rationalization of incentive schemes. The reform also focuses on steps enhancing legal stability, lowering compliance costs, aiming at reducing litigation, and reducing policy-induced debt bias. In addition, measures are proposed to improve the international competitiveness of the tax and strengthen the territorial approach through measures such as the adoption of a universal participation exemption regime (while

[5] The debt recovery scheme grants waivers on accrued interest, enforcements costs, procedural fees, and cash penalties to the taxpayers that settle their tax (PIT, VAT, CIT) and social security contributions debt. The principal debt will not be waived.

[6] The scheme was to be used to facilitate termination of contracts in the public sector thus helping reduce the public sector workforce.

respecting international standards). The cost of the reform is expected to be minimal in 2014—as the first few CIT installments will be based on the 2013 payments.

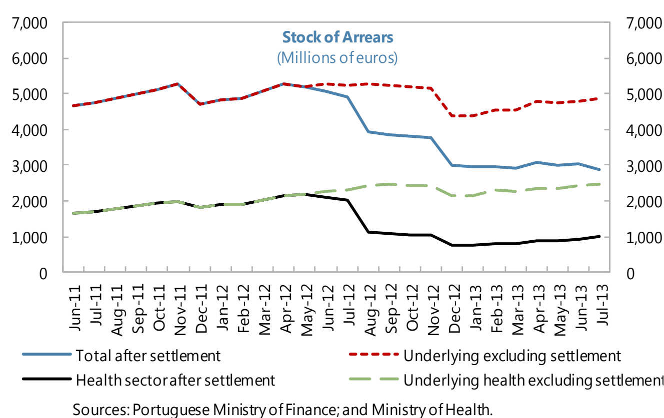
15. Fiscal structural reforms are advancing well, but the authorities continue to face difficulties in controlling arrears in the health sector:

- *Revenue Administration*. Efforts to improve compliance are ongoing. Key projects include a VAT invoicing reform and providing a VAT cash accounting option. A number of PIT compliance initiatives are also being implemented.

- *Local and Regional Finances*. The Regional and Local Finance Laws were approved by Parliament in September. They are expected to improve the inter-governmental fiscal framework by extending the Budgetary Framework Law principles to subnational governments, tightening indebtedness rules, and improving coordination with the central government.

- *Public Financial Management*. A Reform Unit has been set up within the Ministry of Finance (MoF) to undertake a review of the Budgetary Framework Law (BFL) and underlying PFM processes. This unit is preparing an action plan to implement (i) further amendments to the BFL; (ii) a new organizational structure of the MoF and line ministries; and (iii) changes to the budget classification structure.

- *Expenditure Controls and Arrears*. Although the new expenditure commitment control system is operational in most budgetary entities, domestic arrears have continued to accumulate during the first semester, breaching the related continuous indicative target.[7] This was mainly due to developments in the health sector, where arrears have been caused by inadequate budgeting, expenditure control weaknesses, and delays in payments made by SOE hospitals to pharmaceuticals, reflecting ongoing negotiations over debt settlements.



Sources: Portuguese Ministry of Finance; and Ministry of Health.

- *Public-Private Partnerships (PPPs)*. The MoF's PPP unit is operational. It has been tasked with enhancing fiscal transparency, notably by improving reporting on PPPs, and advising line ministries and other government entities on PPP issues, with a view to ensuring fiscal sustainability. The government has also launched a major renegotiation of road PPPs, with the objective of generating permanent savings by revising the scope of contracts and the private

[7] The actual stock of arrears stood at 1.8 percent of GDP at end-June 2013. The underlying stock of arrears (i.e. before the settlement program) declined by €700 million in the fourth quarter of 2012, but increased again in the first semester of 2013 by €400 million.

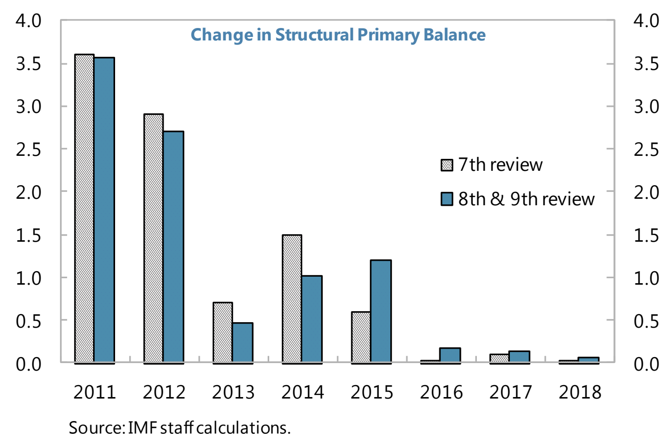
partners' internal rates of return. Agreements have been reached with most concessionaires, and provided the authorities' timeline is respected, savings of some €300 million would be generated in 2013.

- *Tax Courts***.** The number of pending high value tax court cases (above EUR 1 million) has been significantly reduced due to the deployment of special task forces of judges since 2011. There continues to be a slight increase in the number of tax court cases overall and options on how to address this issue are being explored.

16. The financial performance of SOEs has improved, and the privatization program is advancing. Cost-reduction efforts and voluntary redundancy programs brought SOEs closer to operational balance in the first half of 2013.[8] About half of the outstanding derivative contracts of SOEs (in mark-to-market terms) have been resolved to date, further reducing related costs and risks. Although the privatizations of the airline, TAP, and the rail cargo firm, CP Carga, are still on hold, the sale of the airport operator, ANA, has been completed, and total privatization proceeds are now above the initial program target.[9] Pending changes in the legal framework for postal services, the privatization process for the postal company CTT has been launched. A strategic plan for the water and waste sectors has been prepared with a view to improving their efficiency, including by introducing private capital and management in the system. Binding offers for the sale of the waste management business are now expected in the first quarter of 2014. Opening water concessions to private capital and management is expected to take longer.

B. Policy Discussions

17. The 2013 fiscal deficit target is within reach, but the structural effort is projected to be lower than initially planned. The additional measures introduced by the authorities are expected to be sufficient to narrow the deficit to 5.5 percent of GDP in 2013 (5.9 percent of GDP including BANIF's recapitalization costs). Staff cautioned against excessive reliance on temporary measures and, in particular, against the risks of distorting tax compliance incentives by introducing the debt recovery scheme. The authorities in turn stressed the temporary nature of some of the shortfalls and the difficulty of finding permanent measures so late



Source: IMF staff calculations.

[8] SOEs would indeed have registered a small surplus in the absence of the reinstatement of the 13th and 14th month salaries.

[9] The sale of TAP has been on hold, after the initial privatization plan fell through at end-2012 due to inadequate financial assurances by the final bidder. The privatization process has been postponed, but will be re-launched in the near future. The privatization of CP Carga has also been postponed with a view to maximizing market value while restoring its operating balance.

in the year. They also publicly announced they will not have recourse to new debt recovery schemes in the future and committed to tightening incentives for criminal offenders to limit the impact of the scheme on future compliance (MEFP ¶11). The use of one-off measures, however, together with the improved macroeconomic outturn is projected to reduce the primary structural adjustment in 2013 to some 0.5 percent of GDP—compared with the 0.7 percent of GDP envisaged in the seventh review—bringing the cumulative structural effort over 2011–13 to 6¾ percent of GDP.

18. The government deficit target of 4 percent of GDP for 2014 was reaffirmed. The authorities initially felt that a loosening of the fiscal objective was warranted to reduce the fiscal drag in the face of a tentative economic recovery, but ultimately concurred with staff's view that (i) the economic case for a revision of the deficit target was weak in light of the improved economic outlook, the high and still increasing level of public debt, and the difficult financing conditions; and (ii) repeated adjustments of the program targets would erode credibility already shaken by this summer's political turmoil, especially in view of the remaining large fiscal adjustment ahead (see below). Against this background, they acknowledged that the structural adjustment in 2013 was relatively modest and needed to be stepped up. While recognizing that the gross debt trajectory had been ratcheting up since the beginning of the program, the authorities pointed to the significant cash buffers and the lower debt expressed net of government deposits (projected at 121 percent of GDP at end-2013). The authorities also agreed with staff that clear communication would be required to avoid the risk of markets misinterpreting the possible ESA accounting changes and their impact on the debt numbers.

Fiscal Measures, 2014
(Percent of GDP)

Public Expenditure Review	1.7
Wage bill	0.6
Voluntary separations and special mobility	0.1
Single wage scale	0.3
Attrition	0.1
Other 1/	0.1
Pensions	0.4
Increase in retirement age	0.1
Equality between public and private sector regimes	0.2
Means testing of survivor pensions	0.1
Sector-specific measures 2/	0.9
Upfront costs of voluntary separations (one-offs)	-0.1
Other	0.6
Revenue	0.4
One-off	0.2
Total	2.3

Sources: Portugal authorities; and IMF staff calculations.
1/ Including 40-hour week and higher contributions to the health insurance plan.
2/ Includes impact of EU funds top-up mechanism.

19. Further significant structural adjustment will be needed in 2015 and beyond. The 4-percent of GDP deficit target entails structural primary adjustment of about 1 percent of GDP in 2014. Additional structural primary adjustment of roughly 1 percent to GDP will be needed to reach the 2015 overall deficit objective of 2½ percent of GDP. Further structural primary adjustment of about 1 percent of GDP will be needed after 2015 to reach the fiscal compact objective (an assumption not built into the staff's baseline scenario). Staff's baseline assumes no reversal of permanent measures, and the gross measures needed are projected to be broadly in line with the required structural primary adjustment.

20. The adjustment in 2014 will largely be achieved through a permanent reduction in expenditure. The authorities confirmed that the bulk of the adjustment measures would be drawn from the PER package identified at the time of the seventh review.[10] A number of additional measures were identified during the mission.

- *PER*. Following the wide-ranging consultations with all stakeholders, the net yield from the PER package in 2014 has been maintained at 1.7 percent of GDP.[11] The composition of the package, however, has changed: the yield from the horizontal measures (cross-cutting reforms of wages and pensions) has been reduced by almost a half (to 0.9 percent of GDP), with higher sector-specific savings—which mainly include targeted nonrenewals of fixed-term contracts and cuts in intermediate consumption—picking up the slack (see text table). Staff regretted this rebalancing, as implementation of horizontal measures is easier to enforce, monitor, and maintain. The authorities noted that the change in the composition of the package reflects for the most part the need to take into account (i) the Constitutional-Court-induced adjustment to the requalification scheme, (ii) the elimination from the package of the sustainability contribution on pensions—discussed in the seventh review and expected to yield about 0.3 percent of GDP in savings—due to strong political opposition, and (iii) greater discretion given to line ministries to identify spending cuts in order to generate stronger ownership.

- *Additional measures*. In view of the negative carry-over from the 2013 budget execution of 0.4 percent of GDP, and the need to rebuild the 0.3-percent–of GDP budgetary buffer used to meet the 2013 deficit target, additional measures of 0.6 percent of GDP are being introduced (see text table). Permanent measures account for almost two thirds of the total and are revenue-based (MEFP ¶6). Although the mission emphasized the need to strictly limit recourse to temporary measures to boost credibility, the remaining measures (0.2 percent of GDP) are one-offs, exceeding the one-off upfront costs associated with voluntary separations in the public service by about 0.1 percent of GDP.

The legislation underpinning the expenditure reforms and other agreed fiscal measures have been submitted to Parliament.[12] In particular, the draft 2014 budget (including the single wage scale reform) and the draft legislation to implement an effective one-year increase in the retirement age were submitted as prior actions for the completion of the review.

[10] The PER package was designed to address key weaknesses in Portugal's public finances: large size of the public sector and disproportionally high public sector wages and pensions. For a detailed discussion see IMF Country Reports 13/160 and 13/65.

[11] Net of reduced income tax and social security contributions and of upfront costs (severance payments to support voluntary separations from public service).

[12] This includes most of the public administration measures under the PER, aimed at reducing the size of the public sector workforce and at aligning the current public employment regime to the private sector rules. The legislative proposal on the alignment of the rules and benefits of the public sector pension fund (CGA) to the general pension regime was also submitted to Parliament.

21. The authorities are designing the expenditure reform program so as to limit legal risks. Staff expressed concerns regarding the legal risks surrounding fiscal consolidation and the fact that the constitutional challenges thus far entailed strong constraints in addressing deep rooted weaknesses of Portugal's public finances—such as the large size of the public sector and relatively high wages and pensions, sometimes forcing the adoption of lower quality measures. The authorities stressed that the measures were being designed to conform to the Constitutional principles of equality (fair burden-sharing) and proportionality (ensuring that no one is made to experience an undue hardship). In addition, should there be doubts about the constitutionality of specific PER measures, prior review by the Constitutional Court is possible before they are promulgated (MEFP ¶7), allowing for early reaction on the part of the government. Should some of these reforms be determined as unconstitutional, the authorities have also committed to finding alternative measures in order to meet the agreed deficit target. However, it was clear that, in view of the narrowing range of options, this would be a difficult task, especially given the need to avoid lower quality measures, and hence increased risks to the recovery of growth and employment.

22. The mission highlighted a number of areas of the fiscal structural reform agenda where additional efforts are warranted.

- Staff expressed concerns about the lack of control over domestic arrears, particularly in the health sector. With negotiations between SOE hospitals and pharmaceutical companies finalized in September, the authorities were confident hospitals would rapidly be able to regain control over the flow. Nonetheless, staff stressed that more effort was needed to ensure appropriate budgeting, control mechanisms, and effective implementation of cost-saving measures in the health sector.

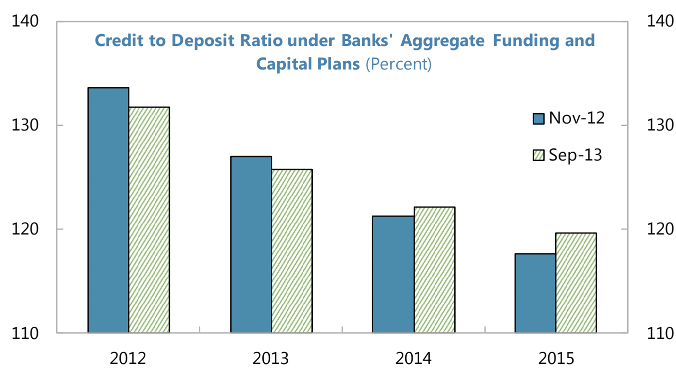
- Although progress is being made to strengthen tax compliance, there is also room to strengthen ongoing initiatives and to extend them to VAT. The establishment of a permanent Compliance Risk Management Unit to enhance the analytical and strategic capacity of the revenue administration now needs to move from the planning to the execution phase. In addition, greater use of the anti-money laundering framework could further support revenue collection.

23. The CIT reform could help boost investment and growth, but needs to be implemented with caution. Staff recommended prudence in estimating the potential growth benefits of the reform. Staff was also concerned about the limited fiscal space and the risk that the reform could favor nontradable sectors that tend to be structurally more profitable than the tradable sector. The authorities committed to implementing the reforms in a sectorally neutral manner and within the existing budgetary envelope. This will imply identifying offsetting measures starting in 2015.

SAFEGUARDING FINANCIAL STABILITY

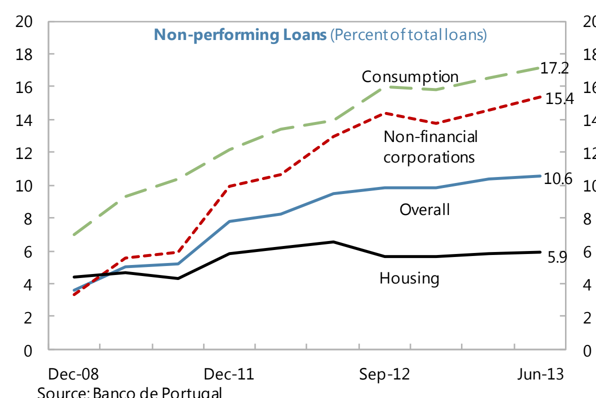
A. Recent Financial Developments

24. Restructuring plans are being finalized for banks that received state aid. Negotiations between the main aided banks, the European Commission (DG Competition), and the Ministry of Finance, have been recently concluded.[13] Despite the significant restructuring efforts being targeted, the banks' latest round of funding and capital plans indicates that the pace and composition of the envisaged adjustment in banks' balance sheets would remain in line with the program's domestic deleveraging path and macro-financial framework (seventh review, MEFP ¶21). In particular, banks have been given the possibility to count, towards the deleveraging targets set by DG Competition, non-core assets under divestment and part of the balance sheet adjustment already achieved before the state aid injection.



Source: Banco de Portugal.

25. However, despite ongoing restructuring efforts, challenging domestic conditions continue to weigh on banks' profitability. The eight largest banks recorded net losses of some €900 million during the first half of 2013, driven by declining net interest income and elevated credit impairments, in part due to the recent credit review by the BdP (see below). Nonperforming loans (NPL) increased to 10.6 percent for the banking system as a whole (from 9.2 percent at end-June 2012)—mainly reflecting the deterioration in banks' corporate loan portfolios. Nevertheless, banks' capital ratios have continued to comply with the more demanding program requirements, with the banking system showing a Core Tier 1 ratio of 11.9 percent.[14]



Source: Banco de Portugal

26. Against this backdrop and despite adequate liquidity buffers, credit conditions remain tight. In the context of stable deposits, banks' Eurosystem exposure stood at around €53 billion, at end-August, with a comfortable collateral buffer of about €30 billion covering over one year of

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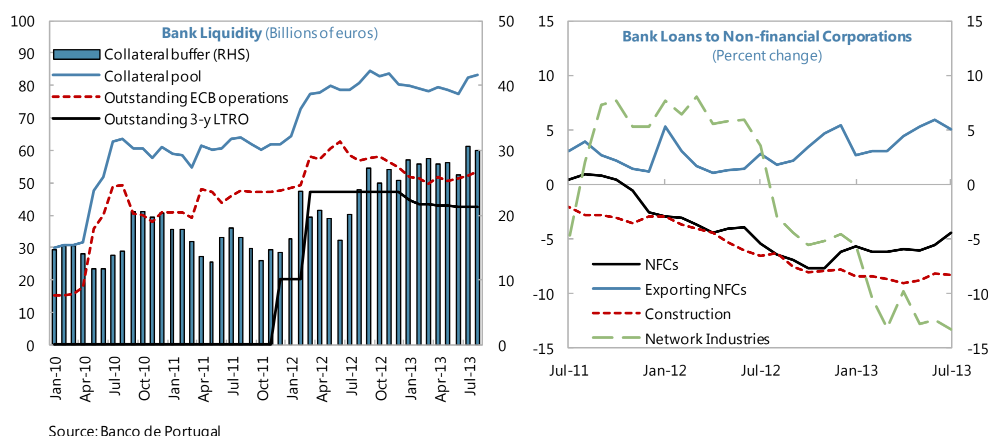
[13] See also European Commission - IP/13/738 24/07/2013. The restructuring plan of Banif, a smaller bank recapitalized in early 2013, is expected to be finalized over the next few weeks.

[14] While banks' capital buffers have materially benefited from the recapitalization operations carried out in 2012 and early 2013, subsequent improvements can also be attributed to the steady reduction in risk weighted assets.

banks' refinancing needs. However, despite improved liquidity conditions, weak banks' profitability has continued to exert pressure on lending rates. The adjustment of balance sheets however has remained consistent with the necessary economic rebalancing. In particular, while credit to the nontradable sectors—notably construction, energy, and commerce—has continued to contract sharply by some 10 percent as of end-July 2013, credit by domestic banks to exporting companies continues to gradually improve.



Source: Banco de Portugal

27. Overall, however, the highly-indebted segments of the economy are deleveraging only gradually. Household debt restructuring is progressing, especially through the general regime, with about €7.5 billion in credits restructured by end-June 2013. However, deleveraging by nonfinancial companies has started to gain more traction only very recently. This process has been partly facilitated by the number of in-court insolvencies and out-of-court debt restructurings.[15] However, while according to a recent stakeholders' survey conducted by the Minister of Economy the current legal toolkit appears adequate,[16] companies do not seem to be entering the debt restructuring framework early enough to effectively improve their recovery prospects, calling for more efforts to promote early access to these instruments.

B. Policy Discussions

Banking Supervision

28. In view of ongoing pressures on the banking system, there was agreement on the need to vigilantly supervise the banking sector. Staff welcomed Banco de Portugal (BdP)'s ongoing

[15] About 5,000 processes entered the courts per quarter since 2011Q4, including about 600 overall invoking the new PER instrument. Creditors and debtors have also started to use the recently established out-of-court procedure mediated by the SME development agency, IAPMEI (the so-called SIREVE), with about 275 cases entering as of end-August 2013.

[16] To increase the number of well-qualified insolvency administrators, the government recently adopted a temporary regime to train new insolvency administrators, ahead of the set up of the new supervisory authority, CAAJ, when a formal competition for new insolvency administrators will be launched.

supervisory activities, also given their important role in preparing the banking system for the forthcoming initiatives at euro-area level:

- *Credit Impairment Review.* Following the on-site inspection programs that were completed in 2011 and 2012, the eight largest banks have been subject to a third credit impairment review over the summer. The audit was conducted by an external consultant under BdP's supervision, with the participation of the banks' external auditors and focused on (i) the verification of current impairment levels for a broad sample of credits, notably high-risk exposures; (ii) a follow-up of the findings identified in the previous on-site inspections on collective impairment; and (iii) an assessment of management and fair value calculation of the participation units held by the banks in restructuring funds. Staff reviewed the impairment deviations identified by the audit in each of these areas—overall amounting to €1.1 billion and already fully reflected by their participating banks in their end-June results—as well as the resulting recommendations issued by the BdP and currently being incorporated in the banks' internal models.

- *Supervisory Standards and Communication Strategy.* The BdP has launched a new communication strategy aimed at proactively enhancing transparency (notably in English) on its supervisory standards and activities, building on the recent on-site inspection programs and credit impairment review. As part of these efforts, it plans to publish on its website detailed guidelines on the minimum standards for the calculation of credit impairments—including on collateral valuation—applied to all Portuguese banks to ensure sufficiently conservative and comparable approaches for measuring impairments. Moreover, the BdP has established additional disclosure requirements, as part of the banks' information disclosure to the public, on restructured loans.

29. Efforts by the BdP to further strengthen the banks' quarterly stress tests under the program were also deemed critical to assess bank's resilience. In collaboration with EC/ECB/IMF staff, the BdP has recently recalibrated the credit risk model used to provide methodological guidance to the banks for their quarterly bottom-up exercises. As a next step, it was also agreed that a new top-down methodology, currently under development by the BdP, will be used as a way to more systemically challenge banks' bottom-up projections. The BdP intends to implement the various enhancements by the time of the coming stress test exercise, to be discussed as part of the next review (MEFP ¶18). Resources from the Bank Solvency Support Facility remain available to provide support to the banking system should further capital needs emerge—even though the BdP will continue to encourage banks to first seek private solutions.

30. Banks' capital requirements under the program have been recalibrated to ensure consistency with the legal developments at EU level. In line with prospective requirements included in the CRD IV package, the 10 percent Core Tier 1 baseline requirement under the program will be replaced—as of January 1, 2014—by a 7 percent Common Equity Tier 1 capital requirement, to be computed considering all the transitional provisions (MEFP ¶19). In parallel, measures will be taken to ensure that banks maintain current capital buffers to (i) allow for future loss absorption;

(ii) offset the gradual phase-in of regulatory adjustments; and (iii) ensure compliance with the July 2013 EBA Recommendation on the preservation of capital as well as any future initiatives.[17]

Private Sector Deleveraging

31. The authorities remain committed to promoting an orderly deleveraging process, under a three-pronged strategy:

- *Facilitating continued access to credit to viable firms:* While banks have been able to reduce significantly their exposure to the Eurosystem during this year, the continued provision of exceptional liquidity at long maturities plays a critical role in preventing a supply-driven credit crunch. In parallel, the government has made available this year two tranches of government guaranteed credit lines totaling €3 billion, with another €2 billion under consideration for 2014. However, the authorities agreed that the extension of new guarantees should take place in the context of an in-depth review of the national guarantee system (NGS) aimed at minimizing risks for the State, given the associated contingent liabilities (Box 2 and MEFP ¶23).[18]

- *Promoting alternative funding sources:* As part of the authorities' initiatives to promote access to capital markets, notably for SMEs, possible changes to the regulatory environment applicable to the commercial paper market to facilitate its expansion among a wider investor base are currently under discussion (MEFP ¶23). In parallel, the authorities are discussing with their European partners further initiatives to support funding conditions, including potential mechanisms to securitize SME credit as well as banks' high-quality mortgage portfolios.

- *Reducing information asymmetries:* Given the important role played by credit bureaus in providing the necessary information to assess firms' credit standing and thus facilitating the link between creditors and borrowers, the BdP is implementing a number of improvements and regulatory changes to the Central Credit Registry (CCR). As of January 2014, this will include additional information on restructured loans and, as of July 2014, additional information on guarantees and collaterals (MEFP ¶24). Moreover, the BdP is assessing available options, in consultation with the Portuguese Data Protection Authority, to allow banks to have access to company-specific data from the corporate balance sheet database as well as historical information on credit from the CCR.

32. At the same time, staff stressed that more efforts are needed to step up banks' restructuring efforts. In the context of continuing financial fragmentation and structurally low profitability, highly leveraged nonfinancial firms continue to pose significant risks to the domestic banking system. Addressing the corporate debt overhang is therefore essential to reduce downside

[17] In addition, the authorities have recently submitted to Parliament the necessary amendments to the recapitalization law to reflect the recent Banking Communication from the European Commission; and remain committed to swiftly transpose the new EU Directive on bank recovery and resolution once it has been formally adopted.

[18] The government has also recently announced new EIB operations for €1 billion, to be focused primarily on banking loans to the export sector, supported by a state counter-guarantee.

risks to growth, support credit flow to the viable segments of the economy, and buttress financial stability. Moreover, effective corporate restructuring is key to facilitate the much-needed re-allocation of labor and capital resources from the nontradable to the tradable sectors. While the enhancement of the legal framework, for both in-court and out-of-court procedures, is now completed, early utilization to the new restructuring tools remains unsatisfactory. In this context, staff considered critical the BdP's stepped-up efforts to ensure that the banking system engages in a timely manner with troubled debtors, before their viability is in jeopardy. In particular, staff welcomed the special assessment program recently initiated by the BdP on banks' loan restructuring and asset recovery processes (MEFP ¶17). The special program, which benefits from external expertise, is expected to be completed by early November 2013 and will be complemented by a broader survey of the Portuguese regulatory framework, including any remaining gaps and bottlenecks.

BOOSTING COMPETITIVENESS AND GROWTH

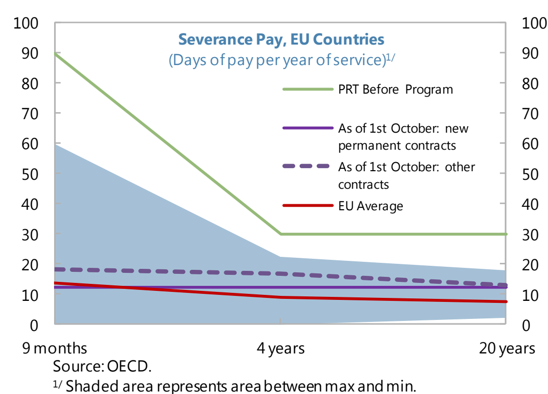
A. Recent Structural Developments

33. Structural reforms are advancing, in spite of setbacks in some areas:

- *Competition/regulation frameworks.* The framework law for the functioning of regulators which aims at establishing a sound regulatory environment and promoting market efficiency was recently enacted. The corresponding bylaws of the National Regulatory Authorities are now being amended accordingly.

- *Services/administrative burden*. Further progress is being made in opening up services, consistent with the EU services directive, and cutting down on red tape. Nonetheless, some delays have been experienced, reflecting partly the government reshuffling during the summer.

- *Labor market.* A new reduction in severance pay has entered into force (October 1, structural benchmark) bringing the level closer to EU average (see chart). However, the Constitutional Court ruled in September against legislative provisions that entered into force in mid-2012 that would have relaxed the protection of labor market insiders in case of redundancy or unsuitability. The government committed to finding alternative reform options that respect the ruling. Following consultations with social partners, the alternatives will be discussed with staff at the time of the tenth review. Further progress is being made in implementing Active Labor Market Policies (ALMPs) aimed at addressing mismatches between labor supply and demand.



Source: OECD.
1/ Shaded area represents area between max and min.

- *Judicial system*. Significant progress has been achieved toward increasing the efficiency of the judicial system (see Box 3). The new Code of Civil Procedure, which entered into force in September, and the Judicial Organization Act, which Parliament adopted in June, constitute a major overhaul of the legal system. The authorities have now resolved the backlog of enforcement court cases pending as of May 2011. The reform of the legal framework for enforcement agents is also progressing well—the current supervisory agency for enforcement agents (CPEE) has significantly stepped up its efforts to supervise enforcement agents; and progress is being made toward the setting up of a new supervisory agency, CAAJ, which will further enhance effective supervision and monitoring of enforcement agents.

B. Policy Discussions

34. Although a critical mass of reforms is now in place, staff expressed concerns that the reform agenda may not be sufficiently ambitious. Within the constraints of the monetary union, implementing structural reforms is the preferred way to foster a more competitive economy and underpin sustainable external adjustment and strong growth, while avoiding a socially difficult internal devaluation. At the same time, because raising productivity takes time, improving external competitiveness also requires reducing production costs, including wages. Yet, despite the important reforms enacted under the program, there remain persistent nominal rigidities.[19] With only modest improvement in cost-competitiveness indicators to date, there remains a risk that the turnaround in the external current account may not be sustainable and that ongoing reforms will not be sufficient to boost supply conditions to generate a rapid turnaround in the economy. In addition, although the sharp rise in unemployment partly reflects structural factors—such as adjustment of highly-leveraged corporate to tighter financing conditions and skills mismatch in view of the rebalancing of the economy—more wage flexibility would also help boost employment, particularly at the low end of the skill distribution.

35. The authorities were more optimistic about the effectiveness of the reform agenda and medium-term growth prospects. They stressed that while time should be given for reforms to bear fruit, some flexibility was at play, explaining the rapid external adjustment and the tentative signs of recovery. They also noted that focusing on labor-cost-based indicators could be misleading, as the strong export performance to date may also be related to non-price competitiveness factors. Staff stressed that with imports of investment goods and consumer durables likely to recover from unusually low levels, strong and sustained export growth would be necessary to support a lasting turnaround of the current account deficit, consistent with a gradual improvement in the large negative International Investment Position (-117 percent of GDP at end-2012).

36. Overall, there was agreement that efforts should be made to identify unaddressed policy distortions and other potential priority reform areas (MEFP ¶17). Two specific areas were discussed:

[19] See also Appendix IV in IMF Country Report No. 3/160.

- *Labor market reforms*. With unemployment uncomfortably high, staff suggested to investigate policy options to ensure more effective decentralization of wage bargaining; encourage more wage flexibility; and ensure proper alignment of incentives to challenge dismissals in court—since the recent cut in severance pay for fair dismissals has opened a significant gap with severance pay for unfair dismissals. There was agreement that these options would be discussed at the time of the tenth review.

- *Electricity sector*. Staff encouraged the authorities to take further steps to improve the sustainability of the national electricity system, while preventing excessive price increases.[20] The authorities' strategy to invite the main players to the negotiating table in an attempt to renegotiate legacy contracts, hence alleviating upward pressures on the "tariff deficit" by reducing rents in some areas, has borne fruits. However, in spite of these as well as new proposed steps (mainly cost-saving measures), the authorities' updated projections *(mid-June Structural Benchmark*) indicate that, in view of the downward demand pressures, real electricity prices would need to rise by close to 2 percent per year—½ percentage point above initial projections—to eliminate the "tariff debt" by 2020—an option which would penalize Portugal's competitiveness. In light of this, the authorities agreed to investigate options to better balance the burden of adjustment between the various stakeholders of the electricity sector, notably by eliminating remaining excess rents (MEFP ¶28). They have announced the introduction of a levy on energy operators which will help clawing back part of these excessive rents. However, the extent to which this measure will contribute to reducing the "tariff deficit" and the sustainability of the system will depend on how related-revenues are used, since part of it is to be used for the budget.

FINANCING, RISKS, AND PROGRAM MODALITIES

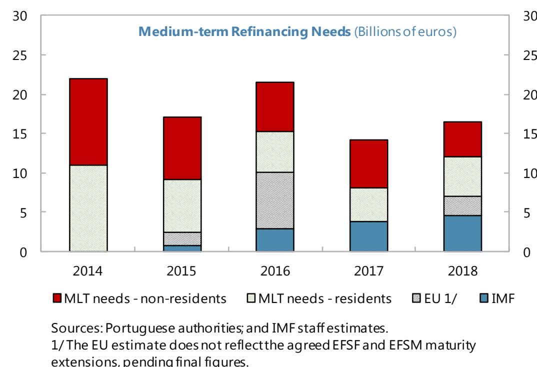
37. The path to regaining full market access when the program ends next May is narrow, but financing assurances are in place for the next 12 months.

- The political fallout in July, followed by new adverse Constitutional Court rulings, has delayed the authorities' pre-financing plans for 2014. And, with a sub-investment grade rating constraining the investor base, the window to demonstrate renewed ability to tap the market and sustainable access of the scale necessary to fulfill Portugal's large medium-term financing needs before the program ends in May is narrow.[21] Nonetheless, long-term sovereign yields have declined since a staff level agreement was reached on the combined eighth and ninth

[20] With the electricity system costs determined independently of the level of demand—mainly through contracts with generators that hedge the sale price from the market price (CMECs, PPAs and feed-in tariffs)—and with the prices paid by the final users about 13 percent below these costs, the electricity system is expected to generate a deficit ("tariff deficit") of about €1 billion this year. Related debt, which is owed by the final user, is either securitized or held on EDP's (the main player on the Portuguese electricity market) balance sheet.

[21] Further ratings downgrades cannot be ruled out. For example, in mid-September, Standard & Poor's put Portugal on negative credit watch.

reviews; and new successful international bond issues in the next few months can therefore not be ruled out if program implementation is strong.



Sources: Portuguese authorities; and IMF staff estimates.
1/ The EU estimate does not reflect the agreed EFSF and EFSM maturity extensions, pending final figures.

- In view of the current cash position, and with timely IMF and EU disbursements, the authorities would have adequate resources to meet their financing needs throughout mid-2014, including the large bond redemption (€6 billion) in June 2014. Should access to the bond market remain constrained, the authorities also envisage bond exchanges, notably with domestic banks, to smooth the amortization profile and purchases of bonds by the social security fund in the primary market. Combined with additional net T-bill issuance and reliance on additional retail savings products prospects of covering the financing needs over the next 12 months (large maturing bond (€7.8 billion) in October) are reasonable.

38. Nonetheless, support from European partners will remain important to help assuage medium-term financing challenges. In particular, should market uncertainty persist despite successful completion of the next few program reviews, they could be called upon to fulfill their commitment to support Portugal until full market access is regained. In addition, once market access is restored, recourse to the ECB's Outright Monetary Transaction (OMT) program would also go some way in helping improve the monetary transmission mechanism in Portugal.

39. Exceptional access remains justified. Notwithstanding progress on the financing front for both private and public sectors, exceptional access under the program remains critical to address Portugal's funding needs (Criterion 1). While staff considers public debt to be sustainable over the medium term, it cannot be asserted with high probability. However, systemic risk from contagion to other vulnerable euro area countries, should the sovereign fail to service its debt, continues to justify exceptional access (Criterion 2). Prospects for regaining market access within the period that Fund resources are outstanding remain good, although recent market turbulences have somewhat delayed the authorities' strategy in this regard, and there remains uncertainty regarding the potential scale of market access. Nevertheless, commitments by euro area leaders to support Portugal until full market access is regained—provided the authorities persevere with strict program implementation—give additional assurances that financing will be available to repay the Fund (Criterion 3). Despite recent political and social tensions, and notwithstanding significant legal risks, prospects for program success remain reasonably strong, given the authorities' solid track record, including in finding alternative fiscal measures when faced with adverse Constitutional Court rulings, and the renewed commitment to the program objectives by the government coalition (Criterion 4).

40. Capacity to repay the Fund remains adequate. The Fund's exposure to Portugal is projected to rise to 16 percent of GDP in 2014, with debt service expected to peak at 5.3 percent of exports of goods and services, or 2.6 percent of GDP in 2018. Despite recent political tensions and the legal risks surrounding public expenditure reforms, program implementation capacity remains

strong, and the rapid turnaround of external imbalances also provides assurance that adequate resources will be available to repay the Fund.

41. Downside risks to the attainment of the program's objectives remain significant. The key immediate risk is that some of the measures underlying the 2014 Budget fail to survive constitutional challenges. Should this happen, political determination will be critical to promptly reformulate the budget and replace these measures by offsetting ones and ensure the fiscal objectives remain within reach. The materialization of downside risks to the macro-fiscal outlook noted above would also require implementation of corrective actions to keep the fiscal program on track and regain market confidence. On the financing front, renewed stress in euro area financial markets, a more general tightening of global financial conditions, and materialization of the risks noted above could further delay market re-access. Decisive counter-measures in case of materialization of these downside risks will be critical because the margin for maneuver has become limited, against the backdrop of a higher debt peak and the narrow path to full market access.

42. In view of the delays in program discussions, and since strong actions have been taken to bring the program back on track, the authorities have requested the completion of the combined eighth and ninth reviews. Since the Board discussion for the eighth and ninth reviews is scheduled to take place after September 30, 2013, the controlling performance criteria for these reviews are the end-September 2013 PCs. However, since the data to assess performance at end-September PCs are not yet available at the time of the Board meeting and there is no clear evidence that the PCs will not be observed, a waiver of applicability is being requested. The tenth program review, which is tentatively scheduled to take place at end-December, will be based on a formal assessment of observance of the end-September PCs.

STAFF APPRAISAL

43. Program implementation has remained broadly on track, in spite of a political crisis and significant legal challenges. The political turmoil over the summer and new Constitutional Court ruling against an important public expenditure reform delayed the preparation of the PER-related legislations as well as other reforms. Nonetheless, the authorities' efforts to regain lost ground with regard to the program schedule have paid off. A draft 2014 budget consistent with the reaffirmed deficit target of 4 percent of GDP has been submitted to Parliament, together with underpinning expenditure reform legislations. In addition, slippages in the execution of the 2013 budget are being addressed—although they rely partly on one-off measures—and the end-year target is within reach. Finally, the government is working on a set of measures to offset the recent Constitutional Court ruling against part of the labor market reforms that had been enacted earlier in the program. Overall, following a relatively modest structural fiscal adjustment in 2013, the profile over 2014-2015 is appropriately ambitious and evenly balanced.

44. However, implementation risks are high, and the increased uncertainty has narrowed the path to full market access by the end of the program. The dissonances within the government, against a background of mounting austerity and reform fatigue, are of substantial

concern. Renewed tensions need to be avoided as they would delay the recovery and increase downside risks to the program. Moreover, the successive adverse Constitutional Court rulings have complicated policy making considerably and heightened economic uncertainty. In light of this, renewed financial markets volatility has delayed the authorities' plans to follow up on the successful bond issuances earlier this year. New bond issuances in the next few months are possible, but continuous exemplary program implementation is necessary to sustain issuance on the scale necessary to satisfy the large medium-term financing needs.

45. Political determination to sustain the fiscal consolidation effort is therefore paramount. With the debt trajectory having edged up since the beginning of the program—gross debt is now set to peak at 128 percent of GDP on current policies and outlook—and tighter financing conditions, there are no easy alternatives to further fiscal adjustment. And this adjustment needs to be advanced through measures of structural nature, avoiding reliance on one-offs, which are detrimental to the credibility of the adjustment process. Approval and full implementation of the agreed package of fiscal measures, including the expenditure measures identified in the context of the PER, is therefore imperative. Should some of these measures be ruled unconstitutional, it will be critical for the government to identify and implement measures to meet the agreed deficit target. Given the limited room for maneuver, this will be extremely difficult. Nonetheless, it is a must for a successful program exit. In this context, it would still be important to tackle Portugal's key sources of weakness in public finances—such as the large size of the public sector and relatively high public sector wages and pensions compared to peers—and avoid measures less favorable to growth and the recovery of employment.

46. The adjustment effort also needs to be supported by further progress on fiscal structural reforms. Continued efforts in implementing the law on expenditure commitment controls, further strengthening revenue administration, restructuring SOEs, and reducing the scope of (and tackling risks stemming from) PPPs will also be important to limit risks to budget execution. While progress has been made on all of these fronts, the difficulty in regaining full control over domestic arrears, particularly in the health sector, calls for renewed efforts to ensure appropriate budgeting, effective implementation of cost-saving measures, and tighter expenditure controls.

47. Financial stability has been maintained, but continued vigilance is necessary. The capital and liquidity conditions of the banking system remain adequate, but banks are operating in a challenging environment, which erodes their profitability. In light of this, recent supervisory initiatives—including the credit impairment review—are welcome. Given banks' exposures to the highly leveraged corporate sector, continued vigilance remains essential, along with required additional provisions at specific banks as necessary. Efforts to further strengthen banks' quarterly stress tests under the program are also critical to assess banks' resilience. Access to credit remains difficult, notably for SMEs. In these conditions, efforts to increase the efficiency of the numerous initiatives to assist viable companies in funding their activities are necessary. Early utilization to the new restructuring tools is also essential to sustain an orderly deleveraging process.

48. The improved near-term economic outlook should not distract from the need to advance structural reforms forcefully to underpin a sustainable recovery. While recent

indicators signal that the economy may have bottomed out, there remain uncertainties as to the durability of the recovery. In addition, medium-term growth challenges remain substantial. In particular, fostering competitiveness is essential; and within the constraints of the monetary union, this requires a combination of measures to raise productivity—which is a gradual process—and reduce input costs, including wages, for the tradable sector. Important reforms have been implemented under the program, and the unwinding of external flow imbalances has been rapid. Nonetheless, with only moderate improvement in price-competitiveness indicators so far, there remain doubts as to whether the structural reform agenda has been ambitious enough to generate a strong supply response. In light of this, the authorities are urged to identify additional policy options to tackle labor market rigidities and reduce production costs by compressing excessive profit margins in the nontradable sector. The planned comprehensive reform of the corporate income tax could also help foster investment and competitiveness, but has to be implemented within the existing budgetary envelope.

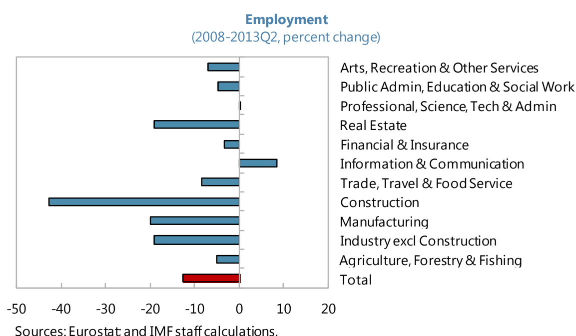
49. Continued external support and effective crisis management at the euro-area level are also important for the success of the program. While strong implementation of the adjustment program remains a sine qua non for regaining full market access, institutional reforms and strong crisis management policies at the euro-area level are also essential to help Portugal withstand shocks. The commitment by European leaders to support Portugal until market access is restored, as long as the program is on track, continues to provide a valuable financing assurance. In addition, once market access is restored, recourse to the ECB's OMTs would help address financial segmentation and restore an appropriate transmission of monetary policy.

50. Staff recommends completion of the combined eighth and ninth reviews and the granting of waivers of applicability of end-September PCs.

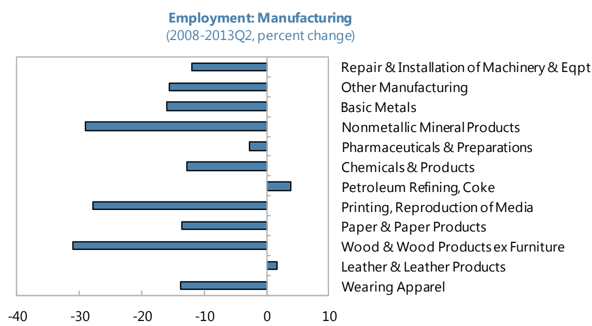
Box 1. Portugal: Recent Labor Market Development

The adjustment in the Portuguese labor market has to a large extent taken place through labor shedding. Employment has declined by 13 percent from the 2008 peak, with unemployment rate rising from below 8 percent to some 16 percent. While the average nominal compensation declined by 3 percent during 2010–12, it has, as of the second quarter of this year, gone back to a level higher than the 2010 peak, due mainly to the reinstatement of the 13th and 14th month salary for public sector employees which were temporarily suspended during 2011–12.

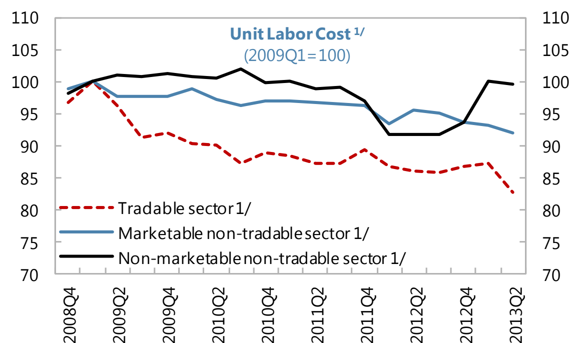
The employment loss reflects cyclical and, to a lesser extent, structural factors. The decline since the peak has been broad based, consistent with a cyclical decline in aggregate demand. Although job losses have been as pronounced in manufacturing as in real estate, within manufacturing the loss appears less severe (or some increase) in sectors where Portugal exports more now—pointing to some structural nature of the adjustment (see charts).



Sources: Eurostat; and IMF staff calculations.



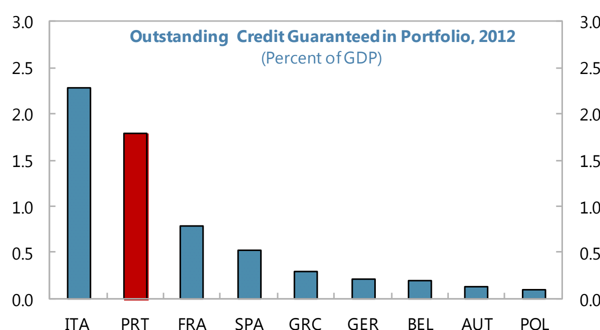
Despite only modest improvement in the overall price competitiveness, ULCs in the tradable sector seem to have improved faster than that in the nontradable sector. Although it is mainly due to labor shedding in the tradable sector, this could partly explain the ongoing rapid external adjustment. Nevertheless, without a significant improvement of internal competitiveness, which would require a strong reduction in the relative price of nontradables, there is a risk that a large part of the resources currently devoted to the tradable sector due to depressed domestic demand will be reallocated to nontradable sector once the economy recovers.



Sources: Eurostat; and IMF staff calculations.
1/ Tradable sector refers to manufacturing. Non-marketable non-tradable sector refers to public administration, education, and social work. Arts, Entertainment & Recreation; Professional, Science & Tech. Marketable non-tradable sector refers to the rest of the economy. Productivity is gross value added divided by employment.

Box 2. Portugal: Review of the National Guarantee System

- The Portuguese guarantee system (NGS) was established in 1994. In 2008, as a response to the financial challenges brought by the global crisis, the government increased its coverage with the establishment of several guaranteed credit lines dedicated to SMEs (PME Investe I-VI and PME Crescimento I-II). Since then, more than €10 billion of guaranteed-credit lines have been extended. Today, the Portuguese mutual guarantee system represents one of the largest in Europe, with €4.3 billion in outstanding credit guaranteed.



Source: European Association for Mutual Guarantee Societies.

- The use of government guarantees represents an important tool, as well as one of the few available instruments at hand, to support continued access to credit by viable firms, given the difficult funding conditions and severe financial fragmentation in Portugal. At the same time, it can also become an important source of fiscal risks for the State if not administered effectively (the state counter-guarantees covers on average 46 percent of the outstanding credit guarantee lines, in case of default). Moreover, the rate of utilization of these instruments has been much less than expected, with about €800 million of the PME Crescimento line not tapped in 2012 and another €800 million unused as of mid-October 2013.

- To promote effective use of the lines while minimizing risks for the State, the authorities requested early this year an external auditing of the NGS processes and operations, which helped identify key recommendations, currently being addressed and expected to be finalized by end-January 2014 (MEFP ¶23). These include:

i. A reassessment of the scheme objectives, to ensure that only viable and credit-worthy companies in the productive sectors of the economy have access to the lines;
ii. A review of loan and guarantee pricing mechanisms, notably through the development of new competitive bidding mechanisms to allocate the credit lines to the banks at favorable prices for end users;
iii. A review of the governance structure and operational framework, to avoid possible conflicts of interest and promote a competitive environment.
iv. An enhancement of the NGS risk management capabilities, together with an improvement of the monitoring and management of government exposure, to minimize risks and potential losses for the State.

- To support all these efforts, the authorities have also recently established a quarterly monitoring framework, with information on amounts disbursed, average interest rates, and default rates, by different sectors of the economy.

Box 3. Portugal: Progress in Judicial Reform

Improving the efficiency of the judicial system was identified as one of the key objectives of the structural reform agenda to strengthen claims enforcement and, ultimately, improve the business environment and access to credit. The authorities' strategy was designed around short-term objectives (resolving the backlog of enforcement and tax court cases) and medium-term goals (expediting civil and enforcement court processes, reforming court organization, and strengthening oversight and monitoring of enforcement agents). The authorities benefited from technical assistance.

Backlog of Enforcement Court Cases. All pending enforcement court cases as of May 2011 were reviewed. 45 percent (over ½ million) of these cases were closed. In addition, the clearance rate for enforcement court cases (i.e., the percentage of newly filed versus resolved cases) improved significantly—to 158 percent in the first quarter of 2013. This was achieved through:

- ***Measures aimed at resolving the stock of pending enforcement court cases*.** Since November 2011, on a quarterly basis, task forces reviewed all pending enforcement cases with a view to classifying such court cases and resolving those that could be closed. In 2013, the authorities adopted a Decree Law for a set of urgent measures to combat the court case backlog, by enabling the expedient closure of enforcement court cases which have been pending and inactive for an excessive period of time.

- ***Measures aimed at reducing the inflow of new enforcement court cases.*** The authorities increased court fees for certain types of claims and for repeat litigators to disincentivize spurious litigation. They also changed VAT rules for unrecoverable claims to reduce the number of cases filed in court merely for VAT recovery. The authorities envisage a special pre-trial triage mechanism for enforcement cases. It will enable creditors to verify whether debtors have assets, and on that basis, whether to pursue enforcement. A draft law will be submitted to Parliament in early 2014.

Code of Civil Procedure (CPC). The new CPC—a modern code consistent with international best practices—entered into force in September, after a long process of consultation with experts and key stakeholders.

- ***Agile and modern civil process***. The new CPC provides for a program at the beginning of each process, cuts down on excessive administrative burdens, and empowers judges by setting timeframes for their decisions and enabling them to dismiss parties' submissions that aim at delays. It also provides for civil and enforcement trials by one judge.

- ***Efficient claims enforcement***. In order to enable a smooth and efficient enforcement of claims, the number of enforcement titles has been reduced. Enforcement proceedings have been streamlined and made more efficient. Cases that are pending for excessive periods due to inaction may be stricken from the court register.

Court Organization. Following extensive consultation between the MoJ and stakeholders, Parliament adopted in June a new court organization law, which will enter into force in the course of 2014. To implement the new court organization, a few supporting statutes are necessary. The new court organization reflects international best practices and includes the following key elements:

- ***Streamlining and reorganization of the court network***. The court network will be streamlined by closing underutilized courts (about 54 courts). The number of court districts (*comarca*) will be significantly reduced to 23 across the country and aligned with the administrative districts (concentration). Thus, it enables a dynamic and flexible allocation of judges within one district court (flexibility). Specialized court sections will be created to enable judges to specialize (specialization).

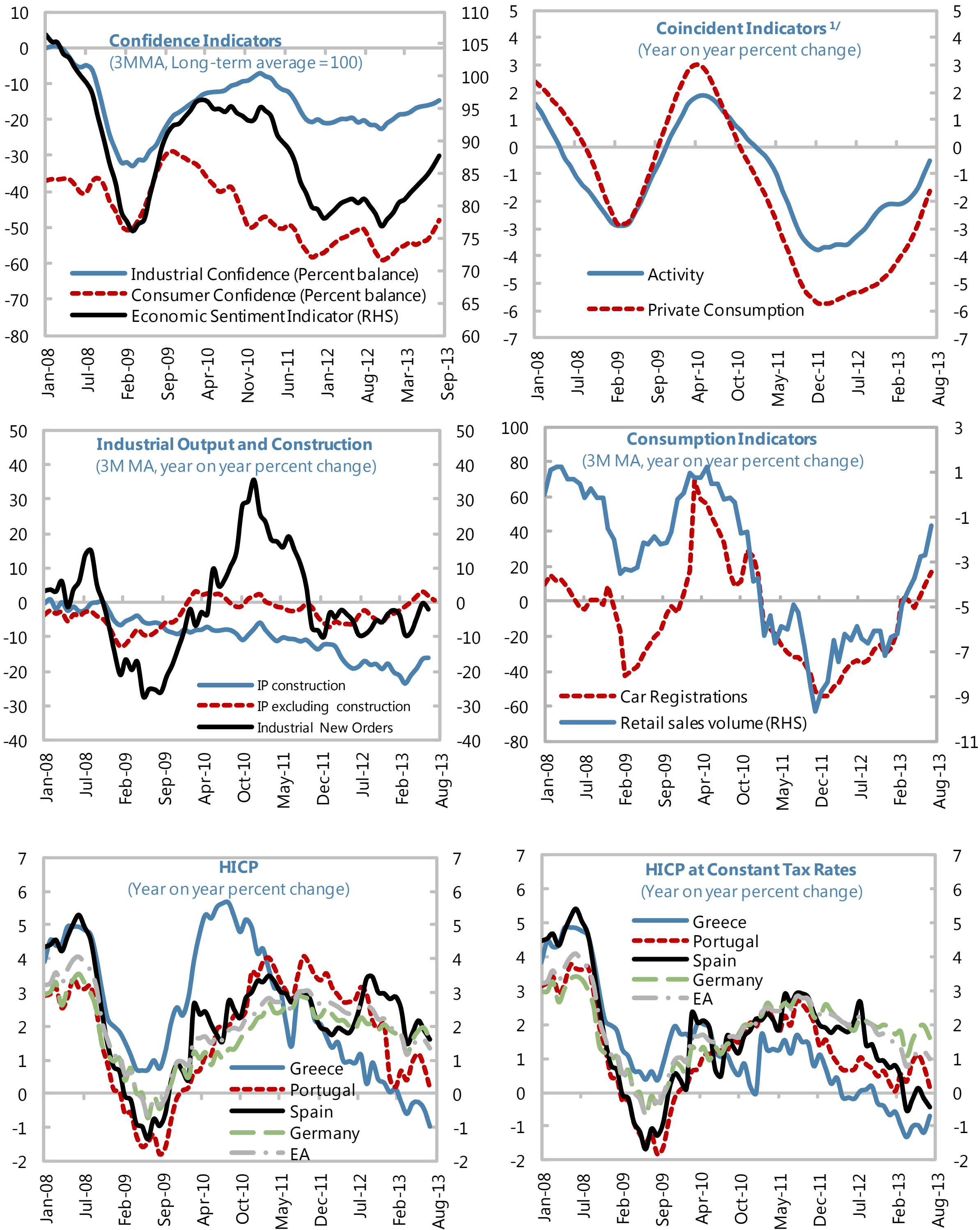
- ***Modern court and judge performance management***. Courts will be managed by a president judge with the assistance of clerks and professional administrators. A performance management system for judges will be introduced that will enable an efficient and effective management of judges and court cases.

Enforcement Agents Framework. Decisive steps were taken to enhance the framework for enforcement agents:

- ***Agency to monitor and supervise enforcement agents***. The authorities submitted to Parliament a new framework to supervise and monitor enforcement agents through a new independent agency, CAAJ. This agency will enable a modern and effective supervision and monitoring of enforcement agents.

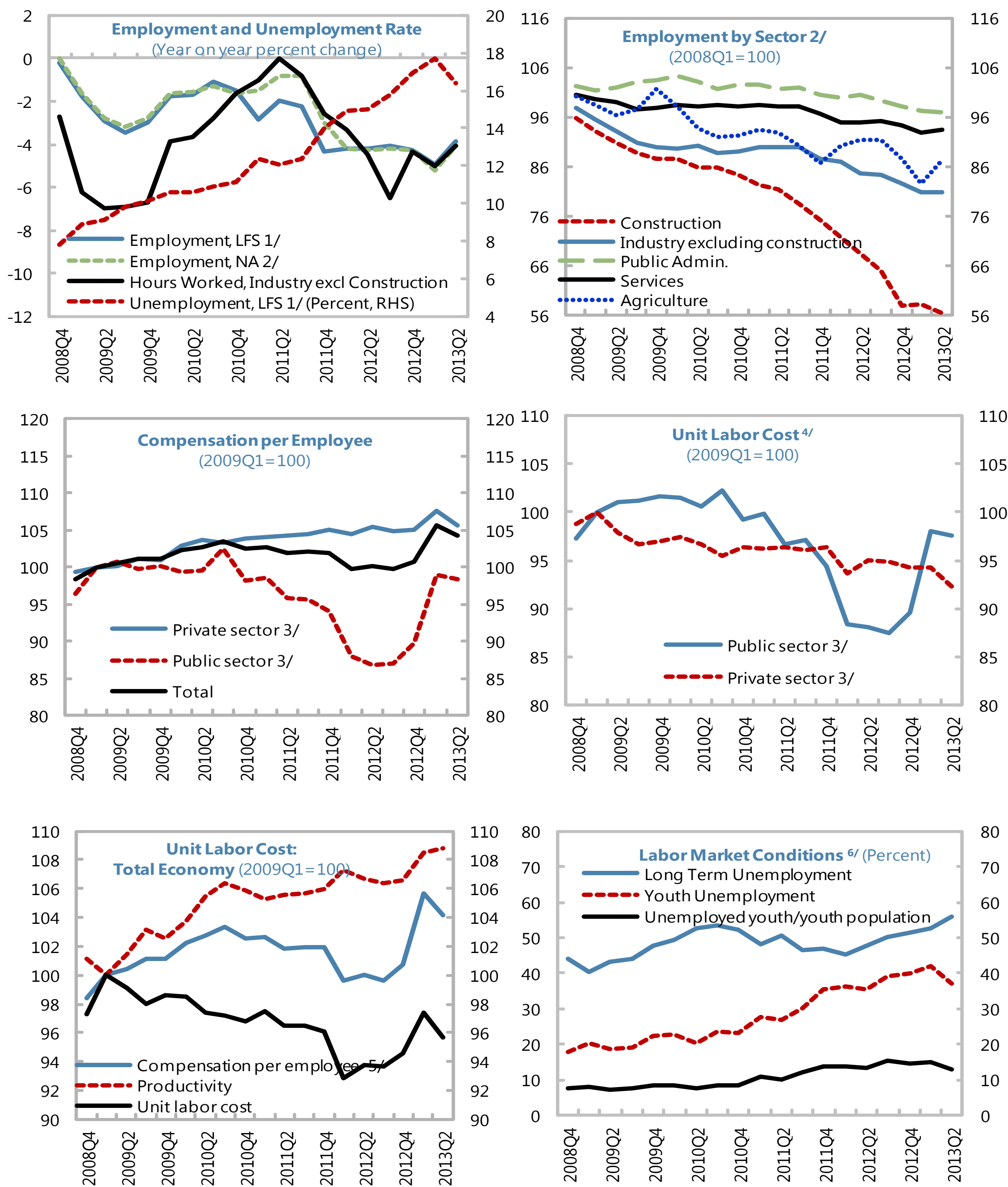
- ***Fees***. The new fee structure for enforcement agents entered into force in September 2013. It aims at simplifying and clarifying the regime and incentivizing speedy and efficient claims enforcement.

Figure 1. Portugal: High Frequency Indicators



Source: Statistical Office of the European Communities; European Commission; Bank of Portugal; and Fund staff calculations.
1/ Calculated by the Bank of Portugal.

Figure 2. Portugal: Labor Market Indicators



Source: Statistical Office of the European Communities; European Commission; Bank of Portugal; and Fund staff calculations and estimates.

1/ Labor Force Survey.

2/ National Accounts.

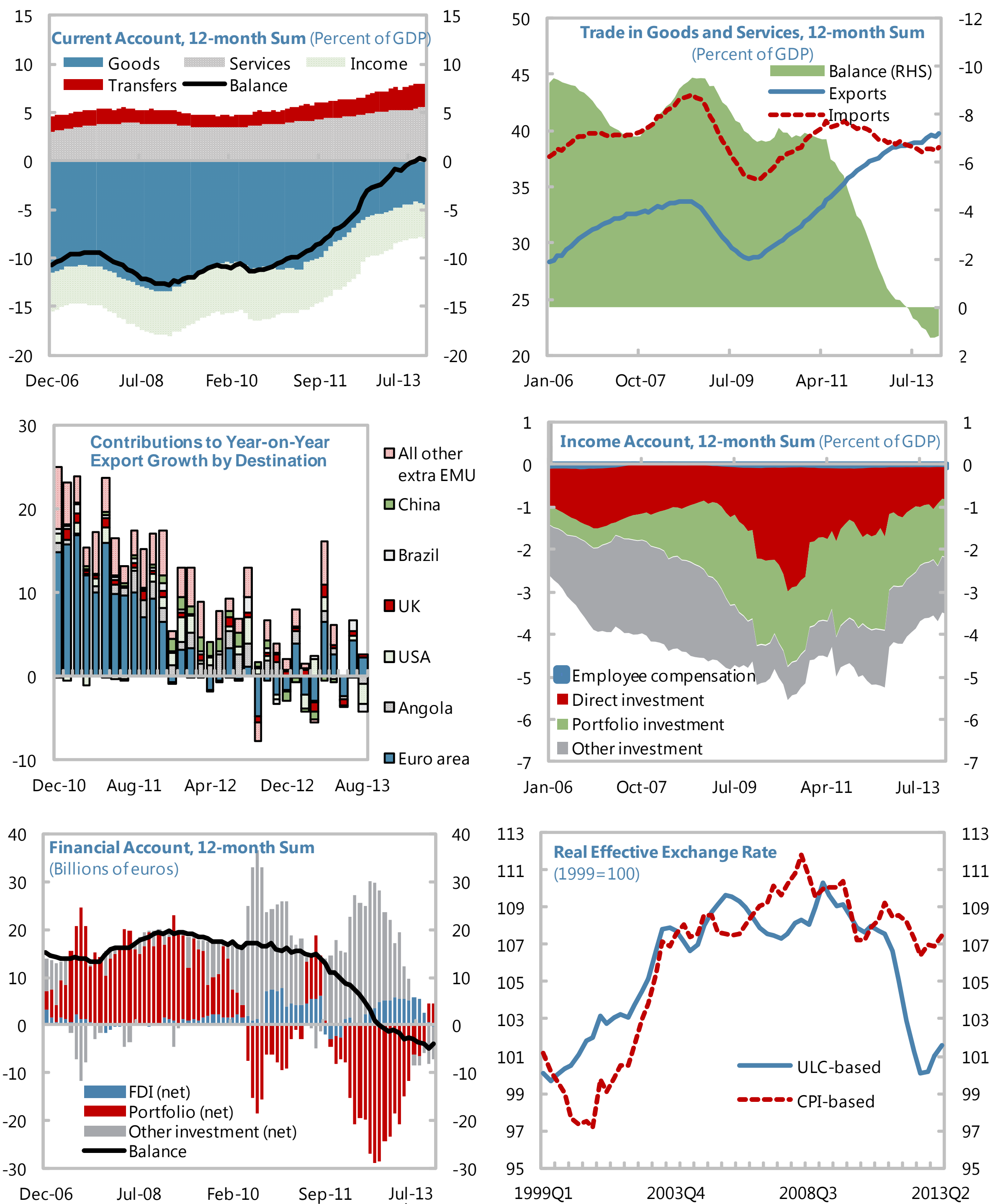
3/ Public sector refers to public administration, education, and social work. Private sector refers to the rest of the economy.

4/ Staff estimates. Productivity is gross value added divided by employment.

5/ Effective from 2013, private sector employees can choose to receive Christmas bonus monthly instead of once in Q4.

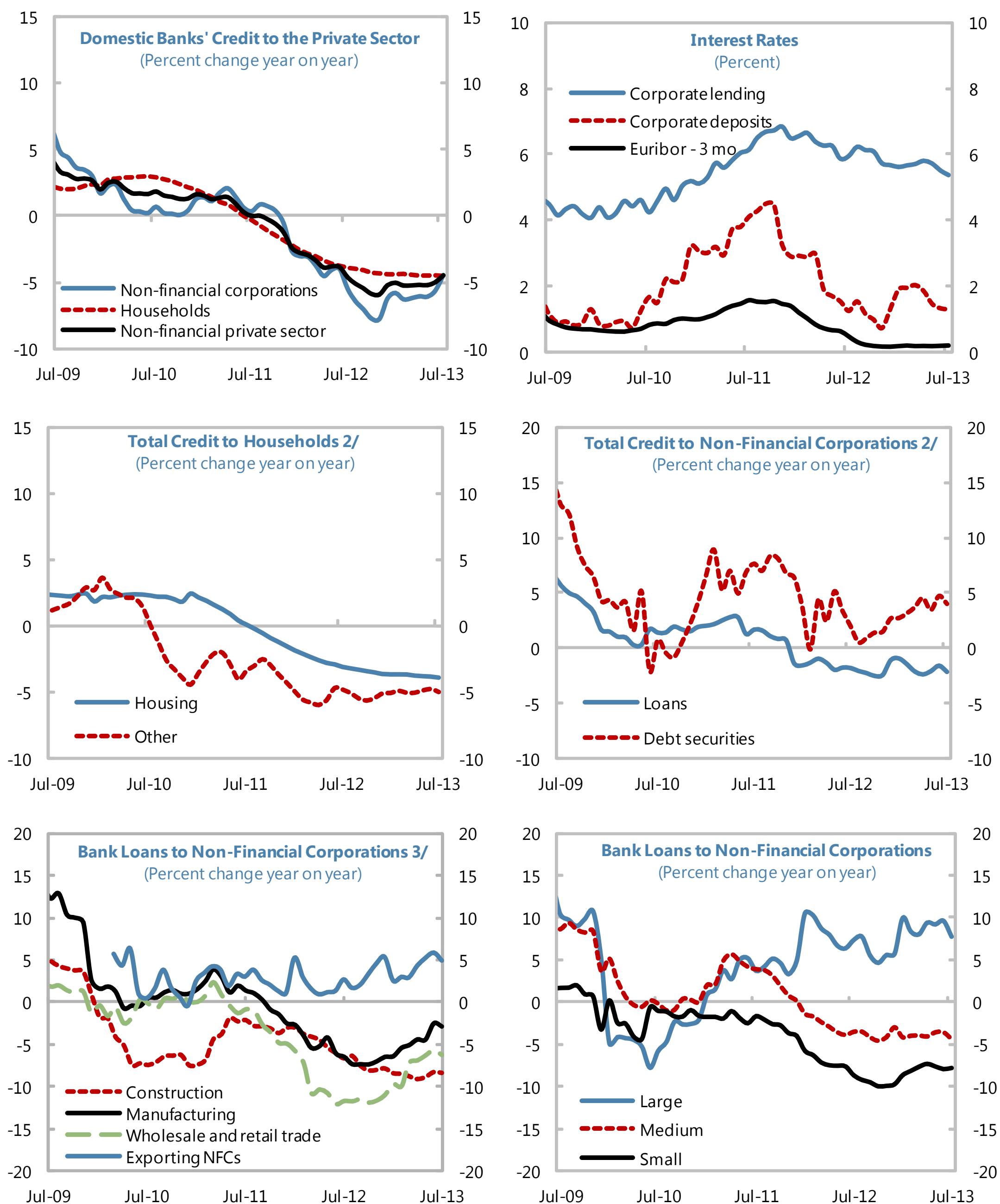
6/ Long term unemployment rate as percent of total unemployed; youth unemployment rate as percent of youth labor force.

Figure 3. Portugal: Balance of Payments Developments



Sources: INE; Banco de Portugal; Eurostat; and IMF staff calculations.

Figure 4. Portugal: Financing of the Economy, 2009–13 1/



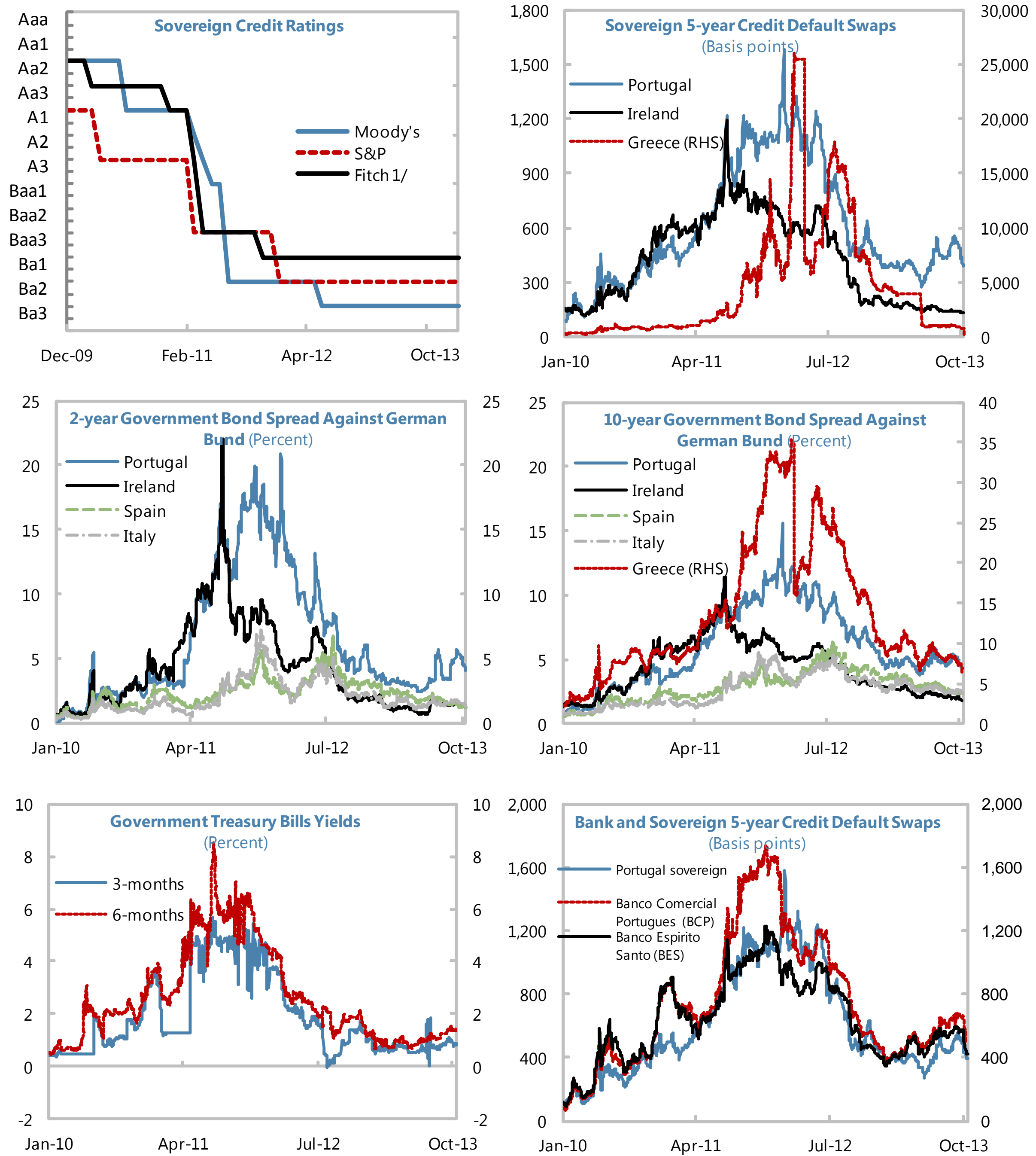
Source: Banco de Portugal.

1/ Credit and loan figures are adjusted for securitisation operations and monthly transactions (calculated using the outstanding amounts corrected of reclassifications, write-offs/write-downs, exchange rate changes and price revaluations). Whenever relevant, figures are additionally adjusted for credit portfolio sales, as well as for other operations with no impact on non-financial corporations' effective financing.

2/ Total credit granted to residents by resident and non-resident entities is reported on a consolidated basis and includes loans, debt securities and trade credits.

3/ Private-owned exporting companies, defined as: a) companies that export more than 50% of the turnover; or b) companies that export more than 10% of the turnover and the total amount exceeds 150 thousand euro (with both criteria met in the last

Figure 5. Portugal: Financial Indicators

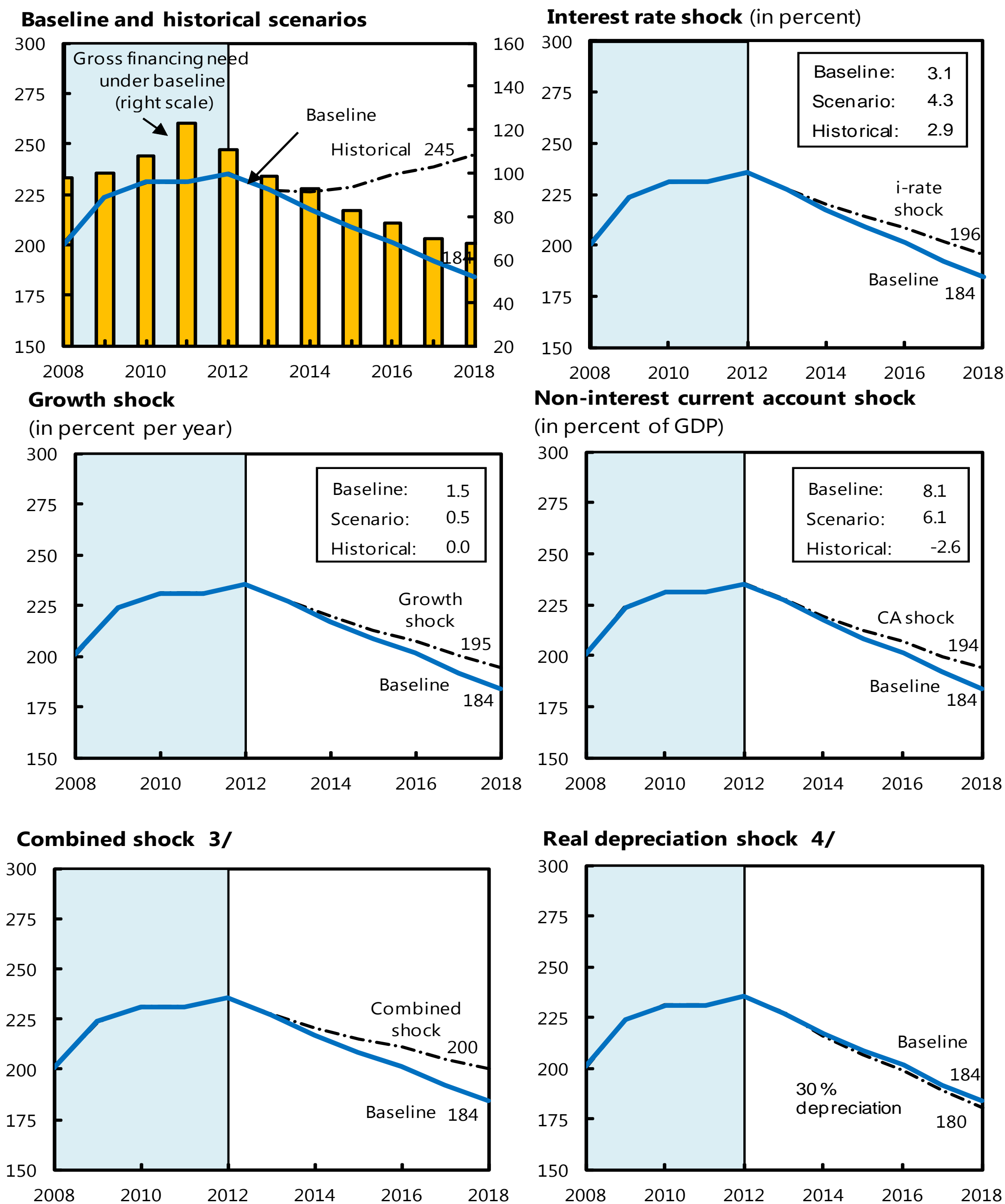


Sources: Bloomberg; and IMF staff calculations.

1/ Rating used is the LT Foreign Currency Issuer Default

Figure 6. Portugal: External Debt Sustainability: Bound Tests 1/ 2/

(External Debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks, except the interest rate shock which is a permanent one standard deviation shock. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to growth rate, and current account balance, and 1/2 standard deviation shock to the real interest rate.

4/ One-time real depreciation of 30 percent occurs in 2013.

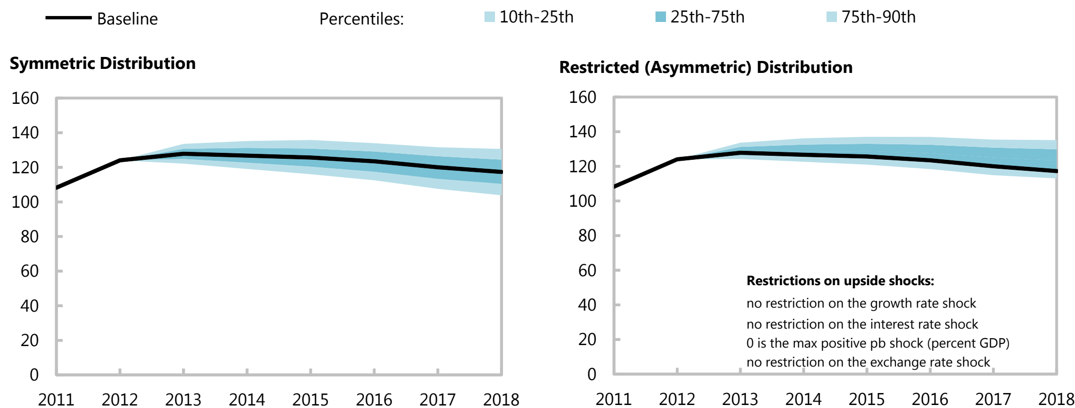
Figure 7. Portugal: Public DSA Risk Assessment

Heat Map

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

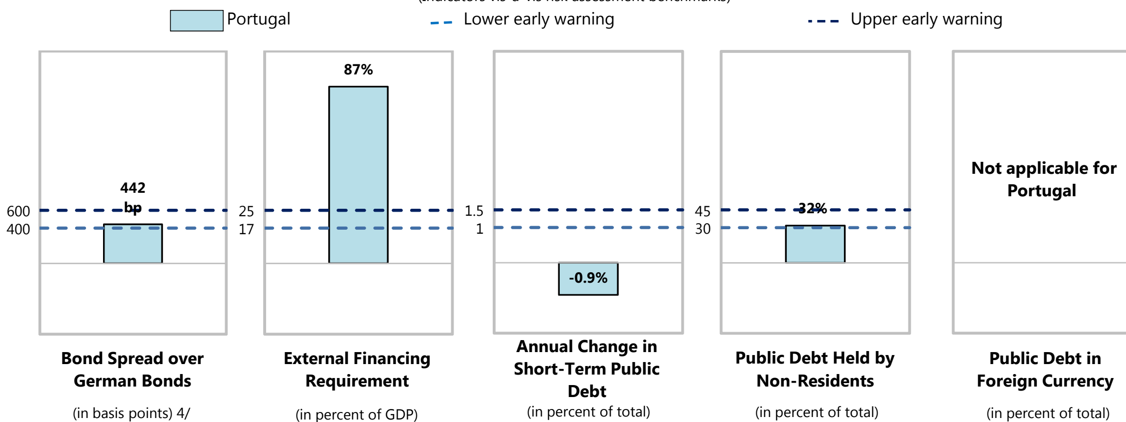
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant. In the case of Portugal, while the MAC DSA template indicates that the contingent liabilities shock is not relevant, due to limited bank vulnerabilities, the relevant cell is nonetheless highlighted in red given sizable contingent liabilities from SOEs and PPPs.

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

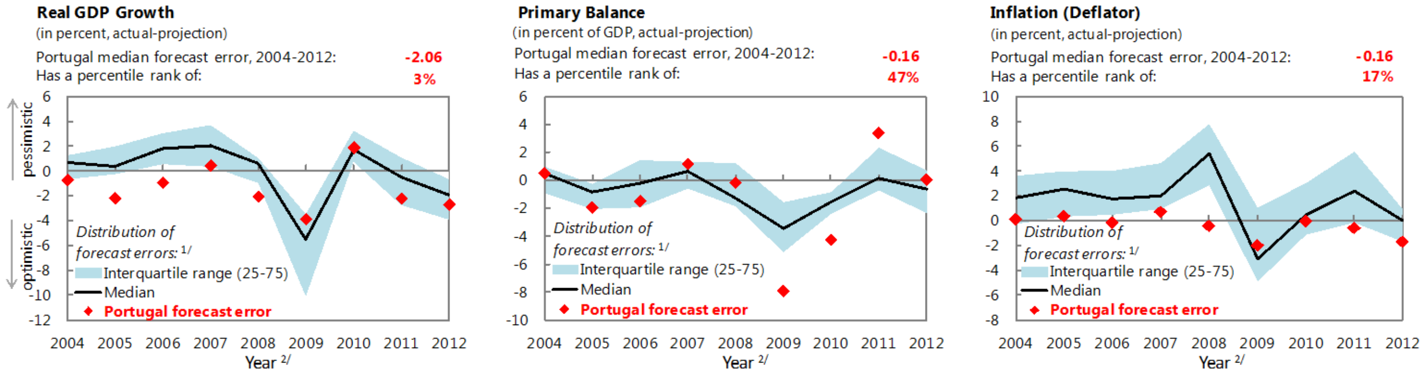
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant,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

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents. In the case of Portugal, the external financing requirements figure includes bank deposits by non-residents (accounting for about 45 percent of GDP).

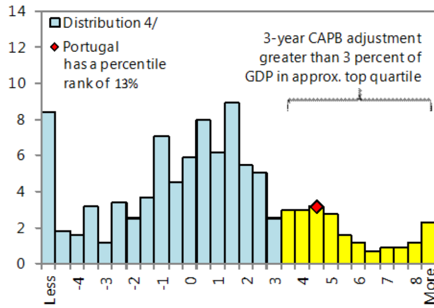
4/ An average over the last 3 months, 25-Jul-13 through 23-Oct-13.

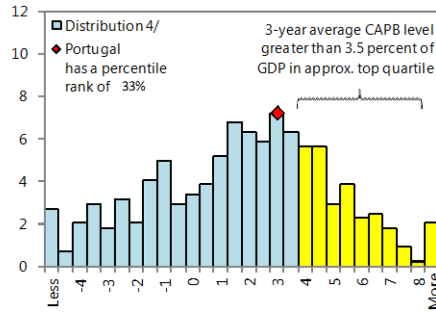
Figure 8. Portugal: Public DSA – Realism of Baseline Assumptions

Forecast Track Record, versus program countries



Assessing the Realism of Projected Fiscal Adjustment





Source: IMF Staff.

1/ Plotted distribution includes program countries, percentile rank refers to all countries. For the primary balance, Portugal forecast error for 2004-2009 was constructed using comparable WEO series.

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

3/ Not applicable for Portugal.

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

Figure 9. Portugal: Public Sector DSA – Baseline Scenario

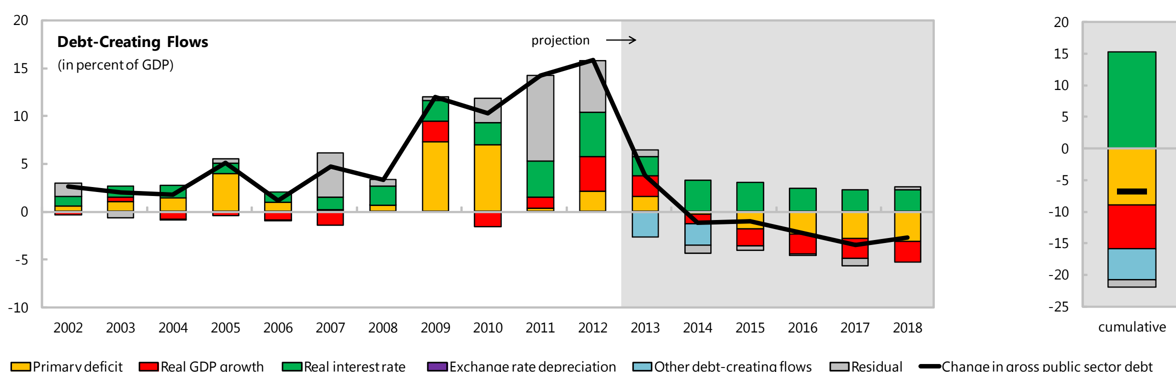
(Percent of GDP, unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of October 23, 2013		
	2002-2010 [2/]	2011	2012	2013	2014	2015	2016	2017	2018	Sovereign Spreads		
Nominal gross public debt	67.9	108.2	124.1	127.8	126.7	125.7	123.5	120.0	117.3	Spread (bp) 3/		442
Public gross financing needs	...	28.1	29.1	19.8	26.5	24.3	25.1	20.7	22.8	CDS (bp)		369
Real GDP growth (in percent)	0.6	-1.3	-3.2	-1.8	0.8	1.5	1.7	1.8	1.8	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	2.3	0.3	-0.3	1.9	0.9	1.0	1.7	1.8	1.8	Moody's	Ba3	Ba3
Nominal GDP growth (in percent)	2.9	-1.0	-3.5	0.1	1.7	2.5	3.4	3.6	3.6	S&Ps	BB	BB
Effective interest rate (in percent) [4/]	4.7	4.2	3.9	3.5	3.5	3.5	3.7	3.7	3.8	Fitch	BB+	BB+

Contribution to Changes in Public Debt

	Actual			Projections							
	2002-2010	2011	2012	2013	2014	2015	2016	2017	2018	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	4.8	14.3	15.8	3.8	-1.1	-1.0	-2.2	-3.4	-2.7	-6.8	
Identified debt-creating flows	3.7	5.3	10.4	3.1	-0.3	-0.6	-2.0	-2.6	-3.0	-5.5	
Primary deficit	2.6	0.3	2.1	1.6	-0.3	-1.8	-2.4	-2.8	-3.1	-8.9	0.2
Primary (noninterest) revenue and grants	40.7	45.0	40.9	43.2	42.8	42.7	42.5	42.0	41.5	254.7	
Primary (noninterest) expenditure	43.2	45.3	43.1	44.8	42.5	40.9	40.1	39.2	38.4	245.8	
Automatic debt dynamics [5/]	1.2	5.0	8.3	4.2	2.3	1.2	0.3	0.2	0.2	8.4	
Interest rate/growth differential [6/]	1.2	5.0	8.3	4.2	2.3	1.2	0.3	0.2	0.2	8.4	
Of which: real interest rate	1.5	3.8	4.7	2.0	3.2	3.0	2.4	2.3	2.3	15.2	
Of which: real GDP growth	-0.3	1.2	3.6	2.2	-1.0	-1.8	-2.0	-2.1	-2.1	-6.9	
Exchange rate depreciation [7/]	0.0	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	-2.7	-2.2	0.0	0.0	0.0	0.0	-4.9	
Privatization Revenue (negative)	0.0	0.0	0.0	-0.6	-0.3	0.0	0.0	0.0	0.0	-0.9	
Increase in deposits (- means drawdown of deposits)	0.0	0.0	0.0	-2.1	-2.0	0.0	0.0	0.0	0.0	-4.0	
Residual, including asset changes [8/]	1.0	9.0	5.4	0.7	-0.8	-0.4	-0.2	-0.8	0.3	-1.3	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Bond Spread over German Bonds.

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

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

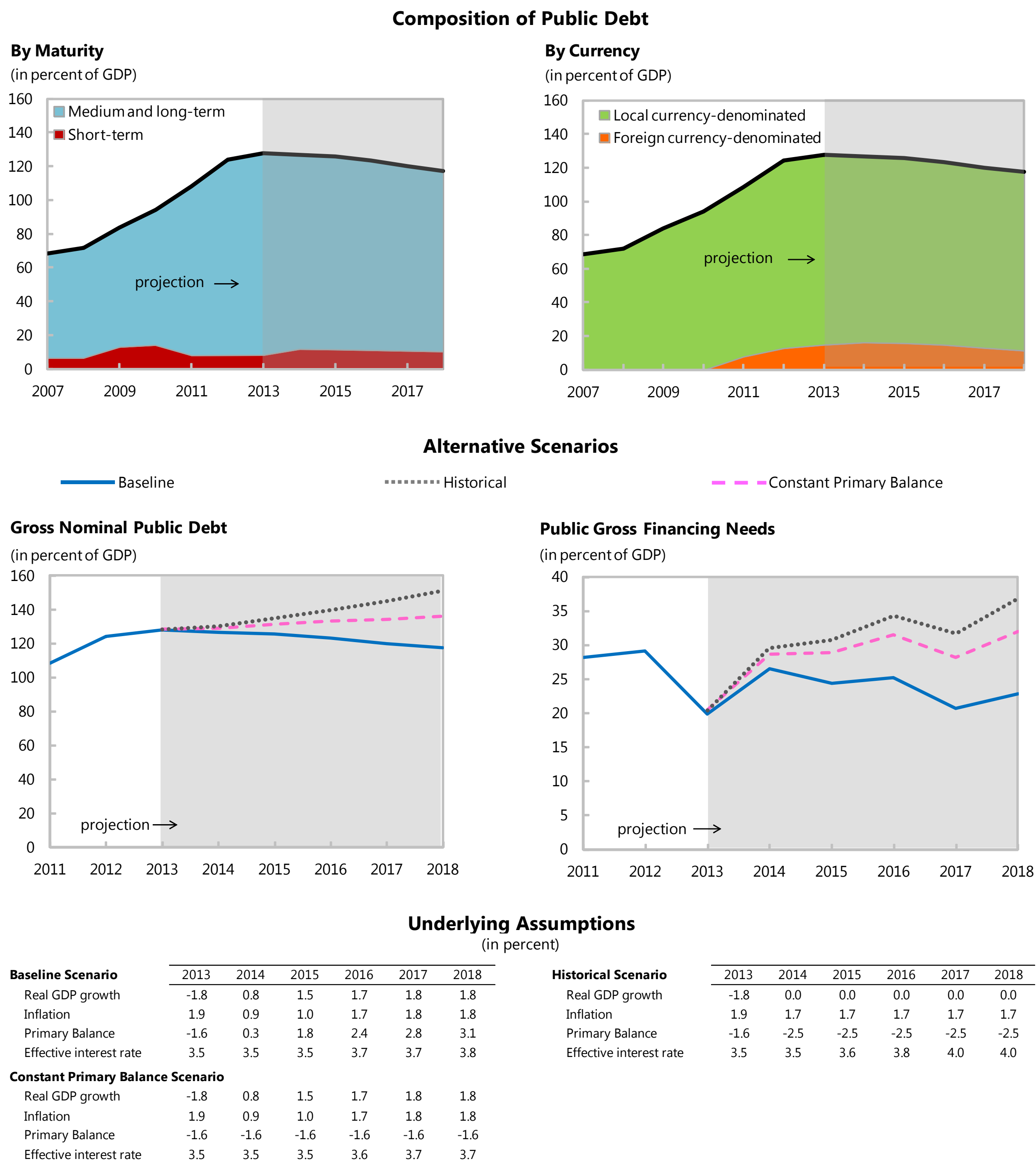
6/ The real interest rate contribution is derived from the denominator in footnote 4 as r - π (1+g) and the real growth contribution as -g.

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

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

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

Figure 10. Portugal: Public DSA – Composition of Public Debt and Alternative Scenarios



Underlying Assumptions
(in percent)

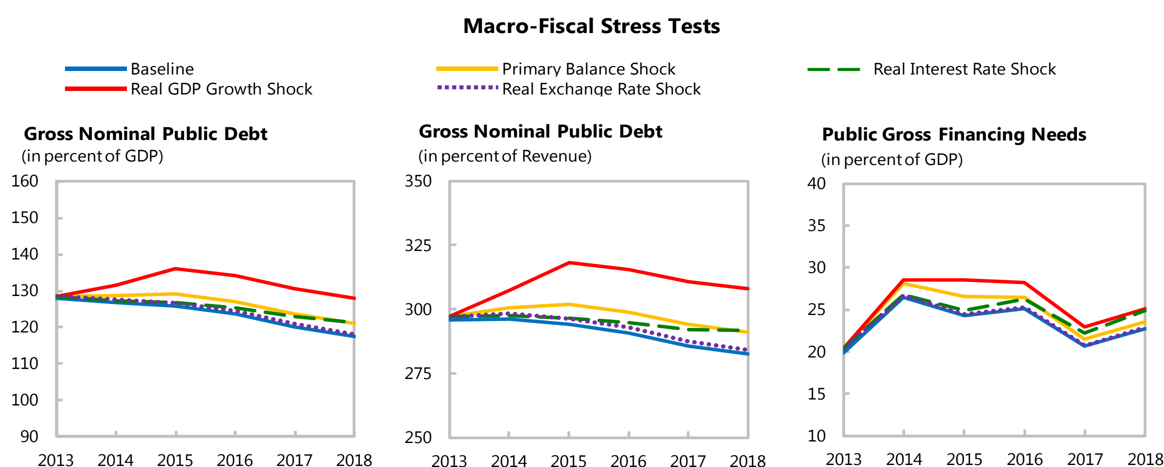
Baseline Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	-1.8	0.8	1.5	1.7	1.8	1.8
Inflation	1.9	0.9	1.0	1.7	1.8	1.8
Primary Balance	-1.6	0.3	1.8	2.4	2.8	3.1
Effective interest rate	3.5	3.5	3.5	3.7	3.7	3.8
Constant Primary Balance Scenario						
Real GDP growth	-1.8	0.8	1.5	1.7	1.8	1.8
Inflation	1.9	0.9	1.0	1.7	1.8	1.8
Primary Balance	-1.6	-1.6	-1.6	-1.6	-1.6	-1.6
Effective interest rate	3.5	3.5	3.5	3.6	3.7	3.7

Historical Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	-1.8	0.0	0.0	0.0	0.0	0.0
Inflation	1.9	1.7	1.7	1.7	1.7	1.7
Primary Balance	-1.6	-2.5	-2.5	-2.5	-2.5	-2.5
Effective interest rate	3.5	3.5	3.6	3.8	4.0	4.0

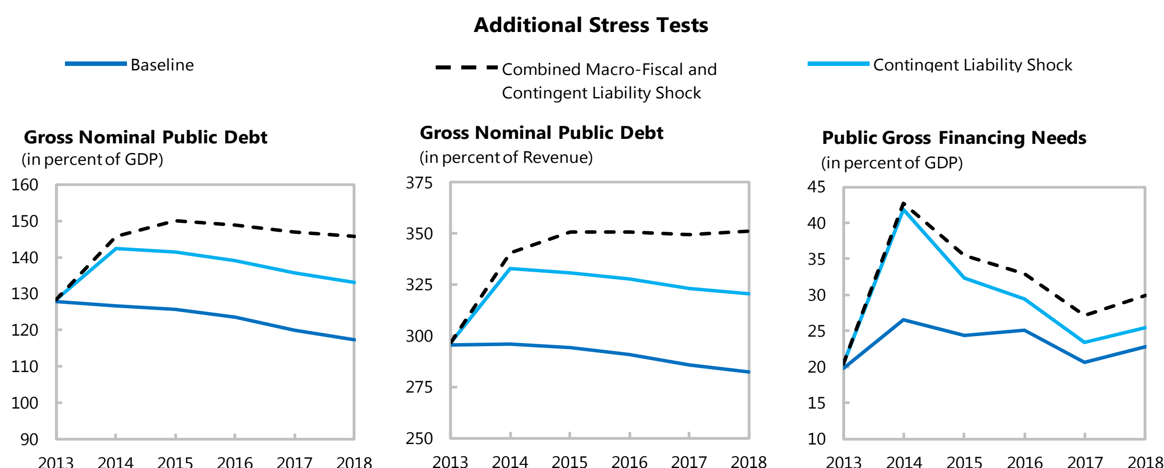
Source: IMF staff.

Figure 11. Portugal: Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2013	2014	2015	2016	2017	2018
Real GDP growth	-1.8	0.8	1.5	1.7	1.8	1.8
Inflation	1.9	0.9	1.0	1.7	1.8	1.8
Primary balance	-1.6	-1.0	0.5	2.4	2.8	3.1
Effective interest rate	3.5	3.5	3.5	3.7	3.8	3.8
Real Interest Rate Shock						
Real GDP growth	-1.8	0.8	1.5	1.7	1.8	1.8
Inflation	1.9	0.9	1.0	1.7	1.8	1.8
Primary balance	-1.6	0.3	1.8	2.4	2.8	3.1
Effective interest rate	3.5	3.5	3.9	4.2	4.6	4.7
Combined Shock						
Real GDP growth	-1.8	-1.2	-0.5	1.7	1.8	1.8
Inflation	1.9	0.4	0.5	1.7	1.8	1.8
Primary balance	-1.6	-15.0	1.1	2.4	2.8	3.1
Effective interest rate	3.5	3.5	3.9	4.4	4.8	4.9

Real GDP Growth Shock	2013	2014	2015	2016	2017	2018
Real GDP growth	-1.8	-1.2	-0.5	1.7	1.8	1.8
Inflation	1.9	0.4	0.5	1.7	1.8	1.8
Primary balance	-1.6	-0.8	-0.2	2.4	2.8	3.1
Effective interest rate	3.5	3.5	3.5	3.8	3.8	3.8
Real Exchange Rate Shock						
Real GDP growth	-1.8	0.8	1.5	1.7	1.8	1.8
Inflation	1.9	1.0	1.0	1.7	1.8	1.8
Primary balance	-1.6	0.3	1.8	2.4	2.8	3.1
Effective interest rate	3.5	3.5	3.5	3.6	3.7	3.7
Contingent Liability Shock						
Real GDP growth	-1.8	0.8	1.5	1.7	1.8	1.8
Inflation	1.9	0.9	1.0	1.7	1.8	1.8
Primary balance	-1.6	-14.7	1.8	2.4	2.8	3.1
Effective interest rate	3.5	3.6	3.4	3.7	3.8	3.8

Source: IMF staff.

Table 1. Portugal: Selected Economic Indicators

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

				Projections					
	2010	2011	2012	2013	2014	2015	2016	2017	2018
Real GDP	1.9	-1.3	-3.2	-1.8	0.8	1.5	1.7	1.8	1.8
Total domestic demand	1.8	-5.1	-6.6	-3.6	-0.2	0.7	1.1	1.3	1.3
Private consumption	2.5	-3.3	-5.4	-2.5	0.1	0.7	0.7	0.8	0.8
Public consumption	0.1	-5.0	-4.7	-4.0	-2.8	-2.2	0.5	0.4	1.0
Gross fixed investment	-3.1	-10.5	-14.3	-8.5	1.2	3.7	3.7	4.3	3.8
Private	-8.3	-5.2	-11.4	-10.1	2.5	4.9	4.1	4.8	4.3
Government	27.1	-32.9	-31.4	4.1	-7.0	-4.8	0.3	0.0	-0.8
Exports	10.2	6.9	3.2	5.8	5.0	5.3	5.6	5.6	5.6
Imports	8.0	-5.3	-6.6	0.8	2.5	3.8	4.4	4.6	4.7
Contribution to Growth									
Total domestic demand	2.0	-5.5	-6.9	-3.6	-0.2	0.7	1.0	1.2	1.2
Private consumption	1.7	-2.2	-3.5	-1.6	0.1	0.5	0.4	0.5	0.5
Public consumption	0.0	-1.1	-1.0	-0.8	-0.5	-0.4	0.1	0.1	0.2
Gross fixed investment	-0.7	-2.1	-2.6	-1.4	0.2	0.6	0.6	0.7	0.6
Foreign balance	-0.1	4.4	3.7	1.9	1.0	0.7	0.7	0.6	0.6
Savings-investment balance (percent of GDP)									
Gross national savings	9.8	11.3	14.8	15.7	15.8	16.5	17.5	18.7	20.0
Private	16.8	16.2	19.8	19.8	18.0	17.4	17.8	18.6	19.6
Public	-7.0	-4.9	-5.1	-4.0	-2.3	-0.9	-0.4	0.0	0.4
Gross domestic investment	20.2	18.4	16.7	14.8	14.8	15.4	15.8	16.5	17.2
Private	16.3	15.8	14.8	12.8	12.9	13.6	14.1	14.7	15.4
Public	3.9	2.7	1.9	2.0	1.9	1.8	1.8	1.8	1.8
Resource utilization									
Potential GDP	0.7	-0.2	-0.9	-1.0	-0.5	0.5	0.8	1.1	1.1
Output Gap (% of potential)	-0.3	-1.3	-3.7	-4.4	-3.2	-2.2	-1.4	-0.7	0.0
Employment	-1.5	-1.5	-4.2	-3.9	-0.5	0.4	0.6	0.6	0.6
Unemployment rate (%) 1/	10.8	12.7	15.7	17.4	17.7	17.3	16.8	16.2	15.6
Prices									
GDP deflator	0.6	0.3	-0.3	1.9	0.9	1.0	1.7	1.8	1.8
Consumer prices (harmonized index)	1.4	3.6	2.8	0.6	1.0	1.2	1.5	1.5	1.5
Compensation per worker (whole economy)	2.0	-0.6	-2.0	2.5	-0.8	0.0	0.6	0.8	1.0
Labor productivity	3.5	0.3	1.1	2.2	1.3	1.0	1.1	1.2	1.2
Unit labor costs (whole economy)	-1.4	-0.9	-3.1	0.3	-2.1	-1.0	-0.5	-0.4	-0.2
Money and credit (end of period, percent change)									
Private sector credit	-0.3	-1.5	-6.5	-4.4	-3.0	-0.6	1.0	1.5	1.8
Broad money	-1.3	-1.3	-6.2	0.0	1.7	2.5	3.4	3.6	3.6
Interest rates (percent)									
Short-term deposit rate	1.7	3.5	3.0	2.3	2.7	3.0	3.5	3.8	3.8
Government bond rate, 10-year	5.3	10.2	10.6	6.5	6.0	5.5	5.0	5.0	5.2
Fiscal indicators (percent of GDP)									
General government balance 2/	-9.9	-4.3	-6.5	-5.9	-4.0	-2.5	-2.0	-1.6	-1.2
Primary government balance	-7.0	-0.3	-2.1	-1.6	0.3	1.8	2.4	2.8	3.1
Structural balance	-9.0	-6.6	-4.1	-3.6	-2.7	-1.5	-1.4	-1.3	-1.2
Structural primary balance (percent of potential GDP)	-6.2	-2.6	0.1	0.5	1.6	2.8	2.9	3.1	3.1
General government debt	94.0	108.2	124.1	127.8	126.7	125.7	123.5	120.0	117.3
External sector (percent of GDP)									
Trade balance (goods)	-11.1	-8.3	-5.2	-3.3	-2.3	-1.8	-1.4	-1.0	-0.8
Trade balance (G&S)	-7.2	-3.8	0.1	2.9	4.2	5.1	5.8	6.3	6.7
Current account balance	-10.6	-7.0	-1.5	1.0	1.0	1.1	1.6	2.2	2.8
Net international investment position	-107.2	-104.8	-116.8	-114.2	-109.8	-104.7	-98.3	-91.4	-84.1
REER based on ULC (1999=100)	108.0	106.7	101.1	102.3	101.1	100.2	99.5	99.0	98.7
(rate of growth)	-1.4	-1.2	-5.3	1.1	-1.2	-0.9	-0.7	-0.5	-0.3
REER based on CPI (1999=100)	107.8	108.7	107.3	107.2	107.7	108.0	108.2	108.4	108.7
(rate of growth)	-2.1	0.9	-1.3	-0.1	0.5	0.2	0.2	0.2	0.2
Nominal GDP (billions of euro)	172.9	171.1	165.1	165.3	168.2	172.3	178.1	184.6	191.3

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

1/ The unemployment rate series contains a structural break in 2011.

2/ EDP notification concept.

Table 2a. Portugal: General Government Accounts 1/
(Billions of euros)

	2011	2012	Projections 2/ 2013 7th Review	2013	2014 7th Review	2014	2015	2016	2017	2018
Revenue	77.0	67.6	70.0	71.5	70.5	71.9	73.6	75.6	77.6	79.5
Taxes	40.4	38.1	39.7	40.4	40.1	41.2	42.4	43.8	45.0	46.2
Taxes on production and imports	23.5	22.5	21.7	21.9	22.3	22.6	23.3	24.1	24.7	25.2
Current taxes on income, wealth, etc. and capital taxes	16.9	15.5	18.0	18.5	17.8	18.7	19.1	19.7	20.3	21.0
Current taxes on income, wealth, etc.	16.9	15.3	18.0	18.5	17.8	18.7	19.1	19.7	20.3	21.0
Capital taxes	0.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	21.0	19.1	19.7	19.9	20.1	19.6	19.5	19.7	20.0	20.2
Grants and other revenue	15.6	10.4	10.6	11.2	10.3	11.1	11.7	12.1	12.6	13.0
Property income	1.2	1.2	1.2	1.4	1.2	1.4	1.5	1.5	1.6	1.6
Sales of goods and services	4.3	4.6	5.2	4.8	5.3	4.6	4.7	4.9	5.0	5.2
Other current revenue	2.3	2.3	2.3	3.1	2.3	3.3	3.6	3.7	3.9	4.0
Capital transfers and investment grants	7.8	2.2	1.9	1.9	1.5	1.8	2.0	2.0	2.1	2.2
Expenditure 3/	84.4	78.2	79.0	81.2	77.2	78.7	78.0	79.3	80.6	81.8
Expense	83.9	79.7	80.2	82.2	78.6	79.8	79.3	80.6	82.0	83.3
Compensation of employees	19.4	16.5	17.3	17.5	15.6	15.8	15.2	15.2	15.3	15.3
Use of goods and services	7.9	7.4	7.2	7.9	7.2	7.8	7.6	7.7	7.8	7.9
Consumption of fixed capital	3.9	3.9	4.3	4.1	4.3	4.1	4.2	4.4	4.5	4.7
Interest (ESA95)	6.9	7.2	7.2	7.2	7.3	7.3	7.6	7.9	8.2	8.4
Subsidies	1.2	1.0	0.9	1.2	0.9	1.3	1.3	1.3	1.3	1.4
Social benefits	37.8	37.1	39.3	38.4	39.0	38.3	38.3	38.9	39.5	40.1
Grants and other expense	6.9	6.6	4.0	6.0	4.2	5.3	5.2	5.3	5.4	5.5
Other current expense	4.4	4.2	4.0	4.5	4.0	4.8	4.4	4.5	4.6	4.6
Capital transfers	2.4	2.3	0.0	1.5	0.3	0.5	0.8	0.8	0.8	0.8
Net acquisition of nonfinancial assets	0.5	-1.4	-1.3	-1.0	-1.4	-1.1	-1.3	-1.4	-1.4	-1.5
Gross fixed capital formation	4.5	2.5	3.0	3.1	2.9	3.0	2.9	3.0	3.1	3.2
(-) Consumption of fixed capital	-3.9	-3.9	-4.3	-4.1	-4.3	-4.1	-4.2	-4.4	-4.5	-4.7
Acquisitions less disposals of other nonfinancial assets	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-3.0	-8.2	-5.9	-6.7	-3.8	-3.8	-1.5	-0.7	0.1	0.8
Net lending (+)/borrowing (–) (ESA95)	-7.4	-10.7	-9.0	-9.8	-6.7	-6.8	-4.4	-3.6	-3.0	-2.4
Net lending (+)/borrowing (–) (EDP notification)	-7.4	-10.6	-9.0	-9.8	-6.7	-6.8	-4.4	-3.6	-3.0	-2.4
Net lending (+)/borrowing (–) (program) 4/	-6.8	-7.8	-9.0	-9.1	-6.7	-6.8	-4.4	-3.6	-3.0	-2.4
Net acquisition of financial assets	14.2	4.8	...	...	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	...	...	...	...	...	...	...	...
Currency and deposits	10.2	1.2	...	...	...	...	...	...	...	...
Debt securities	0.4	6.4	...	...	...	...	...	...	...	...
Loans	0.4	1.2	...	...	...	...	...	...	...	...
Equity and investment fund shares	-0.3	-1.1	...	...	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	...	...	...	...	...	...	...	...
Financial derivatives and employee stock options	-0.2	-0.2	...	...	...	...	...	...	...	...
Other accounts receivable	3.7	-2.6	...	...	...	...	...	...	...	...
Net incurrence of liabilities	21.8	15.5	...	...	...	...	...	...	...	...
SDRs	0.0	0.0	...	...	...	...	...	...	...	...
Currency and deposits	-3.1	-1.4	...	...	...	...	...	...	...	...
Debt securities	-11.2	-6.8	...	...	...	...	...	...	...	...
Loans	35.5	27.1	...	...	...	...	...	...	...	...
Equity and investment fund shares	0.0	0.0	...	...	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	...	...	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	...	...	...	...	...	...	...	...
Other accounts payable	0.5	-3.5	...	...	...	...	...	...	...	...
Memorandum items:										
Primary balance	-0.5	-3.5	-1.8	-2.6	0.6	0.5	3.2	4.3	5.2	6.0
Interest (EDP notification)	6.9	7.1	7.2	7.2	7.3	7.3	7.6	7.9	8.2	8.4
Debt at face value (EDP notification)	185.2	204.8	202.1	211.4	208.1	213.0	216.6	219.9	221.5	224.4
Nominal GDP	171.1	165.1	164.5	165.3	167.5	168.2	172.3	178.1	184.6	191.3

Sources: Portuguese statistical authorities; and IMF staff projections.

1/ GFSM 2001 presentation.

2/ Projections assume no structural fiscal effort after 2015. In contrast, the authorities assume additional effort in order to achieve the European "fiscal compact" objective (structural deficit of less than 0.5 percent of GDP). Compared with the baseline, adherence to the "fiscal compact" would lower the debt-to-GDP ratio by three percentage points by 2020.

3/ Historical data include expenditure commitments that have given rise to arrears of the general government.

4/ Excludes the impact of several large transactions that were booked differently at the time the original deficit targets were set. In 2011, those were €600 million in bank restructuring costs (IMF Country Report 12/77). In 2012, those were ANA concession (€1,200 million), increase in the share capital of CGD (€750 million), reclassfied operations of Sagestamo (€750 million), and valuation changes of BPN (€100 million). In 2013, they include the increase in the share capital of Banif (€700 million).

Table 2b. Portugal: General Government Accounts 1/
(Percent of GDP)

			Projections 2/							
	2011	2012	2013 7th Review	2013	2014 7th Review	2014	2015	2016	2017	2018
Revenue	45.0	40.9	42.6	43.2	42.1	42.8	42.7	42.5	42.0	41.5
Taxes	23.6	23.1	24.2	24.5	23.9	24.5	24.6	24.6	24.4	24.2
Taxes on production and imports	13.7	13.7	13.2	13.3	13.3	13.4	13.5	13.5	13.4	13.2
Current taxes on income, wealth, etc. and capital taxes	9.9	9.4	11.0	11.2	10.6	11.1	11.1	11.0	11.0	11.0
Current taxes on income, wealth, etc.	9.9	9.3	11.0	11.2	10.6	11.1	11.1	11.0	11.0	11.0
Capital taxes	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	12.3	11.6	12.0	12.0	12.0	11.6	11.3	11.1	10.8	10.6
Grants and other revenue	9.1	6.3	6.5	6.8	6.1	6.6	6.8	6.8	6.8	6.8
Property income	0.7	0.7	0.7	0.8	0.7	0.8	0.8	0.8	0.8	0.8
Sales of goods and services	2.5	2.8	3.2	2.9	3.1	2.7	2.7	2.7	2.7	2.7
Other current revenue	1.3	1.4	1.4	1.9	1.4	2.0	2.1	2.1	2.1	2.1
Capital transfers and investment grants	4.6	1.4	1.1	1.2	0.9	1.1	1.1	1.1	1.1	1.1
Expenditure 3/	49.3	47.4	48.0	49.1	46.1	46.8	45.3	44.5	43.7	42.8
Expense	49.0	48.3	48.8	49.7	46.9	47.5	46.0	45.3	44.4	43.5
Compensation of employees	11.3	10.0	10.5	10.6	9.3	9.4	8.8	8.5	8.3	8.0
Use of goods and services	4.6	4.5	4.4	4.8	4.3	4.6	4.4	4.3	4.2	4.1
Consumption of fixed capital	2.3	2.4	2.6	2.5	2.6	2.4	2.4	2.5	2.4	2.4
Interest (ESA95)	4.0	4.3	4.4	4.3	4.4	4.4	4.4	4.4	4.4	4.4
Subsidies	0.7	0.6	0.5	0.7	0.5	0.8	0.8	0.7	0.7	0.7
Social benefits	22.1	22.5	23.9	23.2	23.2	22.8	22.2	21.8	21.4	21.0
Grants and other expense	4.0	4.0	2.5	3.6	2.5	3.1	3.0	3.0	2.9	2.9
Other current expense	2.6	2.6	2.4	2.7	2.4	2.8	2.6	2.5	2.5	2.4
Capital transfers	1.4	1.4	0.0	0.9	0.2	0.3	0.4	0.4	0.4	0.4
Net acquisition of nonfinancial assets	0.3	-0.9	-0.8	-0.6	-0.8	-0.6	-0.8	-0.8	-0.8	-0.8
Gross fixed capital formation	2.6	1.5	1.8	1.9	1.7	1.8	1.7	1.7	1.7	1.7
(-) Consumption of fixed capital	-2.3	-2.4	-2.6	-2.5	-2.6	-2.4	-2.4	-2.5	-2.4	-2.4
Acquisitions less disposals of other nonfinancial assets	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-1.8	-5.0	-3.6	-4.0	-2.2	-2.3	-0.9	-0.4	0.0	0.4
Net lending (+)/borrowing (–) (ESA95)	-4.3	-6.5	-5.5	-5.9	-4.0	-4.0	-2.5	-2.0	-1.6	-1.2
Net lending (+)/borrowing (–) (EDP notification)	-4.3	-6.4	-5.5	-5.9	-4.0	-4.0	-2.5	-2.0	-1.6	-1.2
Net lending (+)/borrowing (–) (program) 4/	-4.0	-4.7	-5.5	-5.5	-4.0	-4.0	-2.5	-2.0	-1.6	-1.2
Net acquisition of financial assets	8.3	2.9	...	...	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	...	...	...	...	...	...	...	...
Currency and deposits	6.0	0.7	...	...	...	...	...	...	...	...
Debt securities	0.2	3.9	...	...	...	...	...	...	...	...
Loans	0.3	0.7	...	...	...	...	...	...	...	...
Equity and investment fund shares	-0.2	-0.7	...	...	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	...	...	...	...	...	...	...	...
Financial derivatives and employee stock options	-0.1	-0.1	...	...	...	...	...	...	...	...
Other accounts receivable	2.2	-1.6	...	...	...	...	...	...	...	...
Net incurrence of liabilities	12.7	9.4	...	...	...	...	...	...	...	...
SDRs	0.0	0.0	...	...	...	...	...	...	...	...
Currency and deposits	-1.8	-0.9	...	...	...	...	...	...	...	...
Debt securities	-6.5	-4.1	...	...	...	...	...	...	...	...
Loans	20.7	16.4	...	...	...	...	...	...	...	...
Equity and investment fund shares	0.0	0.0	...	...	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	...	...	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	...	...	...	...	...	...	...	...
Other accounts payable	0.3	-2.1	...	...	...	...	...	...	...	...
Memorandum items:										
Primary balance	-0.3	-2.1	-1.1	-1.6	0.4	0.3	1.8	2.4	2.8	3.1
Structural balance (Percent of potential GDP)	-6.6	-4.1	-3.2	-3.6	-1.6	-2.7	-1.5	-1.4	-1.3	-1.2
Structural primary balance (Percent of potential GDP)	-2.6	0.1	1.0	0.5	2.5	1.6	2.8	2.9	3.1	3.1
Interest (EDP notification)	4.0	4.3	4.4	4.3	4.4	4.4	4.4	4.4	4.4	4.4
Debt at face value (EDP notification)	108.2	124.1	122.9	127.8	124.2	126.7	125.7	123.5	120.0	117.3

Sources: Portuguese statistical authorities; and IMF staff projections.

1/ GFSM 2001 presentation.

2/ Projections assume no structural fiscal effort after 2015. In contrast, the authorities assume additional effort in order to achieve the European "fiscal compact" objective (structural deficit of less than 0.5 percent of GDP). Compared with the baseline, adherence to the "fiscal compact" would lower the debt-to-GDP ratio by about three percentage points by 2020.

3/ Historical data include expenditure commitments that have given rise to arrears of the general government.

4/ Excludes the impact of several large transactions that were booked differently at the time the original deficit targets were set. In 2011, those were €600 million in bank restructuring costs (IMF Country Report 12/77). In 2012, those were ANA concession (€1,200 million), increase in the share capital of CGD (€750 million), reclassified operations of Sagestamo (€750 million), and valuation changes of BPN (€100 million). In 2013, they include the increase in the share capital of Banif (€700 million).

Table 3. Portugal: General Government Stock Positions
(Billions of euros)

	2008	2009	2010	2011	2012
Net financial worth	-93.1	-108.7	-111.2	-93.5	-129.0
Financial assets	45.7	48.6	58.5	73.7	83.1
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0
Currency and deposits	7.3	6.8	7.7	18.0	19.2
Debt securities	1.5	1.9	1.8	2.2	8.6
Loans	3.0	2.8	4.1	4.6	5.8
Equity and investment fund shares	25.8	28.7	34.4	34.7	38.0
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	0.0
Financial derivatives and employee stock options	-0.1	0.0	0.1	0.4	0.4
Other accounts receivable	8.1	8.5	10.3	13.8	11.2
Liabilities	138.8	157.2	169.7	167.2	212.2
Special Drawing Rights (SDRs)	0.0	0.0	0.0	0.0	0.0
Currency and deposits	19.5	18.9	18.1	15.0	13.6
Debt securities	98.1	114.3	120.5	85.2	105.4
Loans	15.7	17.4	22.5	58.6	85.3
Equity and investment fund shares	0.0	0.0	0.0	0.0	0.0
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	0.0
Financial derivatives and employee stock options	0.0	0.0	0.0	0.9	1.2
Other accounts payable	5.6	6.5	8.5	7.6	6.7
Memorandum items:					
Gross debt (at market value)	138.8	157.2	169.6	166.3	211.0
Gross debt at face value	128.9	147.6	171.0	192.8	211.6
Gross debt at face value (EDP notification)	123.3	141.1	162.5	185.2	204.8
Other economic flows - financial assets	...	1.8	5.0	1.1	4.6
Other economic flows - liabilities	...	0.3	-9.5	-24.2	29.5

Sources: Portuguese statistical authorities; and IMF staff calculations.

Table 4. Portugal: General Government Financing Requirements and Sources 1/
(Billions of euros)

	2010	2011	2012	2013	2014	2015	2016	2017	2018
Gross borrowing need	58.4	59.3	67.1	45.2	46.3	45.9	49.0	40.0	43.6
Overall balance	17.0	7.5	10.6	9.8	6.8	4.4	3.6	3.0	2.4
Amortization	31.0	40.7	39.5	30.7	41.0	42.3	45.7	38.4	40.7
M<	7.7	12.8	18.7	11.5	23.6	16.4	12.2	11.1	10.2
Residents	0.7	3.9	11.5	5.0	12.5	8.5	5.9	4.9	5.6
Of which within general government	0.0	0.4	3.2	0.9	1.7	1.7	0.7	0.7	0.7
Non-residents	7.1	8.9	7.2	6.5	11.1	8.0	6.4	6.2	4.6
ST 2/	23.3	27.9	19.8	19.2	17.4	23.6	23.6	23.6	23.6
Residents	6.4	16.9	18.0	18.3	15.3	19.3	16.7	16.7	16.7
Of which within general government	1.1	3.3	4.7	6.0	…	…	…	…	…
Non-residents	16.9	11.0	1.8	0.9	2.1	4.3	6.9	6.9	6.9
EU and IMF 3/	0.0	0.0	1.0	0.0	0.0	2.3	9.9	3.7	6.9
Other (net) 4/	10.4	11.0	17.0	4.7	-1.4	-0.7	-0.4	-1.5	0.5
Of which within general government	4.6	3.9	5.0	…	…	…	…	…	…
Gross financing sources	58.4	23.9	38.6	35.1	38.5	45.9	49.0	40.0	43.6
Privatization receipts	0.7	0.6	2.2	1.0	0.5	0.0	0.0	0.0	0.0
Market access	59.0	36.8	36.3	31.1	34.7	45.9	49.0	40.0	43.6
M<	31.0	18.0	17.1	13.7	11.1	22.4	25.4	16.4	20.0
Residents	15.9	13.7	15.2	8.2	7.1	12.1	11.5	8.0	9.8
Of which from general government	3.0	6.1	6.2	…	…	…	…	…	…
Non-residents	15.1	4.3	1.9	5.4	4.0	10.2	14.0	8.4	10.2
ST 2/	27.9	18.8	19.2	17.4	23.6	23.6	23.6	23.6	23.6
Residents	16.9	17.0	18.3	15.3	19.3	16.7	16.7	16.7	16.7
Of which from general government	3.3	4.7	5.6	…	…	…	…	…	…
Non-residents	11.0	1.8	0.9	2.1	4.3	6.9	6.9	6.9	6.9
Use of deposits 5/	-1.3	-13.5	0.0	3.0	3.3	0.0	0.0	0.0	0.0
Of which intra-government	-0.6	-3.2	1.2	…	…	…	…	…	…
Financing under the program 3/	0.0	35.3	28.5	9.9	7.9	0.0	0.0	0.0	0.0
European Union	…	22.2	20.4	6.5	5.2	…	…	…	…
IMF	…	13.1	8.2	3.4	2.7	…	…	…	…
Net placement (market access-amortization)	28.0	-3.9	-3.1	0.3	-6.3	3.7	3.3	1.6	2.9
Residents	25.8	9.9	4.0	0.2	-1.4	-0.1	0.7	1.2	0.7
M<	15.3	9.8	3.7	3.2	-5.4	2.5	0.7	1.2	0.7
ST (net increase)	10.5	0.1	0.3	-3.0	4.0	-2.6	0.0	0.0	0.0
Non-residents	2.2	-13.8	-6.1	0.1	-4.9	3.7	2.6	0.4	2.2
M<	8.0	-4.6	-5.3	-1.1	-7.0	1.1	2.6	0.4	2.2
ST (net increase)	-5.9	-9.2	-0.9	1.2	2.2	2.6	0.0	0.0	0.0

Source: Portuguese authorities and Fund staff estimates.

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

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

3/ Changes to IMF disbursements compared to initial programmed amounts reflect EUR/SDR exchange rate variations. Program financing from the EU includes the EUR 1.1 billion EFSF prepaid margin and EUR 0.1 billion in issuance costs (2011) and the roll-over of a EUR 1 billion short-term loan (2012). On June 21st 2013, ECOFIN has decided to extend the average maturity of EFSM loans by 7 years, which will bring the average maturity from 12.5 to 19.5 years. Pending the definition of the final maturity date of each individual loan, the table still reflects the original maturities.

4/ Includes use of Bank Solvency Support Facility and other net financial transactions, net financing from retail government securities programs, as well as adjustments for cash-accrual differences and consistency between annual projections and preliminary quarterly accounts.

5/ Changes in government deposits (including deposits in BSSF).

Table 5. Portugal: Balance of Payments, 2010–18

	2010	2011	2012	2013	2014	2015	2016	2017	2018
				Projections					
	(Billions of euro)								
Current account	-18.3	-12.0	-2.6	1.6	1.7	1.9	2.9	4.1	5.4
Balance of goods and services	-12.5	-6.5	0.1	4.8	7.1	8.8	10.3	11.6	12.8
Trade balance	-19.2	-14.2	-8.6	-5.4	-3.9	-3.1	-2.4	-1.9	-1.6
Exports fob	37.4	43.1	45.5	47.8	50.6	54.0	57.0	60.6	64.3
Imports fob	56.6	57.3	54.1	53.2	54.5	57.1	59.5	62.6	65.9
Services, net	6.7	7.7	8.7	10.2	11.0	11.9	12.7	13.5	14.4
Exports	17.6	19.2	19.1	20.7	22.0	23.4	24.9	26.5	28.2
Imports	10.9	11.5	10.4	10.5	10.9	11.5	12.2	13.0	13.8
Of which:									
Tourism	4.6	5.2	5.7	6.5	7.0	7.5	8.0	8.5	9.1
Exports	7.6	8.1	8.6	9.4	10.1	10.8	11.5	12.2	13.0
Imports	3.0	3.0	2.9	3.0	3.1	3.3	3.5	3.7	3.9
Income, net	-7.9	-8.5	-6.4	-6.8	-9.1	-10.4	-10.9	-11.0	-10.7
Current transfers, net	2.2	3.0	3.8	3.6	3.6	3.6	3.5	3.5	3.4
Private remittances, net	2.2	2.4	2.8	2.8	2.7	2.6	2.6	2.8	2.9
Official transfers, net	0.0	0.6	1.0	0.8	0.9	0.9	0.9	0.7	0.5
Capital account	1.9	2.1	3.9	2.4	2.4	2.4	2.4	2.4	2.4
Financial account	15.6	-24.2	-29.4	-13.9	-11.9	-4.3	-5.3	-6.5	-7.8
Direct investment	7.7	-2.7	5.4	5.1	1.6	1.6	1.6	0.6	0.5
Portuguese investment abroad	5.7	-10.7	-1.5	-1.5	-1.6	-1.6	-1.7	-2.8	-2.9
Foreign investment in Portugal	2.0	8.0	6.9	6.6	3.2	3.2	3.3	3.4	3.4
Portfolio investment, net	-9.7	-4.6	-20.9	-15.7	-9.3	7.1	10.7	4.0	7.4
Financial derivatives	0.4	0.5	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other investment, net	18.2	-18.6	-13.9	-3.4	-4.3	-13.1	-17.7	-11.1	-15.8
Reserve assets	-1.0	1.2	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	0.8	0.1	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	...	33.9	27.7	9.9	7.9	...	...	...	...
European Union	...	20.9	19.4	6.5	5.2	...	...	...	...
IMF	...	13.1	8.2	3.4	2.7	...	...	...	...
Memorandum items:									
Net international investment position 1/	-185.2	-179.4	-192.8	-188.8	-184.7	-180.4	-175.1	-168.7	-160.9
Direct investment, net	-33.6	-30.6	-34.8	-39.9	-41.5	-43.2	-44.8	-45.4	-45.9
Portfolio investment, net	-52.1	-31.7	-25.3	-9.6	-0.2	-7.4	-18.1	-22.1	-29.5
Financial derivatives	-1.1	-2.4	-3.6	-3.7	-3.8	-3.8	-3.9	-4.0	-4.0
Other investment, net	-114.1	-131.2	-146.2	-152.8	-156.3	-143.2	-125.5	-114.4	-98.6
Reserve assets	15.7	16.5	17.2	17.2	17.2	17.2	17.2	17.2	17.2
Nominal GDP	172.9	171.1	165.1	165.3	168.2	172.3	178.1	184.6	191.3
	(Percentage of GDP)								
Current account	-10.6	-7.0	-1.5	1.0	1.0	1.1	1.6	2.2	2.8
Current account (including capital transfers)	-9.4	-5.8	0.8	2.4	2.4	2.5	3.0	3.5	4.1
Of which: Balance of goods and services	-7.2	-3.8	0.1	2.9	4.2	5.1	5.8	6.3	6.7
Net international investment position 1/	-107.2	-104.8	-116.8	-114.2	-109.8	-104.7	-98.3	-91.4	-84.1
Direct investment, net	-19.5	-17.9	-21.1	-24.1	-24.7	-25.0	-25.1	-24.6	-24.0
Portfolio investment, net	-30.1	-18.5	-15.3	-5.8	-0.1	-4.3	-10.2	-12.0	-15.4
Financial derivatives	-0.7	-1.4	-2.2	-2.2	-2.2	-2.2	-2.2	-2.1	-2.1
Other investment, net	-66.0	-76.7	-88.6	-92.4	-93.0	-83.1	-70.5	-62.0	-51.5
Reserve assets	9.1	9.6	10.4	10.4	10.2	10.0	9.6	9.3	9.0

Sources: Bank of Portugal; and IMF staff calculations.

1/ End-of-period data.

Table 6. Portugal: External Financing Requirements and Sources, 2010–18
(Billions of euros)

	2010	2011	2012	2013	2014	2015	2016	2017	2018
GROSS FINANCING REQUIREMENTS	186.0	210.5	183.0	163.2	155.4	142.2	137.0	128.9	128.7
Current account deficit	18.3	12.0	2.6	-1.6	-1.7	-1.9	-2.9	-4.1	-5.4
Medium- and long-term debt amortization	28.8	29.6	32.8	31.6	34.5	27.4	24.1	25.8	29.2
Public sector	7.1	8.9	7.2	6.5	11.1	8.0	6.4	6.2	4.6
Banks	18.5	16.7	18.6	16.7	18.0	13.9	12.6	15.4	19.9
Other private	3.3	4.1	7.0	8.3	5.4	5.5	5.2	4.2	4.7
Short-term debt amortization	138.9	168.9	147.6	133.3	122.6	114.4	105.8	103.5	98.0
Public sector	40.3	71.0	63.6	67.0	66.8	60.6	47.3	36.7	32.1
Central Bank	23.4	59.9	61.0	66.1	64.7	56.4	40.4	29.8	25.2
General government and SOEs	16.9	11.1	2.7	0.9	2.1	4.3	6.9	6.9	6.9
Banks	79.5	76.6	57.4	47.7	39.0	37.9	39.4	41.0	42.8
Other private	19.1	21.3	26.6	18.6	16.8	15.9	19.1	25.8	23.2
EU and IMF 1/	0.0	0.0	0.0	0.0	0.0	2.3	9.9	3.7	6.9
SOURCES OF FINANCING	186.0	176.6	155.3	153.3	147.5	142.2	137.0	128.9	128.7
Capital account (net)	1.9	2.1	3.9	2.4	2.4	2.4	2.4	2.4	2.4
Foreign direct investment (net)	7.7	-2.7	5.4	5.1	1.6	1.6	1.6	0.6	0.5
Inward	2.0	8.0	6.9	6.6	3.2	3.2	3.3	3.4	3.4
New borrowing and debt rollover	194.1	161.4	143.4	142.3	138.5	138.4	139.0	128.5	132.2
Medium and long-term borrowing	25.2	14.7	10.1	19.7	24.1	32.6	35.5	30.4	37.2
General Government	15.1	4.3	1.9	5.4	4.0	10.2	14.0	8.4	10.2
Banks	3.7	2.0	2.6	7.6	15.2	15.7	14.6	17.0	21.3
Other private	6.4	8.4	5.6	6.7	4.9	6.6	7.0	5.0	5.6
Short-term borrowing	168.8	146.7	133.3	122.6	114.4	105.8	103.5	98.0	95.0
Public sector	71.0	62.8	67.0	66.8	60.6	47.3	36.7	32.1	29.6
Central Bank	59.9	61.0	66.1	64.7	56.4	40.4	29.8	25.2	22.7
General government	11.0	1.8	0.9	2.1	4.3	6.9	6.9	6.9	6.9
Banks	76.6	57.4	47.7	39.0	37.9	39.4	41.0	42.8	44.6
Other private	21.3	26.6	18.6	16.8	15.9	19.1	25.8	23.2	20.9
Other (includes asset operations)	-17.7	15.8	2.6	3.5	5.0	-0.2	-6.0	-2.5	-6.4
Of which: Net errors and omissions	0.8	0.1	0.5	0.0	0.0	0.0	0.0	0.0	0.0
FINANCING GAP	0.0	33.9	27.7	9.9	7.9	0.0	0.0	0.0	0.0
European Union (2/3 of total) 1/	…	20.9	19.4	6.5	5.2	…	…	…	…
IMF (1/3 of total) 2/	…	13.1	8.2	3.4	2.7	…	…	…	…
ROLLOVER RATES									
General government	109.2	30.5	29.0	100.9	63.0	139.7	157.6	116.9	149.3
Private	89.7	79.5	68.0	76.7	93.3	110.4	115.8	101.8	102.0
Banks	81.9	63.6	66.2	72.4	93.1	106.4	106.9	105.9	105.2
Other private	124.1	138.0	72.1	86.9	93.8	120.0	135.0	94.2	95.0

Source: Bank of Portugal and staff estimates.

1/ Net of intra-year EFSF treasury bill issuance and amortization and EFSF pre-paid margin. On June 21st 2013, ECOFIN has decided to extend the average maturity of EFSM loans by 7 years, which will bring the average maturity from 12.5 to 19.5 years. Pending the definition of the final maturity date of each individual loan, the table still reflects the original maturities.

2/ Changes to IMF disbursements compared to initial programmed amounts reflect EUR/SDR exchange rate variations.

Table 7. Portugal: Selected Financial Indicators of the Banking System, 2008–13Q1

(Percent)

	2008	2009	2010	2011	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Capital Adequacy									
Regulatory capital to risk-weighted assets	9.4	10.5	10.3	9.8	10.7	12.3	12.3	12.6	13.0
Regulatory Tier 1 capital to risk-weighted assets	6.6	7.9	8.3	8.6	9.5	11.0	11.1	11.3	11.7
Capital to assets 1/	5.8	6.5	6.7	5.3	5.8	6.2	6.6	6.7	6.9
Asset composition and quality									
Nonperforming loans to total gross loans 2/	3.6	4.8	5.2	7.5	8.0	9.2	9.8	9.8	10.4
Nonperforming loans to total gross loans 3/	3.5	4.8	5.1	…	…	…	…	…	…
Sectoral distribution of loans									
Residents	83.7	83.6	83.3	84.0	83.2	82.4	82.5	83.3	83.2
Deposit-takers	6.2	5.8	5.3	6.5	6.8	7.3	6.3	7.7	7.2
Central bank	1.3	1.2	0.5	0.9	0.4	0.4	0.7	1.1	0.8
Other financial corporations	3.6	3.7	3.9	2.9	2.7	2.7	2.7	2.4	2.3
General government	1.6	1.7	2.9	2.6	3.2	2.7	2.7	2.2	2.2
Nonfinancial corporations	31.6	31.5	30.7	31.0	30.6	30.0	30.3	30.2	30.5
Other domestic sectors	39.5	39.6	39.9	40.1	39.6	39.2	39.8	39.8	40.1
Nonresidents	16.3	16.4	16.7	16.0	16.8	17.6	17.5	16.7	16.8
Earnings and profitability									
Return on assets	0.3	0.4	0.5	-0.3	0.5	0.1	0.0	-0.3	-0.3
Return on equity	5.7	7.3	7.5	-5.5	8.2	2.5	0.3	-5.4	-3.7
Interest margin to gross income	59.5	53.8	52.3	57.5	51.3	47.9	46.6	46.7	41.7
Noninterest expenses to gross income	58.0	58.3	58.9	63.9	58.2	55.0	57.0	59.6	66.2
Liquidity									
Liquid assets to total assets 4/	12.8	13.2	19.0	13.8	11.2	12.7	13.9	14.8	14.9
Liquid assets to short-term liabilities 4/	67.7	84.5	86.2	85.3	90.5	101.5	131.0	140.0	148.7
Loans to deposits 5/	…	161.5	157.8	140.2	136.9	136.3	133.3	127.9	124.4
Foreign-currency-denominated liabilities to total liabilities 6/	5.8	5.1	5.1	4.1	3.9	3.9	4.0	4.2	4.5

Source: Bank of Portugal.

1/ On accounting basis; consolidated.

2/ New NPL ratio in line with international practices. On a consolidated basis.

3/ New NPL ratio in line with international practices. On a consolidated basis, excluding institutions under intervention.

4/ Three-month residual maturity.

5/ Loans to customers (net of impairments) and securitized non-derecognized credit to customers divided by resources from customers and other loans.

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

Table 8. Portugal Monetary Survey, 2011–18
(Millions of euros, unless otherwise indicated; end of period)

	Dec-11	Dec-12	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18
			Projections					
Aggregated Balance Sheet of Monetary Financial Institutions (MFIs) 1/								
Assets	472,496	457,423	430,814	417,812	417,290	423,057	427,574	431,323
Cash	1,606	1,605	892	900	904	908	912	916
Claims on Bank of Portugal	5,692	8,136	2,589	1,872	1,072	614	352	201
Claims on other FIs	53,526	46,870	46,682	41,450	40,792	41,450	40,792	40,250
Claims on non MFIs	307,347	296,034	285,079	276,354	274,779	277,960	282,202	286,678
General government	32,309	38,759	39,093	37,842	37,727	38,537	39,188	39,290
Central government (excluding SOEs)	19,115	27,109	28,028	26,259	25,779	26,575	27,292	27,319
loans	38	464	352	349	344	339	334	311
securities	19,078	26,645	27,677	25,910	25,435	26,236	26,958	27,007
Bonds	10,307	16,078	20,109	17,135	17,961	18,761	19,484	19,533
Tbills	8,770	10,567	7,567	8,774	7,474	7,474	7,474	7,474
Regional and local government (excl SOEs)	6,405	5,684	5,524	5,524	5,524	5,524	5,524	5,585
SOEs	6,797	5,975	5,540	6,058	6,423	6,438	6,372	6,386
Private sector	275,038	257,275	245,986	238,512	237,053	239,423	243,014	247,389
Claims on non-residents	96,585	88,380	79,152	80,535	82,626	84,431	84,982	84,938
Other assets	7,740	16,398	16,420	16,700	17,116	17,693	18,333	18,339
Liabilities	472,496	457,423	430,814	417,812	417,290	423,057	427,574	431,323
Liabilities to Bank of Portugal	46,928	53,724	52,354	44,029	28,083	17,469	12,868	10,369
Liabilities to other FIs	60,888	46,542	41,866	42,810	43,394	44,094	44,262	45,147
Deposits of non MFIs	176,290	170,955	169,558	169,955	175,513	181,272	185,012	188,130
General government	12,279	13,218	9,174	5,895	5,895	5,895	5,895	5,895
Private sector	164,011	157,737	160,384	164,060	169,618	175,377	179,117	182,235
Securities other than capital	53,345	46,342	41,147	36,717	37,634	38,860	38,848	38,295
Liabilities to non-residents	105,130	89,474	74,969	72,720	75,702	78,805	82,115	85,564
Other	-10,690	326	298	292	294	304	315	337
Capital and reserves	40,606	50,061	50,623	51,289	56,671	62,253	64,154	63,480
Money and Credit								
Broad Money (M3)	172,547	161,855	161,894	164,656	168,755	174,443	180,751	187,344
Intermediate money (M2)	169,872	156,877	157,091	159,771	163,748	169,267	175,388	181,786
Narrow money (M1)	67,504	65,785	64,795	65,900	67,541	69,817	72,342	74,981
Private sector credit	275,038	257,275	245,986	238,512	237,053	239,423	243,014	247,389
Public sector credit	32,309	38,759	39,093	37,842	37,727	38,537	39,188	39,290
				(Percent of GDP)				
Broad Money	100.8	98.0	97.9	97.9	97.9	97.9	97.9	97.9
Private sector credit	160.7	155.8	148.8	141.8	137.6	134.4	131.7	129.3
Public sector credit	18.9	23.5	23.6	22.5	21.9	21.6	21.2	20.5
				(Percentage change)				
Broad Money	-1.3	-6.2	0.0	1.7	2.5	3.4	3.6	3.6
Private sector credit	-1.5	-6.5	-4.4	-3.0	-0.6	1.0	1.5	1.8
Public sector credit	-4.5	20.0	0.9	-3.2	-0.3	2.1	1.7	0.3
Memo items:								
ECB access (% assets)	9.9	11.7	12.2	10.5	6.7	4.1	3.0	2.4
Credit to deposits (%) 2/	146.1	148.9	144.7	135.3	130.4	128.0	127.1	126.5
Loan to deposits (%) 2/	140.6	145.0	140.9	137.2	133.3	130.9	130.1	129.5
Wholesale market funding (% assets) 3/	29.5	26.0	23.6	22.8	23.6	24.2	24.5	24.9

Sources: Bank of Portugal and staff estimates.

1/ Excludes Bank of Portugal.

2/ Credit to deposit ratio for banking system as a whole based on monetary statistics.

3/ Includes foreign interbank borrowing and securities issued.

Table 9. Portugal: External Debt Sustainability Framework, 2008–18

(Percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Debt-stabilizing non-interest current account 6/
Baseline: External debt	200.8	223.8	231.0	231.3	235.4	227.4	218.1	209.8	202.6	192.9	184.6	-0.8
Change in external debt	5.3	22.9	7.2	0.3	4.2	-8.0	-9.4	-8.3	-7.2	-9.7	-8.3	
Identified external debt-creating flows (4+8+9)	5.1	13.3	0.4	13.6	10.1	1.7	-3.2	-5.2	-6.1	-6.2	-6.7	
Current account deficit, excluding interest payments	4.7	4.8	5.3	0.5	-5.5	-7.0	-7.3	-7.5	-7.9	-8.6	-9.2	
Deficit in balance of goods and services	9.5	7.0	7.2	3.8	-0.1	-2.9	-4.2	-5.1	-5.8	-6.3	-6.7	
Exports	33.2	28.7	31.8	36.4	39.1	41.4	43.1	44.9	46.0	47.2	48.3	
Imports	42.7	35.7	39.0	40.2	39.1	38.5	38.9	39.8	40.2	40.9	41.7	
Net non-debt creating capital inflows (negative)	-4.5	-1.8	-4.6	4.2	0.2	-1.4	-0.5	-1.0	-1.0	-0.4	-0.4	
Automatic debt dynamics 1/	4.9	10.2	-0.3	8.9	15.3	10.2	4.6	3.3	2.9	2.8	2.9	
Contribution from nominal interest rate	7.9	6.1	5.3	6.5	7.0	6.0	6.3	6.4	6.3	6.4	6.4	
Contribution from real GDP growth	0.0	6.0	-4.2	3.6	7.0	4.1	-1.7	-3.1	-3.4	-3.5	-3.4	
Contribution from price and exchange rate changes 2/	-3.0	-1.8	-1.4	-1.2	1.3	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	0.2	9.7	6.8	-13.4	-5.9	-9.7	-6.2	-3.1	-1.1	-3.5	-1.7	
External debt-to-exports ratio (in percent)	605.2	780.1	726.4	635.7	601.5	548.9	505.4	467.3	440.5	408.8	381.8	
Gross external financing need (in billions of Euros) 4/				210.5	183.0	163.2	155.4	143.4	138.6	130.7	129.9	
in percent of GDP				123.1	110.8	98.7	92.4	83.2	77.8	70.8	67.9	
Scenario with key variables at their historical averages 5/						227.4	227.1	229.9	236.0	239.8	245.4	1.3
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	0.0	-2.9	1.9	-1.5	-2.9	-1.8	0.8	1.5	1.7	1.8	1.8	
GDP deflator in Euros (change in percent)	1.6	0.9	0.6	0.5	-0.6	1.9	0.9	1.0	1.7	1.8	1.8	
Nominal external interest rate (in percent)	4.1	3.0	2.4	2.8	2.9	2.6	2.8	3.0	3.1	3.2	3.4	
Growth of exports (Euros, in percent)	2.8	-15.3	13.7	13.2	3.8	6.0	5.9	6.6	5.9	6.3	6.2	
Growth of imports (Euros, in percent)	7.8	-18.1	12.2	1.8	-6.1	-1.3	2.7	4.8	4.6	5.3	5.6	
Current account balance, excluding interest payments	-4.7	-4.8	-5.3	-0.5	5.5	7.0	7.3	7.5	7.9	8.6	9.2	
Net non-debt creating capital inflows	4.5	1.8	4.6	-4.2	-0.2	1.4	0.5	1.0	1.0	0.4	0.4	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator,
g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency--not used here), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an
appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, deflator growth, and non-debt inflows in percent of GDP) remain at their levels
of the last projection year.

Table 10. Portugal: Access and Phasing Under the Extended Arrangement, 2011–14

Review	Review date[1/]	Action	Purchase	
			In millions of SDRs	In percent of quota
	May 20, 2011	Board approval of Extended Arrangement	5,611	544.9
First review	September 12, 2011	Observation of end-June 2011 performance criteria; completion of first review	3,467	336.7
Second review	December 19, 2011	Observation of end-September 2011 performance criteria; completion of second review	2,425	235.5
Third review	April 4, 2012	Observation of end-December 2011 performance criteria; completion of third review	4,443	431.5
Fourth review	July 16, 2012	Observation of end-March 2012 performance criteria; completion of fourth review	1,197	116.2
Fifth review	October 24, 2012	Observation of end-June 2012 performance criteria; completion of fifth review	1,259	122.3
Sixth review	January 16, 2013	Observation of end-September 2012 performance criteria; completion of sixth review	724	70.3
Seventh review	June 12, 2013	Observation of end-March 2013 performance criteria; completion of seventh review	574	55.7
Eighth and Ninth reviews 2/	September 15, 2013	Observation of end-June 2013 performance criteria; completion of eighth and ninth reviews	1679	163.1
Tenth review	December 15, 2013	Observation of end-September 2013 performance criteria; completion of tenth review	803	78.0
Eleventh review	March 15, 2014	Observation of end-December 2013 performance criteria; completion of eleventh review	760	73.8
Twelfth review	May 15, 2014	Observation of end-March 2014 performance criteria; completion of twelfth review	800	77.7
Total			23,742	2,305.7

Source: Fund staff projections.

1/ For completed reviews the dates refer to Board dates and for future reviews the dates refer to expected availability dates.

2/ Since the Board discussion for the 8th and 9th reviews is scheduled to take place after September 30, 2013, the controlling performance criteria for these reviews are the end-September 2013 PCs. However, since the data to assess performance at end-September PCs are not yet available at the time of the Board meeting and there is no clear evidence that the PCs will not be observed, a waiver of applicability may be granted.

Table 11. Portugal: Indicators of Fund Credit
(Millions of euros, unless otherwise indicated)

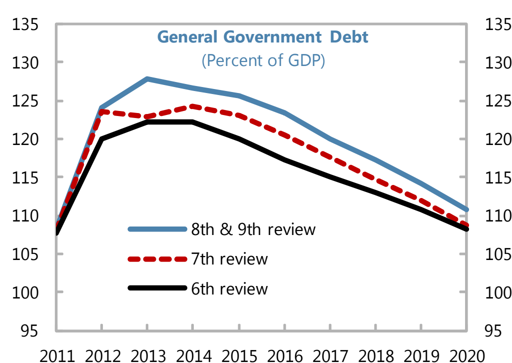
	2011	2012	2013	2014	2015	2016	2017	2018	2019
Disbursements	13,052	8,216	3,399	2,675	…	…	…	…	…
(in percent of quota)	1,117	670	289	229	…	…	…	…	…
(Projected debt service to the Fund, based on existing and prospective drawings)									
Total	14	152	171	852	1,549	3,621	4,549	5,178	5,145
Interest and charges	14	152	171	852	1,010	970	850	695	510
Repayments	0	0	0	0	539	2,650	3,699	4,483	4,635
Total debt service, in percent of									
Exports of goods and services	0.0	0.2	0.2	1.2	2.0	4.4	5.2	5.6	5.2
GDP	0.0	0.1	0.1	0.5	0.9	2.0	2.5	2.7	2.6
(Projected level of credit outstanding based on existing and prospective drawings)									
Outstanding stock	13,052	22,777	25,355	27,247	26,834	24,318	20,751	16,382	11,747
in percent of quota	1,117.1	1,857.4	2,154.2	2,305.7	2,260.3	2,038.2	1,729.8	1,358.1	973.9
in percent of GDP	7.6	13.8	15.3	16.2	15.6	13.7	11.2	8.6	6.0
Memorandum Items (in billions of euros)									
Exports of goods and services	62	65	69	73	77	82	87	92	98
GDP	171	165	165	168	172	178	185	191	196

Source: Fund staff projections. Exchange rate forecasts against the SDR as per WEO assumptions.

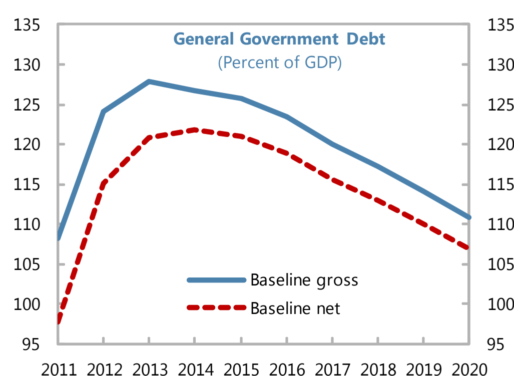
Annex. Public Debt Sustainability Analysis (DSA)

This annex updates the analysis presented at the time of the seventh review (IMF Country Report No. 13/65), applying the new DSA framework for Market-Access Countries. The analysis suggests that Portugal's gross debt trajectory remains sustainable under baseline assumptions (that the planned fiscal consolidation and reform agenda are implemented as envisaged under the program), but is vulnerable to plausible shocks, given the country's sizable debt burden and gross financing needs. Nevertheless, debt dynamics could become unsustainable under a combined scenario with macro-financial shocks and realization of sizable contingent liabilities.

1. **Under the revised baseline, debt is projected to peak at close to 128 percent of GDP already in 2013.** The five-percentage-point increase in debt in 2013 vis-à-vis the seventh review is largely due to revised assumptions concerning two one-off transactions. Specifically, the transfer of the shares of the state-owned bank CGD to Parpública (a state-owned enterprise that is outside the general government perimeter) has been suspended, while the reallocation of the Social Security portfolio from foreign assets to government securities initially expected to take place in 2013 has been postponed. Moreover, the government now intends to maintain a larger cash buffer than initially projected at the time of the seventh review. Together these account for six percentage points of the increase in the projected debt ratio at end-2013 (partly offset by positive exchange rate and macro revisions). Portugal's debt net of government deposits—which is a better approximation of the net worth of the public sector—is projected to rise smoothly to its peak of 122 percent of GDP in 2014 and then decline.



Sources: Portugal authorities; and IMF staff estimates.



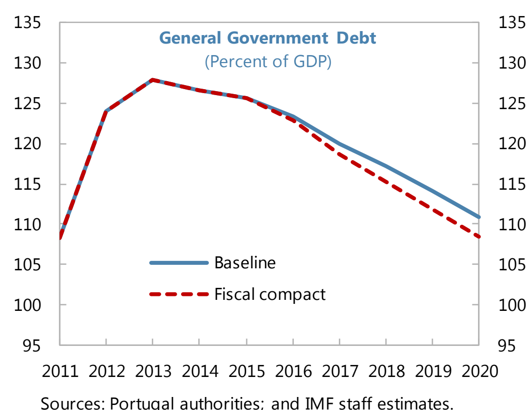
Sources: Portugal authorities; and IMF staff estimates.

2. **Portugal's sizable debt burden and gross financing needs pose significant risks to debt sustainability.** As presented in Figure 7, Portugal's debt ratio exceeds the debt burden benchmark for advanced economies of 85 percent of GDP, suggesting that the country's debt level is highly vulnerable already under the baseline scenario. Nevertheless, despite the high risks posed by Portugal's gross financing needs (above the benchmark of 20 percent of GDP under the baseline),

the debt profile is subject to medium to low risks in terms of market perception, projected change in short-term debt, and the share of public debt held by non-residents.[1]

3. Also reflecting the sizable fiscal effort already achieved under the program, Portugal's primary balance exceeds its debt stabilizing threshold over the projection period. Under the baseline scenario, the fiscal primary balance is expected to reach about 3 percent of GDP by 2018. Moreover, the 3-year change in the cyclically-adjusted primary balance indentified in Figure 8 for Portugal is in the top quartile of the fiscal adjustments observed in other countries with debt greater than 60 percent of GDP. While, due to the 3-year rolling nature of the estimate, this largely reflects the country's fiscal efforts already achieved over 2011–13 and not just the consolidation plans in outer years, Portugal's debt profile remains vulnerable to a primary balance shock (Figure 10). This is also highlighted by the asymmetric fan chart in Figure 7, which shows the upside to the debt outlook if only negative shocks to the primary balance were to materialize.

4. The authorities' medium-term fiscal strategy targets a more ambitious adjustment path than staff's baseline scenario. In particular, the authorities aim at achieving a structural deficit of ½ percent of GDP starting in 2017, in line with the Fiscal Compact objective. Compared with staff's baseline (which simply assumes a passive scenario as of 2016), this implies an additional primary structural effort of some 0.7 percent of GDP in 2016–17 and permanently lower deficits (by ½ percentage points of GDP) in the medium term, resulting in a debt-to-GDP ratio that is nearly three percentage points of GDP lower by 2020 (text chart with customized scenario).



Sources: Portugal authorities; and IMF staff estimates.

5. The baseline remains highly sensitive to shocks, especially if a combination of them were to materialize in the near term (Figure 11):

- Under a *growth shock* that lowers output by cumulative 4 percentage points in 2014–15 (and in turn inflation by a cumulative 1 percentage point), debt would peak at 136 percent of GDP in 2015, 10 points higher compared with the 2015 baseline.

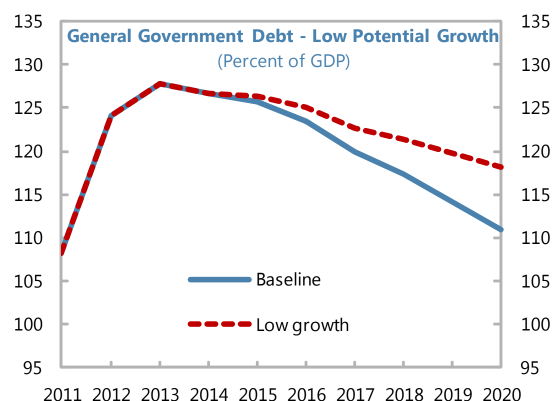
- A sustained *interest rate shock* of 200 bps on all debt throughout the projection period (consistent with the effective interest rate levels recorded at the peak of the crisis) is not expected to have a large immediate effect, but it would slow down the rate of debt decline in the medium term, so that by 2018 the debt-to-GDP ratio is almost 3 points higher compared with the baseline.

[1] Please refer to paragraph 38 for further discussion of Portugal's financing needs and the authorities' funding strategy.

- Realization of *contingent liabilities* (for 15 percent of GDP in 2014, in line with earlier staff work-see IMF Country Reports 12/77 and 13/65) would immediately push the 2014 debt ratio close to 142 percent of GDP; debt would fall below 120 percent of GDP only after 2018.

- A *combined shock* that incorporates all of the scenarios mentioned above would lead to debt peaking at almost 150 percent of GDP in 2014 and declining only gradually to 145 percent of GDP by 2018—a clearly unsustainable outcome.

6. A scenario with lower potential growth would also have important implications for the debt adjustment path in the medium term. Although Portugal's forecast track record is comparable to that of other countries with Fund-supported programs during the crisis period 2009-12, the growth forecast error tended to be significantly higher in earlier years (Figure 8). Staff estimates potential growth to reach nearly 2 percent by 2020, as structural reforms start bearing fruit and the economy successfully rebalances from the non-tradable to the tradable sectors.[2] However, if *potential growth* were to turn out lower than currently projected (from two to one percent in real terms), the rate of debt decline in the medium term would slow down, resulting by 2020 in a debt-to-GDP of ratio of 118 percent, 7 points higher compared with the baseline (text chart with customized scenario).



[2] Staff's analysis, in the context of the 2012 Article IV consultation (Country Report No. 13/18) suggests—using an augmented growth-accounting framework—that achieving a 2-percent growth rate over the long-term is a realistic objective for Portugal, consistent with moderate growth convergence. Nevertheless, this is contingent on effective implementation of wide-ranging reforms aimed at reducing wage and profit markups and enhancing the business environment.

Appendix. Portugal: Letter of Intent

Lisbon, October 24, 2013

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Ms. Lagarde:

1. The attached Memorandum of Economic and Financial Policies (MEFP) describes the progress made in recent months toward the objectives laid out in our program supported by the Extended Arrangement. It also updates previous MEFPs and highlights the policy steps to be taken in the months ahead.

2. We have made further progress toward the program objectives. Some delays generated by the political situation and government reshuffling over the summer, as well as new adverse rulings by the Constitutional Court on spending measures and labor reforms have been dealt with. The end-June deficit and performance criteria were met. All but one of the six structural benchmarks initially planned for the June-October period were also met, with the last one expected to be completed by end-October.

3. The macroeconomic outlook has recently improved. Growth and employment in the second quarter turned out to be better than expected, with sequential real GDP growth turning positive and unemployment falling, signaling that output may have bottomed out. Nonetheless, headwinds from private sector deleveraging and fiscal consolidation will remain significant. Though most structural reforms envisaged in the program are now in place, and are beginning to have an impact, we remain strongly committed to further reforms aimed at bolstering price and cost competitiveness and setting the basis for a strong and durable recovery. In this regard, significant steps are underway to further improve the dynamism and efficiency of the labor and product market, reduce costs for exporters, and further improve our business environment.

4. We are committed to achieving our fiscal objectives. This year's deficit target (5½ percent of GDP) is within reach, as we have tightened budget execution and taken exceptional measures to offset budget overruns earlier in the year and non-tax revenue shortfalls, some of them due to exceptional factors. As a prior action for completion of this review, we have submitted to Parliament a 2014 budget that aims at a general government deficit of 4 percent of GDP, as well as some of the necessary supporting legislation. The draft budget is, to a large extent, underpinned by the public sector reforms identified in the context of the 2013 PER, ensuring a consolidation strongly tilted towards permanent measures to reduce expenditure. Fiscal consolidation will continue in 2015, with a targeted deficit of 2½ percent of GDP.

5. We are committed to preserving financial sector stability and supporting a balanced and orderly balance sheet deleveraging in the economy. While the capital and liquidity conditions of the banking system remain adequate, Banco de Portugal (BdP) continues to vigilantly supervise the banking system in view of the challenging operating environment. Moreover, to facilitate the ongoing balance sheet adjustment, we are renewing our efforts to promote adequate funding conditions for the most productive and innovative segments of the economy, while ensuring prompt restructuring of viable firms in financial difficulties.

6. On the basis of the strength of the policies outlined in this letter, and in light of our performance under the program, we request the completion of the combined eighth and ninth reviews under the Extended Arrangement, as well as a waiver of applicability for the end-September deficit and debt performance criteria.

7. We remain confident that the policies described in the current and previous MEFPs are adequate to achieve the objectives under the program. We stand ready to take additional measures should they be needed to meet the objectives of the economic program and will consult with the IMF, the European Commission, and the ECB, in advance of any necessary revisions to the policies contained in this letter and attached Memorandum.

8. This letter is copied to Messrs. Dijsselbloem, Rehn, and Draghi.

Sincerely yours,

/s/	/s/	/s/
Paulo Portas	Maria Luís Albuquerque	Carlos da Silva Costa
Deputy Prime Minister	Minister of State and Finance	Governor of the Banco de Portugal

Attachments: 1. Memorandum of Economic and Financial Policies (MEFP)
2. Technical Memorandum of Understanding (TMU)

Attachment I. Portugal: Memorandum of Economic and Financial Policies

October 24, 2013

Macroeconomic Outlook

1. **Activity.** The near-term economic outlook has improved since the seventh review. First, output and employment surprised on the upside in the second quarter, with real GDP expanding (by 1.1 percent quarter-over-quarter) for the first time since late 2010 and the unemployment rate declining to 16.4 percent from 17.7 percent. Second, recent high frequency indicators point to some stabilization in activity and confidence. In light of this, we now expect the economy to contract by 1.8 percent in 2013, compared to 2.3 percent at the time of the seventh review, with the revision reflecting mainly a less negative contribution from domestic demand and strong growth of exports of goods and services, which however is largely offset by an upward revision of imports. Accordingly, the projected 2013 unemployment rate has been revised down from 18.2 to 17.4 percent. Output is expected to remain broadly flat for the rest of the year, and to pick up gradually during the course of 2014—consistent with growth of some 0.8 percent for the year as a whole and unemployment peaking at 17.7 percent—underpinned by a gradual pick-up in investment, conditioned on the continued alleviation of uncertainty and a sustained improvement in confidence. Reflecting still weak domestic demand, we expect headline inflation to average around 0.6 percent this year. Notwithstanding the improved near-term outlook, uncertainties remain as the drag of private sector deleveraging and fiscal consolidation on growth could turn out to be stronger than expected.

2. **External adjustment.** The current account balance has continued to adjust at a faster pace than envisaged previously. It is now projected to turn into a surplus of about 1 percent of GDP this year (compared to an expected 0.3 percent of GDP at the time of the seventh review) and remain at that level next year, bringing the cumulative adjustment since 2009 to some 12 percent of GDP. The revision is largely driven by higher exports—including tourism receipts that increased by 8 percent in January through July. Strong demand from non-EU trading partners and an improvement in Portugal's export market shares in most markets continue to underpin robust export growth. In the short term, weaker demand from trading partners remains the main downside risk to these projections. Although most structural reforms envisaged in the program are now in place and are beginning to have an impact, maintaining robust export growth over the medium term will require continued improvement in external competitiveness.

Fiscal Policy

3. **2013 Budget Execution.** While the end-June quantitative performance criteria on the general government cash balance and debt were met, we need to overcome a number of budgetary challenges. Overall, we expect to meet our annual deficit target (5½ percent of GDP, excluding the BANIF recapitalization costs of 0.4 percent of GDP), but with an unfavorable net carry-over from

the 2013 budget execution to 2014 of some 0.4 percent of GDP and the need to rebuild a budgetary reserve (0.3 percent of GDP). Specifically:

- Budgetary overruns and revenue shortfalls totaling about 0.8 percent of GDP reflect a combination of one-off factors (0.2 percent of GDP) stemming from a shortfall in the reprogrammed EU funds and delays in the planned port concession, as well as pressures (0.6 percent of GDP) from increased contributions to the EU budget, the transfer to Greece of the income from the Greek bond holdings in Banco de Portugal's investment portfolio (consistent with the Eurogroup agreement), shortfalls in contributions to the public pension scheme, and overruns in wages and intermediate consumption. In addition, despite efforts to apply the commitment control law, slippages in the health sector are causing a net accumulation of arrears in SOE hospitals (some €300 million year-to-date).

- Nevertheless, the use of the provisional budget allocation (0.3 percent of GDP), the reduction in funds available to the line ministries (0.1 percent of GDP), and recourse to a one-off tax and social security contribution debt recovery scheme (0.4 percent of GDP) should offset these deviations.

Under these assumptions, underlying structural primary adjustment would reach nearly 0.5 percent of GDP.

4. **Fiscal path for 2014-15.** We remain committed to achieving our 2014 deficit target of 4 percent of GDP in 2014—consistent with a structural primary adjustment of 1 percent of GDP. To achieve these objectives while arresting the accumulation of domestic arrears, measures of around 2.3 percent of GDP will be needed in 2014. Most of these measures have been drawn from the public expenditure review (PER—see below). We have submitted the Budget Law to Parliament on October 15 as a *prior action* for the completion of this review. Fiscal consolidation will continue in 2015, with a targeted structural primary adjustment of about 1 percent of GDP.

5. **Public Expenditure Review (PER).** We modified the package of expenditure reforms initially identified in the context of the PER to reflect consultations with social partners as well as the recent developments, including an adverse Constitutional Court ruling. The reforms are proceeding. The expected yield of the PER package is now €3.1 billion (net of reduced income taxes and social contribution collections) or €2.9 billion when including the upfront costs of mutual agreements terminations in 2014. There was a rebalancing of the package toward sector-specific measures. Savings will be generated mainly by limiting outlays on the public wage bill and pensions—which account for over two-thirds of primary spending and where Portugal spends more in comparison to peer countries—as well as sector-specific reforms, with a view to increase equity and efficiency in the provision of social transfers and public services. The underlying reforms are organized around three main pillars: (i) a wage bill reform, (ii) a pension reform, and (iii) sector-specific savings.

a. ***PER—wage bill reform.*** The overall objective of the wage bill reform (0.9 billion in net savings) will be to (i) reduce the size of the public sector workforce—addressing excessive employment in particular sub-sectors—while tilting its composition toward high-skilled and

better-trained civil servants; (ii) ensure convergence of the public sector work rules and regulations toward private sector legal regimes (including regarding working hours, working time arrangements, and holiday entitlements); (iii) increase beneficiaries' contributions to ensure self-sustainability of public sector health subsystem; and (iv) simplify the remuneration policy by implementing a single wage scale and streamlining the wage supplement scale. The reduction in the workforce will be achieved through a combination of policies, including lower replacement of retirees, voluntary separations (scheme launched on September 1), and use of the redesigned mobility pool. The increase in working hours to 40-hours per week will also help, while generating efficiency gains more broadly. The current status of the various legislative changes needed to implement these reforms is as follows :

i. The Law aligning the working hours of the public sector to the 40 hours in force in the private sector was already approved. It is now under consideration by the Constitutional Court.

ii. Following the consultations with social partners, the new draft public administration labor law—aiming at aligning current public employment regime to the private sector rules, including for working hours and holiday time—will be submitted to Parliament by end-October (*structural benchmark*).

iii. The draft law on the redesigned mobility pool was also submitted and approved by Parliament, but subsequently deemed unconstitutional by the Constitutional Court and returned to Parliament for amendments. We have redesigned the scheme and the revised draft law now awaits parliamentary approval.

iv. The single wage scale reform and the reduction to the wage supplements will be made effective by January 1, 2014, implemented through a budget provision (*prior action*). A report on a more comprehensive reform of wage supplements is expected by end-December.

b. ***PER—pension reform.*** A pension reform is expected to generate 0.6 billion of net savings. It is based on equity principles with preservation of minimum socially-acceptable income levels, thus protecting those who earn the lowest pensions. Specifically, the reform takes into consideration the need to reduce the current differences between the civil servants' regime and the general social security regime, aiming at enhancing the fairness of the overall pension system. Moreover, while reforms implemented over the past two decades have contributed to long-term sustainability, the amount of pension benefit payments for which the government is currently liable makes the system excessively costly under the current circumstances reassessing the need to take into account demographic developments. Accordingly, the reform is based on three main elements: (i) an effective increase by one-year in the statutory retirement age to 66 years—implemented by adjusting the demographic sustainability factor (*prior action*); (ii) aligning the rules and benefits of the public sector pension funds, CGA, to the general pension regime by changing one of the replacement rate parameters from about 90 to about 80 percent for all applicable beneficiaries, while avoiding double penalization of CGA

beneficiaries, with a pension below €5,030, with the CES contribution *(structural benchmark*), and (iii) means testing survivors' pensions of both CGA and the general pension regime, in cases where these accumulate with other pensions. Each of these reforms is implemented through modifications to the relevant laws. The necessary legislative proposals have been submitted to Parliament.

c. ***Sector-specific expenditure savings.*** Other savings under the PER (1.65 billion of net savings) are generated through a combination of sector-specific reforms, which mainly include intermediate consumption cuts and targeted nonrenewals of fixed-term contracts. Additional cutbacks in SOE and PPP expenditure are generated through further negotiation and operational restructuring. In the education sector for example, rationalization of the school network and a convergence of the key indicators, namely class size, towards peer levels are at the core of our reforms. In the health sector, savings come from further restructuring of the hospital network.

6. **Additional measures.** Due to the negative carryover from the 2013 budget execution and upward expenditure pressures, the PER measures need to be complemented by permanent measures amounting to €0.6 billion (0.4 percent of GDP) to achieve the budget deficit of 4.0 percent in 2014. These include new revenue measures (on company cars, online gambling, diesel passenger cars, alcohol and tobacco, banking, and media spectrum), a reduction of fiscal benefits for pension and real estate funds and a special levy on the energy sector (with revenues in excess of €100 million to be used to reduce the electricity tariff deficit). A number of one-off operations (including port concessions, sales of excess oil reserves, and a transfer from the CTT health fund) adding to €0.4 billion (0.2 percent of GDP) will also contribute to achieving our deficit target, more than offsetting the one-off upfront costs related to the mutual agreements for termination of public sector employment contracts (by about 0.1 percent of GDP).

7. **Legal safeguards.** To mitigate legal risks from future potential Constitutional Court rulings, we will continue to respect the following principles. First, expenditure reforms will be designed with the principle of public/private sector and intergenerational equity in mind as well as the need to address the sustainability of social security systems. Second, legislation underpinning the expenditure reforms will be duly justified on compliance with the fiscal sustainability rules in the recently-ratified European Fiscal Compact, which now ranks higher than ordinary legislation. Third, the government will rely as much as possible on general laws—rather than on one-year budget laws—consistent with the structural nature of the reforms. This also allows the possibility of prior constitutional review of the said laws, thus permitting early reaction on the part of the government in case these reforms raise constitutional issues.

8. **Debt Path.** Under the programmed fiscal path, gross debt is set to peak at close to 128 percent of GDP in 2013 (or at about 122 percent of GDP net of IGCP's projected deposits in 2014). The increase in the debt peak vis-à-vis the seventh review is explained by the suspension of the transfer of the State's CGD shares to Parpública, by the postponement of the reallocation of the Social Security portfolio from foreign assets to government securities, now scheduled to be completed by end-2014, and by a higher projected Treasury cash balance at end-2013.

9. **CIT Reform.** We have launched a far-reaching reform of the Portuguese corporate income tax (CIT) regime aimed at boosting investment and growth. The reform committee presented in July 2013 its recommendations. They consist in simplifying the CIT regime through a broadening of the tax base, the gradual lowering of the rate, the reduction of multiple surcharges, and the rationalization of the incentive schemes. The report also focuses on steps enhancing legal stability, lowering compliance costs, and aiming at reducing litigation. In addition, measures are proposed to improve the international competitiveness of the tax and strengthen the territorial approach, including through the adoption of a universal participation exemption regime (while respecting international standards). The reform would also envisage reducing policy-induced debt bias. It will be implemented within the existing budgetary envelope. A draft law on the CIT reform has already been submitted to Parliament.

Containing Fiscal Risks

10. **Public Financial Management.** We have made further progress in advancing our Public Financial Management reform, but controlling domestic arrears remains challenging, particularly in the health sector. Important steps have been taken in transposing the EU economic and governance fiscal framework. The process will be completed by the first quarter 2014, along with further changes to streamline budgetary procedures. In parallel, we will identify the operational changes necessary to ensure full implementation of the BFL in a draft action plan to be prepared by the eleventh review. We will publish a tax expenditure report as well as a comprehensive Fiscal Risks Report together with the Budget Law. We remain committed to reverting the accumulation of new domestic arrears, the stock of which amounted to €2.9 billion at end-July 2013. While we will proceed with a second settlement program in the health sector—in the value of €432 million—following the same procedures envisaged in the March 2012 strategy document, we are concurrently working with the enforcement authorities in order to effectively sanction public officials who do not comply with the commitment law. Moreover, we are strengthening our efforts to rein in expenditures in this sector through appropriate budgeting and ensuring effective savings measures.

11. **Revenue Administration.** We have completed the property revaluation process—with approximately 5 million properties revalued—a key measure of the 2013 budget. To bolster revenue performance in support of our medium-term fiscal objectives, we remain determined to make further progress in curbing tax evasion. Recent steps in this direction included making fully operational the new Large Taxpayer Unit and conducting successfully a VAT invoicing reform. To limit the impact of the tax and social security contribution debt recovery scheme announced in early October, we have publicly committed not to have recourse to such new schemes in the future and will tighten sanctions for criminal offenders. Looking ahead, key steps to strengthen compliance will include (i) phasing in of a modern compliance risk model, including by establishing a Risk Management Unit; (ii) strengthening PIT compliance management—the pilot projects on the High Net Wealth Individuals and the Self-employed Professionals, and strengthened control of the monthly PIT withholding information, are key instruments in this respect; and (iii) further modernizing tax litigation, building on the results obtained so far.

12. **Public Administration**. Streamlining public administration continues to be a government priority. We have made significant progress in reducing the size of the public sector, reducing the number of public employees by 6 percent since end-2011, reaching our 2-percent annual average target ahead of time. The next step in our reform agenda is the adoption of a general public administration law and other PER reforms to modernize and rationalize public administration (see paragraph 5).

13. **State-Owned Enterprises.** Despite the negative financial impact from the reinstatement of the 13th and 14th month salaries due to the Constitutional Court rulings, cost-reduction efforts and voluntary redundancy programs have moved enterprises significantly closer to operational balance. Looking ahead, we will maintain formal cost-cutting objectives for those firms still showing operating deficits, while other firms will be required to continue improving operating balances with a view to reducing debt burdens and financial costs. We also continue to manage the high debt burdens of some firms, and treasury support has remained within the envelope of budgeted transfers. To further strengthen SOE governance, the Council of Ministers approved in August a Decree-Law which concentrates all shareholder functions in the Ministry of Finance along with the creation of a dedicated Technical Unit. The law also reinforces the monitoring of SOE debt by centralizing borrowing decisions at the Debt Management Agency (IGCP). The unwinding of most derivative contracts of SOEs during 2013 also contributed to reduce significantly financial costs and risks.

14. **Privatization**. The privatization program is broadly on track, and proceeds have exceeded the initial program target. The sale of the airport operator, ANA, has now been formally completed. While preparing the changes in the legal framework for postal services, we have launched the privatization process for the postal company CTT, and expect to receive binding offers by end-2013. The sale of the airline, TAP, however, is still on hold, after the initial privatization plan fell through at end-2012 due to inadequate financial assurances by the final bidder. We are actively seeking buyers for the group as a whole and the process will be re-launched in the near future. The privatization of the rail cargo firm, CP Carga, has also been postponed with a view to maximizing market value while restoring its operating balance. We have prepared a strategic plan for the water and waste sectors, with a view to improving their efficiency, including by introducing private capital and management in the system. Binding offers for the sale of the waste management business are currently anticipated for the first quarter of 2014. Opening water concessions to private capital and management is expected to take longer. The government will further consider expanding the privatization program to include additional assets for sale or concessions.

15. **Public-Private Partnerships (PPPs).** We have taken further steps to achieve a fiscally-responsible PPP model. First, we have launched a major renegotiation of road PPPs. The objective is to generate permanent savings by rationalizing OPEX, CAPEX, and the private partner's internal rate of return. In the case of sub-concessions, savings will be generated by also reducing the scope of the relevant contracts. MoUs have now been signed with most concessionaires, offering good prospects for reaching the revised savings goal of €300 million in 2013, consistent with the supplementary budget. Second, the Ministry of Finance PPP unit is gaining a pivotal role, working

towards enhancing fiscal transparency, improving reporting on PPPs, and expanding its field of action to other sectors, namely health and security, and advising the autonomous region of Madeira. Finally, the ongoing revision of the regulatory framework for the road and rail sector is also part of the strategy to achieve sustainability in these sectors, by reducing operation, maintenance and major repair requirements in line with EU standards. This revision is to be completed by end-October.

16. **Regional and Local Governments.** The Regional and Local Finance Laws were approved by Parliament and published in September. They will improve the inter-governmental fiscal framework, notably by applying the same principles of the Budgetary Framework Law to subnational governments. Moreover, we have streamlined the organization of Parishes, significantly reducing their number. The establishment of a coordination council between the central and subnational governments is expected to enhance the exchange of information in order to support budgetary planning. The credit line to support local governments' arrears settlement is being implemented, following the necessary procedures to validate the claims. The regional government of Madeira's program with the State is broadly on track, but we will continue to closely monitor budgetary risks.

Safeguarding Financial Stability

17. **Bank supervision.** While compliance of the banking system with regulatory capital remains satisfactory, the challenging operating environment warrants continued vigilance. Against this backdrop, the BdP is pursuing various initiatives that seek to further strengthen banks' resilience, and maintain financial stability.

- *Credit Impairment Review*. Following two earlier on-site inspection programs in 2011 and 2012, the BdP has successfully completed a new credit impairment review, with the support of the participating banks' external auditors and an external consultant. The audit focused on (i) the verification of current impairment levels for a broad sample of credits, notably high-risk exposures; (ii) a follow-up of the findings identified in the original on-site inspections program related to collective impairment; and (iii) an assessment of the banks monitoring process related to the management and fair value calculation of the participation units held by the banks in restructuring funds. The limited impairment deviations identified by the review have already been addressed by the affected banks through impairment reinforcements, reflected in their end-June results. Moreover, follow-up recommendations have been issued to the banks, with all the high priority items expected to be implemented by end-December 2013.

- *Review of Restructuring Processes*. While the enhanced legal toolkit on corporate and household insolvency is now fully operational, further efforts remain necessary to promote early and effective use of the new restructuring tools. In this context, the BdP has initiated a special assessment program of banks' operational capacity in the area of loan restructuring and asset recovery, to ensure that the banking system can effectively support the balance sheet adjustment of the private sector, through timely engagement with troubled debtors before their viability is in jeopardy. The special program, which benefits from external

expertise, will evaluate the effectiveness of management processes regarding problem loans, with a special focus on early detection. The exercise will also include a broader survey of the Portuguese regulatory framework, including any remaining gaps and bottlenecks in the implementation of the new debt restructuring tools. The BdP aims to complete the special program by early November 2013.

- *Communication Strategy*. Building on experiences from the various inspection programs and to promote greater transparency on its ongoing supervisory efforts, the BdP plans to publish by mid-November minimum standards for the calculation of credit impairments, including guidance on collateral valuation. Moreover, as a follow-up to the BdP's requirements on identifying and reporting of restructured loans (Instruction No. 18/2012), banks will be required to disclose this information in their annual reports, starting in December 2013.

18. **Stress test exercise.** Banks are making progress implementing the recommendations on their stress testing methodologies and impairment projections, issued as part of the original on-site inspections program. In this context and to further enhance the rigor of the quarterly stress test exercise, the BdP has further enhanced its credit risk model used to provide methodological guidance on default probabilities to the participating banks. Moreover, the BdP is introducing a new top-down stress test to support its review of the bottom-up results. These enhancements will be included in the next round of quarterly stress tests, to be finalized in November 2013.

19. **Transition to CRD IV.** Capital requirements under the program will be set in accordance with the CRD IV package. Accordingly, as of January 1, 2014, the BdP will replace the existing targets and require banks to maintain, at a minimum, a common equity Tier 1 capital level of 7 percent, as defined in CRD IV package considering all the transitional provisions related to the definition of capital. Additional measures will also be in place to preserve banks' current capital buffers, ensuring that they remain commensurate with the challenging operating environment. The new requirements and additional measures will be included in the law transposing the CRD IV package as well as in implementation instructions from the BdP before year end. The implementation of the above framework will also need to comply with the requirements currently envisaged in the EBA Recommendation on the preservation of capital for the banks that are subject to them. We will also ensure compliance with any future regulatory initiatives at European level.

20. **BSSF.** We remain committed to providing further support to the banking sector, in the event new capital needs were to arise. While we will continue to encourage banks to seek private solutions, resources from the Bank Solvency Support Facility (BSSF) remain available to support viable banks if needed. The resources in the BSSF will solely be utilized to provide public support, if needed, to the banking system. State aid will remain subject to strict conditionality, in line with the recently amended EU state-aid rules, aimed at avoiding subsidizing private shareholders and preventing migration of private liabilities to the public sector balance sheet, while ensuring adequate lending to the real economy.

21. **Recovery and Resolution Plans.** The BdP has reviewed and issued recommendations on the recovery plans of the largest banks, and expects to receive the plans from all the other banks by

end-November 2013. Institutions for which resolution plans are mandatory have submitted the data required in the supervisory notice of December 2012, and these are currently being reviewed by the BdP. We have submitted to Parliament the necessary amendments to the recapitalization law to reflect the recent Communication from the European Commission on the Application of the State-aid Rules to Support Measures in Favor of Banks in the Context of the Financial Crisis. Moreover, we remain committed to swiftly transposing the new EU Directive on bank recovery and resolution once it has been adopted.

22. **Funding and Liquidity Conditions.** Nonstandard measures by the ECB to restore the proper transmission of monetary policy have helped ease liquidity pressures and continue to play a pivotal role in absorbing remaining funding constraints, while strengthened collateral buffers provide an important shield against potential adverse shocks. In parallel, we continue to explore with our European partners further initiatives to support funding conditions, including potential mechanisms to securitize banks' high quality mortgage and SME credit. Moreover, the new platforms recently created by the BdP for interbank secured and unsecured lending have become fully operational, supporting the functioning of the domestic interbank market.

23. **Initiatives to Promote Orderly Deleveraging.** Despite improvements in liquidity conditions, the credit situation remains challenging, especially among SMEs. In this context, banks' funding and capital plans should continue to ensure that the deleveraging process takes place in an orderly manner to achieve a stable market-based funding position, while adequate and sustainable financing is provided to the economy. To support this objective, we are stepping up our efforts to promote more efficient financing allocation to the productive segments of the economy through further enhancements to our existing government-sponsored measures, in line with EU state-aid rules, as well as the promotion of alternative private funding options for SMEs. Specifically,

- *Government-Guaranteed Credit Instruments*. We will continue to strive to improve the performance of existing government-guaranteed credit lines, in line with international best practice. On the basis of the recent external audit of the National Guarantee System (NGS), we have defined a detailed implementation plan of key policy recommendations aiming at making these schemes more efficient and minimizing risks for the State. The recommendations include (i) a review of the schemes' objectives and investment selection processes; (ii) measures to further enhance loan and guarantee pricing mechanisms in favor of end users, including through the development of competitive bidding mechanisms for the allocation of guaranteed credit to the banks, with preliminary scenarios for competitive bidding schemes to be presented and discussed by mid-November 2013; (iii) an upgrade of the NGS risk management capabilities and review of its governance structure; (iv) improved monitoring, management, and public disclosure of the State exposure to the NGS operations. We will regularly report on progress with the implementation of these measures, which are expected to be fully finalized by end-January 2014. Moreover, to support viable firms in financial difficulties, we will explore possible modalities for the provision of guaranteed credit in line with EU state aid rules, conditional on the successful completion of a corporate debt restructuring process, with an initial proposal expected by early-November. We will continue to monitor the balance sheet performance of the

firms benefiting from government-guaranteed credit lines through our newly established quarterly monitoring framework.

- *Development of SMEs Commercial Paper*. We are exploring possible changes to the regulatory environment applicable to the commercial paper market to facilitate its expansion among a wider investor base and increase the use of this alternative funding option by the corporate sector, notably SMEs. The necessary draft amendments to the existing rules are currently under discussion and are expected to be approved by the Council of Ministers by end-November.

New initiatives to facilitate credit to firms by the Ministry of Finance, Ministry of Economy, and other relevant entities will be primarily focused on streamlining and improving the efficiency of existing schemes, without creating additional burden on or posing risks to public finance. In this context, the government is conducting a stock-taking exercise aiming at streamlining and centralizing the management of EU structural funds for the 2014-2020 programming period.

24. **Central Credit Registry.** Efforts to promote information sharing, especially for SMEs, are ongoing. The BdP has recently published a new instruction requesting banks to report in the Central Credit Registry (CCR) additional loan information, including (i) as of January 2014, identification of nonperforming and restructured loans; and (ii) as of July 2014, information on government guarantees, as well as the identification of overdue and written-off loans disputed in court. Moreover, the BdP is currently finalizing a proposal for a revision of the decree law regulating the CCR to allow further enhancements, such as the inclusion of additional financial instruments. Additional efforts to permit financial institutions to access historical information on their potential new clients, subject to authorization by the Portuguese Data Protection Authority (CNPD), are in progress. In parallel, the BdP is assessing available options for reducing information asymmetry for smaller companies, taking also into consideration other available data sources, such as the Central Balance Sheet Database (CBSD).

25. **BPN SPVs.** We are implementing the strategy for managing the distressed assets from Banco Português de Negócios (BPN). Two companies have been selected through a competitive bidding process to manage the credit portfolios currently held by Parvalorem, a state-owned Special Purpose Vehicle (SPV). In parallel, the disposal of the participations and assets held by the other two state-owned SPVs is progressing. CGD's state-guaranteed claim will be gradually settled in cash, according to the schedule agreed with the EC, ECB, and IMF staff. Any net recoveries realized on the assets will also be applied towards the settlement of CGD's claim.

Boosting Employment, Competitiveness, and Growth

26. **Overall Reform Strategy.** The ultimate objective of our structural reform agenda is to enhance competitiveness and the business environment, so as to boost medium-term growth and job creation prospects. Significant steps have already been taken on the labor and product market fronts, where reforms have been designed to alleviate nominal rigidities, facilitate adjustment, and foster a reallocation of resources toward the tradable sector. Important steps have also been taken to reduce red tape and raise the efficiency of the judicial system. Nonetheless, we are determined to

further advance structural reforms. In light of this, we are working toward identifying unaddressed policy distortions and other potential priority reform areas.

27. **Labor Market Institutions.** Significant steps have been taken over the past couple of years to make the labor market more dynamic and efficient—including the reform of the Employment Protection Legislation, the reform of unemployment benefits and the reform of the wage-setting mechanism. A new reform of severance pay also entered into force more recently (October 1 Structural Benchmark). In light of the recent Constitutional Court ruling against legislative provisions that made it easier for firms to lay off employees in case of redundancy or unsuitability, the government's immediate priority will be to find alternative reform options that respect the ruling.. Following consultations with social partners, the alternatives will be discussed with IMF/EC/ECB staff at the time of the tenth review. Looking ahead, by end-November, we intend to enhance the activation of the unemployed by improving the role of the counseling services and by stepping up job search requirements, so as to create incentives for job seekers to accept offers and facilitate the job matching process. In view of the still extremely high unemployment, we also intend to continue to assess policy options to promote an adjustment more favorable to employment. In this context, the government will discuss at the time of the tenth review and present by end-December 2013 a report assessing policy options in three main areas: (i) ensuring more effective decentralization of wage bargaining; (ii) ensuring more wage flexibility; and (iii) study proper alignment of incentives to challenge dismissals in court.

28. **Energy.** We continue our efforts to improve the sustainability of the national electricity system. Steps have been taken in the past year to reduce excessive rents, mainly through renegotiation. The overall initial cost reduction targets were largely met, although with shortfalls for some specific measures. Nonetheless, our revised medium-term tariff debt projections (June 15 *Structural Benchmark*) clearly show strong upward pressures on the system debt, reflecting partly downward pressures on demand for electricity are generating. A number of additional measures are being considered to help reduce debt. Since we are concerned about the potential impact of large electricity price increases on competitiveness, we are investigating other options to better balance the burden of adjustment between the various stakeholders of the electricity sector, notably by eliminating remaining excess rents.

29. **Ports.** We are taking steps aimed at reducing costs for exporters. Following reductions in fees on port use (*TUP-Carga*) and a revision of the Ports Work Law, we are now seeking effective transmission of lower labor costs to end-users of port services. In particular, we will engage with concessionaires with a view to modifying existing concession contracts so as to foster price reduction. Specifically, the next steps include designing by the time of the tenth program review a strategy and a detailed timetable for measures ensuring the cost reduction and enhanced performance of both port authorities and port operators. We will also revise incentives for port operators by adopting a new performance-based model for future concessions and encourage entry of new operators. A review of the overall cost savings for exporters generated through these reforms will be conducted by December 2013.

30. **Regulation**. A framework law for the functioning of regulators was recently enacted. The law: (i) establishes a regulatory environment that protects the public interest and promotes market efficiency, (ii) guarantees the independence and financial, administrative and management autonomy of the National Regulatory Authorities in the exercise of their responsibilities, including the necessary conditions to safeguard adequate human and financial resources being able to attract and retain sufficiently qualified staff, and (iii) strengthens the role of the Competition Authority in enforcing competition rules. The corresponding amendments to the bylaws of the National Regulatory Authorities will be approved by the Government by end-November. Once the NRA framework law and follow-up bylaws and internal regulations are in place, the regulators will continue to pursue the adoption of best international regulatory practices, including by organizing international peer review exercises.

31. **Services.** Reforms in the services sector aim at eliminating entry barriers and increase competition. Significant progress has already been made in amending sector-specific legislations to align them with the Services Directive. We expect adoption by Parliament of the remaining necessary amendments—including to the Construction Law—by end-2013, and the related ordinance, ensuring appropriateness of fees linked to construction activities. The new legal framework aiming at improving the functioning of the regulated professions for which regulation involves a professional body (such as accountants, lawyers, notaries) was published earlier this year. The professional bodies' statutes are being amended accordingly for submission by the government to Parliament by yearend, including by eliminating unjustified restrictions to activity and further improving the conditions for mobility of professionals in line with EU Directives in the area of free movement of professionals.

32. **Licensing and Administrative Burden.** Tackling excessive licensing procedures, regulations and other administrative burdens—which are impeding the establishment, operation, and expansion of firms—is a government priority. Although we have faced delays in some areas due to the recent changes in the government and administrative capacity constraints, we remain strongly committed to meeting our revised timeline. Immediate priorities include: (i) adoption of the New Legal Regime on Urbanism and Building (RJUE) by the time of the tenth program review; (ii) completion of an inventory of the regulatory costs in the economy, starting with the most burdensome, on a basis of which we will devise a roadmap for a regulatory simplification; and (iii) completion of the reforms to simplify licensing procedures in the areas of tourism, commerce and industry. We will step up our efforts to make fully operational the Point of Single Contact, an e-government portal which allows administrative procedures to be done online. The new VAT cash accounting regime will also support an improvement of the business climate.

33. **Judiciary.** Most of the key judicial reforms have been successfully implemented. In particular, the new Code of Civil Procedure that entered into force on September 1, 2013 will speed up civil and enforcement proceedings. Another key legislation, the Judicial Organization Act, was adopted by Parliament in June 2013, and we have started to take steps to enable a smooth implementation by setting up a task force and adopting a wide range of implementing legislation. With respect to targeted measures to reduce the backlogged enforcement cases, an additional

179,000 enforcement cases have been cleared, bringing down the total number by about 344,000 enforcement cases since November 2011. We will publish quarterly reports on the clearance rate of enforcement court cases from the third quarter 2013 onwards (within four months after the end of the relevant quarter). We will establish the oversight body for enforcement agents and insolvency administrators (CAAJ) shortly after the entry into force of the CAAJ law, which was submitted to Parliament for approval in June 2013. The CAAJ law will enhance the supervision of enforcement agents, and thus further complement reforms implemented under the new Code of Civil Procedure and the new fee structure for enforcement agents, which entered into force on September 1, 2013 to incentivize speedier enforcement proceeding.

Table 1. Portugal: Quantitative Performance Criteria

(Billions of euros, unless otherwise indicated)

	Mar-13		Jun-13		Sep-13	Dec-13	Mar-14
	Program	Actual	Program	Actual			
1. Floor on the consolidated General Government cash balance (cumulative)	-1.9	-1.4	-6.0	-3.8	-7.3	-8.9	-1.7
2. Ceiling on accumulation of domestic arrears by the General Government (continuous indicative target) 1/	0.0	Not met	0.0	Not met	0.0	0.0	0.0
3. Ceiling on the overall stock of General Government debt	182.2	178.5	187.3	184.1	188.9	191.3	193.0
4. Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by the general government (continuous performance criterion)	0.0	...	0.0	...	0.0	0.0	0.0

1/ Domestic arrears for the purpose of the program increased by close to €0.4 billion in the first half of 2013, largely due to the accumulation of arrears by SOE hospitals.

Table 2. Portugal: Structural Conditionality: Seventh Review Under the EFF

	Measure	Timing	Status
Prior Actions			
1	Submit to parliament a draf 2014 budget consistent with the general government deficit target of 4 percent of GDP (MEFP ¶4-6)		Met
2	Submit to Parliament a draft Law or a budget provision to implement the single wage scale PER measure.		Met
3	Submit to Parliament a legislative proposal that increases the statutory retirement age to 66 years.		Met
Structural Benchmarks			
A. Fiscal policy			
1	Submit to Parliament a new draft public administration labor law that will aim at aligning current public employment regime to the private sector rules, including for working hours and holiday time, and termination of tenure.	July 15, 2013	Partially Met 1/
2	Submit to Parliament a draft law on the redesigned mobility pool.	End-June 2013	Met 2/
3	Submit to Parliament a legislative proposal that increases the statutory retirement age to 66 years.	July 15, 2013	Changed to prior action
4	Submit to Parliament a legislative proposal that aligns the rules and benefits of the public sector pension fund, CGA, to the general pension regime.	July 15, 2013	Met with delay
A. Strengthen financial stability			
5	Submit to Parliament amendments to the law governing banks' access to public capital.	End-January, 2013	Met
B. Enhance competitiveness and address bottlenecks to growth			
6	Enact the severance pay reform that reduces severance payments to 12 days per year for all new permanent labor contracts	October 1, 2013	Met
7	Update projections of the medium-term energy tariff debt path and identify policy options to eliminate the tariff debt by 2020 .	June 15, 2013	Met
C. Strengthen fiscal institutions and reduce fiscal risks			
8	Revise and submit to Parliament the draft regional and local public finance law.	End-Dec 2012	Met
9	Implement a full-fledged Large Taxpayer Office (LTO), to cover audit, taxpayer services, and legal functions concerning all large taxpayers, including the adoption of account managers.	End-Dec 2012	Met

Notes:

1/ The decree-law aligning working hours of the public sector to 40-hours per week as in the private sector was altready submitted and approved by the Parliament. The new draft public administration labor law will be submitted to Parliament by end-October.

2/ The draft law on the redesigned mobility pool was submitted and approved by Parliament. However, it was rejected by the Constitutional Court and has returned to Parliament for amendments.

Attachment II. Portugal: Technical Memorandum of Understanding

October 24, 2013

1. This Technical Memorandum of Understanding (TMU) sets out the understandings regarding the definitions of the indicators subject to quantitative targets (performance criteria and indicative targets), specified in the tables annexed to the Memorandum of Economic and Financial Policies. It also describes the methods to be used in assessing the Program performance and the information requirements to ensure adequate monitoring of the targets. We will consult with the EC, the ECB, and the IMF before modifying measures contained in this letter or adopting new measures that would deviate from the goals of the Program, and provide the EC, the ECB, and the IMF with the necessary information for Program monitoring.

2. For Program purposes, all foreign currency-related assets, liabilities, and flows will be evaluated at "Program exchange rates" as defined below, with the exception of the items affecting government fiscal balances, which will be measured at spot exchange rate (i.e., the rate for immediate delivery) prevailing on the date of the transaction. The Program exchange rates are those that prevailed on May 5, 2011. In particular, the exchange rates for the purposes of the Program are set €1 = 1.483 U.S. dollar, €1 = 116.8390 Japanese yen, €1.09512 = 1 SDR.

3. For reporting purposes, the MoF and BdP will employ the reporting standards and templates considered to be appropriate given the transmission of data covered by this TMU, unless otherwise stated or agreed with the EC, the ECB and the IMF.

General Government

4. **Definition.** For the purposes of the Program, the General Government, as defined in the Budget Framework Law, Law No. 91/2001 of August 20, amended by Law 22/2011 of May 20, includes**:**

- 4.1. The Central Government. This includes:
  - 4.1.1. The entities covered under the State Budget, which covers the budgets of the Central Administration, including the agencies and services that are not administratively and financially autonomous, agencies and services that are administratively and financially autonomous (*Serviços e Fundos Autónomos* – SFA).
  - 4.1.2. Other entities, including Incorporated State-owned enterprises (ISOE), or extra-budgetary funds (EBF) not part of the State Budget, but which are, under the European System of Accounts (ESA95) and ESA95 Manual on Government Deficit and Debt rules, classified by the National Statistical Institute (INE) as part of the Central Government.

- 4.2. Regional and Local Governments, that include:
  - 4.2.1. Regional Governments of Madeira and Azores and Local Governments (*Administrações Regionais and Locais*);
  - 4.2.2. Regional and local government-owned enterprises or companies, foundations, cooperatives and other agencies and institutions, which are, under the ESA95 and ESA95 Manual on Government Deficit and Debt rules, classified by the INE as Local Government.
- 4.3. Social Security Funds comprising all funds that are established in the general social security system.
- This definition of General Government also includes any new funds, or other special budgetary and extra budgetary programs or entities that may be created during the Program period to carry out operations of a fiscal nature and which are, under the ESA95 and ESA95 Manual on Government Deficit and Debt rules, classified by the INE in the correspondent subsector. The MoF will inform the EC, ECB, and IMF of the creation of any such new funds, programs, entities or operations at the time of its creation or statistical re-classification or, in the case of Regional and Local Governments, at the time the Government acknowledges its creation.
- The General Government, as measured for purposes of Program monitoring in 2013, shall not include entities nor operations (including pension funds) that are re-classified into the General Government during 2013, but shall include those reclassified in 2011-12.[1]
- The General Government, as measured for purposes of Program monitoring in 2014, shall not include entities nor operations (including pension funds) that are re-classified into the General Government during 2014, but shall include those reclassified in 2012-13.

5. **Supporting Material**

- 5.1. Data on cash balances of the State Budget will be provided to the EC, the ECB and the IMF by the MoF within three weeks after the end of the month. Data will include detailed information on revenue and expenditure items, in line with monthly reports that are published by the MoF.

[1] An operation refers to part of a legal entity that is involved in the production or delivery of goods and services—including government services provided on a nonmarket basis. As such, it does not include transactions relating to the assets or liabilities of an entity. For example, should an entity handle a number of PPPs, reclassifying only one PPP would be considered as reclassifying an operation. In contrast, taking over part of an entity's debt by the government would not qualify for the exclusion. On this issue, see also paragraph 13.

- 5.2. Data on the cash balances of the other parts of General Government as defined in paragraph 4[2] will be provided to the EC, the ECB and the IMF by the MoF within seven weeks after the end of the month. Data will include detailed information on revenue and expenditure items. Data will also include detailed information on PPP-related revenues and expenditures for those PPP reclassified within the General Government sector according to ESA 95, and called guarantees.

- 5.3. Data on domestic and external debt redemptions (securities), new domestic and external debt issuance (securities), change in the domestic and foreign currency assets and liabilities of the Central Government at the BdP and other financial institutions will be provided to the EC, the ECB, and the IMF by the BdP within 40 days after the closing of each month.

- 5.4. BdP will provide to the EC, the ECB, and the IMF detailed monthly data on the financing of the General Government, as defined in ESA95, within seven weeks after the closing of each month.

- 5.5. Data on the revenues, operating expenses, capital expenditure, remuneration of personnel, EBITDA, and number of staff will be provided for state-owned enterprises (SOEs) on a quarterly basis, within 7 weeks after the end of each quarter. Aggregate data for the SOEs within the perimeter will be provided, with company-specific information for REFER, Estradas de Portugal, Metro de Lisboa, and Metro de Porto. Furthermore data for Comboios de Portugal and Parpública (outside the perimeter) will also be provided.

Quantitative Performance Criteria, Indicative Ceilings, and Continuous Performance Criteria: Definitions and Reporting Standards

A. Floor on the Consolidated General Government Cash Balance (Performance Criterion)

6. **Definition.** The consolidated General Government cash balance (CGGCB) is defined as the sum of the cash balances of the entities covered by the State Budget, the ISOE, the Regional and Local Governments, and the Social Security Funds, and other entities and EBFs, as defined in paragraph 4. Privatization receipts will be excluded from cash receipts. In 2012 and beyond, revenues from the reclassification of pension funds into the general government will not be accounted for as cash revenues for the purpose of the calculation of the consolidated general government cash balance. In 2012-13, the cash proceeds from the sale of the ANA airport concession will be accounted for as cash expenditure-reducing transactions. The net acquisition of financial assets for policy purposes, including loans and equity participation will be recorded as cash

[2] In 2011, data exclude regional and local government-owned enterprises or companies, foundations, cooperatives and other agencies and institutions, which are, under the ESA95 and ESA95 Manual on Government Deficit and Debt rules, classified by the INE as Local Government, i.e., entities referred in paragraph 4.2.2.

expenditures, except for transactions related to the banking sector support and restructuring strategy under the Program. Called guarantees (excluding those related to the banking sector support and restructuring strategy), where entities of the General Government make cash payments on behalf of entities that are not part of the General Government, will be recorded as cash expenditures.

- 6.1. **The Cash Balance of the State Budget.** The cash balance of the State Budget will be measured from above the line, based on budget revenues (recurrent revenue plus nonrecurrent revenue, including EU revenues, minus tax refunds) minus budget expenditures of the State Budget as published monthly on the official website of the DGO of the MoF, and in line with the corresponding line items established in the State Budget. Budget expenditures will exclude amortization payments but include salaries and other payments to staff and pensions; grants to Social Security Funds, medical care and social protection; operational and other expenditure, interest payments; cash payments for military equipment procurement; and EU expenses.

- 6.2. **The Cash Balance of the Regional and Local Governments, Social Security Funds, ISOE and Other Entities or EBFs.** The cash balance of each of these parts of the General Government will be measured from above the line, based on revenues minus expenditures as it will be provided by the DGO of the MoF in the monthly General Government budget execution report (see Para 5), and in line with the corresponding line items established in their respective budgets. All entities including ISOE that prepare accrual-based financial statements will submit monthly cash flow statement in accordance with form and content specified by the MoF. The reporting by Local Government will be phased as set out in paragraph 8 below.

- 6.3. **Adjustor.** The 2013 and 2014 quarterly floors on the consolidated general government cash balance will be adjusted for the cumulative amount of arrears settled in the context of the arrears clearance strategy: (i) health sector arrears (up to €432 million), (i) local government arrears settled through the €1 billion credit facility created in May 2012, and (ii) RAM government arrears subject to concluding the agreement with the central government (up to €1.1 billion).

Other Provisions

7. For the purpose of the program, the expenditure of the central government that is monitored excludes payments related to bank support, when carried out under the program's banking sector and restructuring strategy. However, any financial operation by central government to support banks, including the issuance of guarantees or provision of liquidity, will be immediately reported to the EC, ECB, and IMF.

8. Quarterly consolidated accounts for the General Government on a cash basis will be reported for internal, EC, ECB, and IMF monitoring 7 weeks after the reference period, starting with the first quarter of 2012. The reports will be published externally starting with December 2011 data.

SOEs will be consolidated with the general government accounts starting with the first quarter 2012. The larger municipalities (defined as those with a population of 100,000 voters or more) are required to provide monthly reports under current arrangements, and their cash balance will be included in the calculation of the monthly cash General Government balance. The cash balance of the smaller municipalities, i.e. those with a population of under 100,000 voters, will be excluded until any necessary legal changes requiring them to provide monthly reports have been put in place. In this transitory period, the MoF will provide a monthly estimate of the cash balance of these smaller municipalities excluded from the General Government reports to the EC, the ECB, and the IMF.

9. **Supporting Material**

9.1. Data on cash balances of the State Government, ISOEs, Regional and Local Government and Social Security Funds will be provided to the EC, the ECB and the IMF by the MoF within seven weeks after the end of each month. The information provided will include general government net acquisitions of financial assets for policy purposes, including loans and equity participations, as well as called guarantees where entities that are part of the General Government make cash payments on behalf of entities that are not part of the General Government.

9.2. The MoF will submit quarterly data on General Government accounts determined by the INE in accordance with ESA 95 rules, showing also the main items of the transition from cash balances to the General Government balances in national accounts. The reconciliation will be accompanied by necessary explanatory materials for any indication of potential deviation of the annual general government cash target from the annual general government accrual target determined in accordance with ESA 95 rules.

B. Non-Accumulation of New Domestic Arrears by the General Government (Continuous Indicative Target)

10. **Definitions.** Commitment, liabilities, payables/creditors, and arrears can arise in respect of all types of expenditure. These include employment costs, utilities, transfer payments, interest, goods and services and capital expenditure. Commitments are explicit or implicit agreements to make payment(s) to another party in exchange for that party supplying goods and services or fulfilling other conditions. Commitments can be for specific goods and services and arise when a formal action is taken by a government agency, e.g., issuance of a purchase order or signing a contract. Commitment can also be of a continuing nature that require a series of payments over an indeterminate period of time and may or may not involve a contract, e.g. salaries, utilities, and entitlement payments. Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources (usually cash) embodying economic benefits or service potential. In relation to commitment, the liability arises when a third party satisfies the terms of the contract or similar arrangement. Payables/creditors are a subset of liabilities. For the purposes of the program payables/creditors exclude provisions, accrued liabilities. Arrears are a subset of payables/creditors. For the purposes of the Program domestic arrears are defined as payables/creditors (including foreigner commercial creditors), that

have remained unpaid for 90 days or more beyond any specified due date (regardless of any contractual grace period). In case no due date is specified, arrears are defined as payables/creditors that have remained unpaid for 90 days or more after the date of the invoice or contract. Data on arrears will be provided within seven weeks after the end of each month. The continuous indicative target of non-accumulation of new domestic arrears requires that the total arrears at the end of any month are not greater than the corresponding total at the end of the previous month—based on the same perimeter with respect to the entities covered. This also includes arrears that are being accumulated by the SOEs not included in the General Government.

11. **Supporting Material.** The stock of arrears will be measured through a survey. Reports on the stock of arrears of the General Government are being published monthly. The MoF will provide consistent data on monthly expenditure arrears of the General Government, as defined above. Data will be provided within seven weeks after the end of each month and will include total arrears classified by the different constituent sectors of the General Government sub-sector as defined in paragraph 4, as well as the monthly amounts of arrears cleared under the arrears clearance strategy (see paragraph 6.3).

12. **Adjustor.** In 2013 and 2014, the monthly change in the stock of arrears will be adjusted for any stock adjustment related to the arrears clearance strategy as per paragraph 6.3. This will allow monitoring the underlying flow of new arrears.

C. Ceiling on the Overall Stock of General Government Debt (Performance Criterion)

13. **Definition.** The overall stock of General Government debt will refer to the definition established by Council Regulation (EC) No 479/2009 of 25 May 2009 on the application of the Protocol on the Excessive Deficit Procedure annexed to the Treaty establishing the European Community. For the purposes of the Program, the stock of General Government debt will exclude: (i) debt contracted for bank restructuring, when carried out under the Program's banking sector support and restructuring strategy; (ii) IGCP deposits; and (iii) (from end-September 2011) the *'prepaid margin'* on all EFSF loans.

14. **Adjusters.** For 2013, the ceiling of the overall stock of General Government debt will be adjusted upward (downward) by the amount of any upward (downward) revision to the stock at end-December 2012 general government debt of EUR 204.5 billion. From 2014 onwards, the ceiling of the overall stock of General Government debt will be adjusted upward (downward) by the amount of any upward (downward) reclassification of entities or operations that affects the stock at end-December of the previous year.

15. **Supporting Material.** Quarterly data on the total stock of General Government debt as defined in paragraph 12 will be provided to the EC, ECB, and IMF by the BdP no later than 90 days after the end of each quarter, as reported to the ECB and the Eurostat. Monthly estimates will be provided to the EC, ECB and IMF by BdP no later than seven weeks after the end of each month.

D. Non-Accumulation of New External Debt Payments Arrears by the General Government (Continuous Performance Criterion)

16. **Definition.** For the purposes of the Program, the definition of debt is the same as in paragraph 12. An external debt payment arrear will be defined as a payment on debt to nonresidents, contracted or guaranteed by the general government, which has not been made within seven days after falling due (taking into account any applicable contractual grace period). The performance criterion will apply on a continuous basis throughout the Program period.

17. **Supporting Material.** Any external debt payment arrears of the General Government will be immediately reported by the MoF.

E. Bank Solvency Support Facility

18. The dedicated Bank Solvency Support Facility (BSSF) account will be maintained at the Bank of Portugal. As per previous review, resources for the BSSF will be agreed at each review and deposited in the dedicated account.

F. Overall Monitoring and Reporting Requirements

19. Performance under the Program will be monitored from data supplied to the EC, the ECB, and the IMF by the MoF and BdP. The authorities will transmit to the EC, ECB, and IMF any data revisions in a timely manner.

INTERNATIONAL MONETARY FUND

EXTERNAL RELATIONS DEPARTMENT

Press Release No.13/436
FOR IMMEDIATE RELEASE
November 8, 2013

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Eighth and Ninth Reviews Under an EFF Arrangement with Portugal, Approves €1.91 Billion Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the eighth and ninth reviews of Portugal's performance under an economic program supported by a 3-year, SDR 23.742 billion (about €27.03 billion) Extended Fund Facility (EFF) arrangement. The completion of the review enables the immediate disbursement of an amount equivalent to SDR 1.679 billion (about € 1.91 billion), bringing total disbursements under the EFF arrangement to SDR 21.379 billion (about €24.34 billion).

The Executive Board also approved a request for waivers of applicability for the end-September 2013 performance criteria (PC). This waiver was necessary because the Executive Board meeting was scheduled to take place after end-September but prior to the availability of data to assess the relevant PCs.

The EFF arrangement, which was approved on May 20, 2011 (see Press Release No. 11/190) is part of a cooperative package of financing with the European Union amounting to €78 billion over three years. It entails exceptional access to IMF resources, amounting to 2,306 percent of Portugal's IMF quota.

After the Board discussion, Ms. Nemat Shafik, Deputy Managing Director and Acting Chair, said:

"Portugal's short-term outlook has improved and unemployment has started to decline. Considerable progress has been made in advancing fiscal and external adjustment and structural reforms. Decisive steps were taken to keep the program on track following recent setbacks and legal challenges. Nonetheless, there remain implementation risks and uncertainty surrounding macroeconomic prospects and market financing. Continued strong commitment to the program and political cohesion are therefore critical to strengthen the recovery and regain full market access.

"In light of still fragile debt prospects, tighter financing conditions, and a sizable adjustment ahead, it will be important to sustain the fiscal consolidation effort. Full implementation of the 2014 budget and the underpinning expenditure reforms is particularly critical. The government is committed to taking alternative measures should key planned reforms be ruled unconstitutional. At the same time, further efforts are needed to address underlying weaknesses in public finances, including a large public sector with relatively high wages and pensions. The planned fiscal reforms aim to control expenditure and domestic arrears, restructure state-owned enterprises, and strengthen tax compliance.

"The authorities have a strong record in preserving financial stability, and banks' liquidity and capital conditions remain adequate. Given the challenging economic environment, ongoing initiatives to improve supervision and monitor risks are welcome, including a further strengthening of banks' quarterly stress tests. Channeling credit to viable firms is key to support the recovery and employment. In this context, there is a need to step up restructuring efforts to address the corporate debt overhang.

"Forceful implementation of the ambitious reform agenda is critical to boost competitiveness, jobs, and long-term growth. This includes further advances to address the remaining nominal rigidities and supply-side bottlenecks.

"In addition to strong program implementation, Portugal's success continues to depend on external support and effective crisis management policies at the euro area level, including support by the Eurosystem to help address financial segmentation and restore an appropriate monetary policy transmission."

Statement by Andrea Montanino, Executive Director for Portugal and Ines Lopes, Advisor to Executive Director

1 - Overview

We welcome the IMF Staff Report on the combined eighth and ninth reviews, namely in what regards the recognition of the progress over the last two and a half years. All end-June performance criteria were met as well as all structural benchmarks, given that also the Public Administration Labor Law was approved and sent to Parliament in October.

On October 15th, the Government submitted the State Budget for 2014 to Parliament – which constitutes a prior action for the conclusion of these combined reviews – as well as a Supplementary Budget for 2013. The Supplementary Budget was approved on November 1st. The State Budget for 2014 has been approved in general terms and is currently under discussion. Its final approval is set to occur on November 26th.

In terms of economic activity, the updated macroeconomic scenario confirms the steady improvement in high frequency indicators over the past year and the gradual recovery in quarterly GDP growth. For 2013-2014, GDP growth was revised upwards and unemployment was revised downwards.

Strong compliance with the program has allowed for further progress in all of its dimensions. Fiscal consolidation proceeds, with annual targets proving to be within reach and structural adjustment continuing at a good pace. External adjustment is also on track – following the net lending position achieved in 2012, the current account balance is expected to become positive this year, which represents a major breakthrough for the Portuguese economy. In the financial sector, Portuguese banks are adequately capitalized and in a better position to withstand liquidity shocks. Finally, while important structural reforms have entered into full force, the structural transformation agenda continues to be implemented.

Following the political events in July, as well as the impact of perceived changes in US Fed's monetary policy stance, Treasury Bond yields in the secondary markets increased in all maturities. However, they remain at significantly lower levels than those registered in January 2012 and fall close to values of late 2010. Treasury Bill auctions continue to take place as planned, and they were never interrupted. Overall, recent developments since the end of the review suggest that the Program remains on track. This will pave the way for a gradual build-up of confidence that, with the continued European support, will allow the exit from the Program in June 2014, as initially foreseen.

The present state of play is definitely more favorable than at the start of the Program. The Portuguese authorities are aware of the potential risks ahead, but remain confident that these can be overcome. At the external level, although recent indicators suggest that euro area economies are gradually recovering, uncertainty prevails. While exports to non-EU countries keep growing, unfavorable developments in Portugal's main trading partners could influence economic recovery. In addition, financing conditions continue to prove tight, but the Portuguese authorities remain determined to look for ways to improve access to finance, in particular for SMEs. At the internal level, while the possibility of different views by Constitutional Court concerning some measures could constitute further hindrance, the fact is that the Government has overcome similar setbacks in the past and remains determined to comply with the objectives and commitments set in the Program. At the same time, one should bear in mind that these decisions are part of the democratic process.

2 - Economic Activity

Following ten quarters of consecutive decline, GDP grew by 1.1% in 2013Q2 (-2.1% y-o-y). With this result, Portugal registered the best quarter-on-quarter performance in the European Union. Moreover, recent data continue to be positive, hence suggesting that economic activity may be bottoming out. In fact, there are indications that the economy is likely to have grown in the third quarter, as high frequency indicators continue to improve overall and Banco de Portugal's coincident indicator registered the first positive year-on-year growth since the beginning of the Program (0.1% this September).

In addition, while unemployment rate remains high, recent data from Eurostat suggest a stabilization trend. In monthly terms, unemployment rate fell this September, when compared to August and also to September 2012. In quarterly terms, 2013Q3 marked the second consecutive quarter-on-quarter decline in unemployment rate.

While uncertainty prevails internally and in the euro area, the Portuguese authorities are confident that economic activity may in fact have turned the corner. Measures to boost the recovery, including the CIT reform, will be submitted by Government, carefully taking into account budgetary implications in order not to undermine confidence.

3 - Fiscal Policy

Budget execution in the first three quarters of the year remained in line with the budgetary target of 5.5% of GDP for 2013, as confirmed by recently published data. The General Government budget deficit on a cash basis, according to the Program's definition, was € 4,335.7 million, hence falling below the 2013Q3 target. In addition, the monthly increase of tax revenue in September was the highest since the beginning of 2013. This result benefits

from the recovery of both direct and indirect taxes, hence reflecting an improvement in the economy, as well as further progress in fighting tax evasion. At the same time, the Supplementary Budget submitted to Parliament in mid-October confirms the Portuguese authorities' commitment to meet both Program targets and Fiscal Compact rules, as well the rapid response to challenges that may arise in terms of budget execution.

In 2014, General Government deficit will decrease to 4.0% of GDP, as defined in the seventh review of the economic adjustment program. While the State Budget is still under discussion in Parliament, the Government has proposed consolidation measures amounting to 2.3% GDP, which will allow for important milestones in 2014: (i) first positive primary balance since 1997 (0.3% GDP); (ii) structural adjustment of 1 p.p. GDP; (iii) 86% of permanent measures are on the expenditure side, allowing for the rebalancing of the adjustment effort over the Program period. In addition, as stated in the Staff Report, the net yield from the Public Expenditure Review (PER) package was maintained, despite some changes in composition. The outcome will clearly depend also on economic performance and its adherence to the current macro scenario.

4 - Financial Sector Policies

Over the last three years, a comprehensive strategy has been put in place aimed at strengthening banks' solvency, improving the banking system liquidity, enhancing the effectiveness of supervision, and improving the regulatory framework. In fact, the banking system is now better capitalized and more able to withstand significant and prolonged liquidity shocks, with the core tier 1 ratio of the banking system reaching 11.9 percent at the end of June 2013, 3.2 percentage points higher than in June 2011. In addition, the transparency on asset quality, the pro-activeness of supervision and the regulatory framework and architecture have been stepped up. These developments occurred against the background of a very demanding domestic and external environment, characterized by an encompassing adjustment process in the Portuguese economy, the persistence of financial fragmentation and economic weakness in the euro area.

The improvement of the ratio is not only a result of the capitalizations operations, but also due to Banco de Portugal's recommendations to banks' sales of non-core assets and prudent policy results distribution. Already starting in 2010, most banks voluntarily abstained from distributing dividends and started selling part of the international loan book and participations. Portuguese banks stand now more prepared to go through economic conditions that are showing signs of recovery, which may still bring about additional credit losses, and to undergo a smooth transition to the new European prudential regulatory requirements.

The deleveraging process of Portuguese banks has also started already in 2010 and, accordingly, the loan to deposits ratio, which hovered 160 percent in 2010 (one of the largest among European countries by that time), came down to 123 percent by end-June 2013. This evolution reflected the behaviour of household deposits – which, after growing sharply in 2011, remained relatively stable from 2012 onwards – and a fall in credit granted by banks. In what concerns credit, it should be highlighted that situation is heterogeneous. In fact, the most affected sectors have been those more dependent on domestic demand (trade, construction and real estate development) and credit to exporting firms has been growing steadily. In turn, the resilience of bank deposits contrasts with the developments in other Programme countries and is a sign of the public's confidence in the soundness of the Portuguese banking system.

Significant challenges remain in restoring the profitability of the domestic activity – which continued to remain under pressure, on account of elevated loan impairments and compressed net interest margin, also due to structural factors such as the low yielding mortgage portfolio – and in reshuffling commercial networks to the medium term features of financial services demand, characterised by lower activity in the credit market.

Bank lending to the non-financial private sector continues to decline reflecting the need of many firms to converge to a more sustainable financing structure. At the same time, it is crucial that funding continues to reach the most productive and competitive sectors, including exporting companies. This issue deserves ongoing analytical efforts by Banco de Portugal, involving intense use of micro-level information. Similarly, and in view of improving financial access, namely to SMEs, it was signed a protocol with the German KfW on October 28th, through which KfW is instated as an official advisor in the development of a specialized financial institution.

The architecture of supervision was strengthened and Banco de Portugal has been entrusted with an explicit mandate for macro-prudential policy and has been designated as the resolution authority. That implied deep organizational changes within Banco de Portugal with the creation of a Financial Stability Department.

Prudential supervision was reinforced manifold, with more resources involved both on and off-site being supervisory activities now more intrusive with the maintenance of permanent teams in banks' offices. At the same time, Banco de Portugal became more pro-active in ensuring that banks' assets are accurately valued and, after the two previous exercises, in the first half of 2013, the total loan book was revisited in a new asset quality review that concluded that 1.1 billion of impairment reinforcement was needed. At the end of June 2013, that amount was completely recognized in the banks' accounts. A special inspection programme dedicated to the review of banks' recovery process of problem loans is ongoing,

including the scrutiny of strategies, policies, and procedures in place, as well as an assessment of the adequacy of the resources dedicated to this function and governance and internal control issues.

5 - Structural Reforms

The Government remains committed to its reform agenda to boost growth and create jobs, which is very ambitious and encompassing.

Significant steps have been taken in liberalizing the exercise and activity of regulated professions, in transposing the Services Directive and in improving the regulatory authorities' architecture.

The by-laws of 18 public professional associations and related regimes are being adapted to the horizontal legal framework on public professional associations, being an important step in liberalizing the exercise and activity of regulated professions.

The full transposition of the Services Directive is near completion (only 9 out of nearly 70 diplomas still need to be adjusted). This is an important step in removing outstanding barriers to free trade in services in the EU, a key driver of competiveness.

The Government also continues committed to removing excessive licensing procedures, regulations and other administrative burdens in order to remove bottlenecks in our economy. It should also be noted that the Zero Licensing regime, which introduces a simplified scheme for the installation and operation of various activities, is now fully implemented.

In the energy sector, with the liberalization of both the electricity and gas market already in place, the Government keeps focused on ensuring the sustainability of the National Electricity System (NES). Adding to the already approved and implemented measures announced in May 2012, the Government has presented additional measures to address the pressures in the NES (namely the drop in demand that has resulted from lower than expected economic activity), including the introduction of a levy on the energy operators that will be used for fiscal consolidation purposes and for the sustainability of the NES.

Also in what concerns the communications sector the commitment to continue with the structural reforms was kept. Three tenders for the telecommunications universal service providers were issued. Two of these were successfully completed and the third having remained deserted was attributed by direct award for a period of one year whereupon a new tender process will be evaluated. In the postal sector the decree-law laying down the framework of the postal concession contract was amended.

Portuguese authorities reaffirm the commitment towards the privatization program which has already surpassed the initial overall financial objectives. The Government continues to see the program as an important tool for opening up the Portuguese economy and attracting new investment that will increase Portugal's competitiveness in the medium-term. As such, work is ongoing in order to ensure that binding offers for CTT (postal company) are received by the end of 2013 and for EGF (waste management) in early 2014. Furthermore, the restructuring of Águas de Portugal is underway.

In the health sector, operational improvements geared at cost control and efficiency such as the publishing of clinical and prescription guidelines continue to be implemented. To this end a decree law was published opening the MCDT market to new players thereby fostering competition. Difficult negotiations with the pharmaceutical industry were concluded resulting in the state's drug expenditure being reduced to 1% of GDP in 2013. The reorganization plans for the hospital network were presented and the Government remains committed to this reform as well as to further improve expenditure control mechanisms so as to better control and eliminate arrears.

In what concerns judicial reforms, the main commitments agreed under the program have been completed and efforts went even beyond as detailed and recognized in Box 3 of the Staff Report.

Labor Market reforms

In the Labor Market, significant progress has been made since the beginning of the program. A distinctive mark of these reforms has been the tripartite agreement, which served as a basis for the revised labor code, and was signed by the Government, all the employers' associations and the confederation of labor unions UGT, thus minimizing social unrest. An example of a recent move in this area is a new reduction in the severance payments, which entered into force on October 1st, that brought the value from 30-36 days/year in the beginning of the program to a value aligned with the EU average (12 days/year). The recent Constitutional Court ruling, while keeping most of the changes introduced in the Labor Code revision of 2012, rejected some of the provisions regarding the individual dismissal. The Government will work with the Social Partners in designing alternative measures with similar effects, while respecting the Court ruling.

Overall, the Government's view of the labor market is more prudent than the one expressed in the staff report. There is the belief that there is not enough data, nor has sufficient time passed after the recent reform, to reach confident conclusions on this topic. In recent exchanges the Government has argued that the deep change in the economy and the severe economic crisis makes it next to impossible to assess what is cyclical and what is structural in

recent developments in the labor market[1]. This recommends restraint in privileging a dominant explanatory variable from the usual ones: wage rigidity, structural change, reallocation of resources, or credit constraints. This last factor, for example, should be assessed more carefully in coming discussions in light of a recent working paper published by the Bank of Portugal[2]. More specifically, views of "persistent nominal rigidities" or "modest improvement in the overall price competitiveness[3]" are, in the view of the Government, not supported by the data. Nor are the views that the unskilled are bearing most of the costs of the crisis, as the Government has shown, in particular if the period of the adjustment program (2011-13) is taken into account. In sum, the Government recognizes the centrality of this issue, the need to monitor developments closely and fine tune reforms as needed. But the Government also believes that the assessment and resulting policy implications, should at this time be more cautious and tentative.

[1] For example, the recent paper by the European Commission "Labour Market Developments in EU 2013" suggests that "the NAWRU in the current situation is likely to overstate the magnitude of unemployment linked to structural factors, notably in countries most severely hit by the crisis", pointing out "that in some cases it could be of poor guidance for structural policy because of the possible large discrepancies between the NAWRU and the value of unemployment explained by institutions and structural factors only."

[2] See Carneiro, Portugal, Varejão, "Catastrophic Job Destruction", Banco de Portugal Working Papers 14, October 2013 in which "[authors] uncover what we believe is convincing evidence that the severity of credit constraints played a significant role in the current job destruction process."

[3] Especially in light of the strong performance of exports and gains in market share.