INTERNATIONAL MONETARY FUND

IMF Country Report No. 14/102

# PORTUGAL

April 2014

## ELEVENTH REVIEW UNDER THE EXTENDED ARRANGEMENT, AND REQUEST FOR EXTENSION OF THE ARRANGEMENT AND WAIVERS OF APPLICABILITY OF END-MARCH PERFORMANCE CRITERIA

In the context of the Eleventh Review Under the Extended Arrangement and Request for Extension of the Arrangement and Waivers of Applicability of end-March Performance Criteria, the following documents have been released and are included in this package:

- The **Staff Report** for the Eleventh Review Under the Extended Arrangement and Request for Extension of the Arrangement and Waivers of Applicability of end-March Performance Criteria, prepared by a staff team of the IMF for the Executive Board's consideration on April 17, 2014, following discussions that ended on March 2, 2014, with the officials of Portugal on economic developments and policies underpinning the IMF arrangement under the Extended Arrangement. Based on information available at the time of these discussions, the staff report was completed on April 1, 2014.
- A **Press Release** including a statement by the Chair of the Executive Board.
- A **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 for staff reports and other documents allows for the deletion of market-sensitive information.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: http://www.imf.org

**International Monetary Fund**
**Washington, D.C.**

©2014 International Monetary Fund

INTERNATIONAL MONETARY FUND

# PORTUGAL

April 1, 2014

## ELEVENTH REVIEW UNDER THE EXTENDED ARRANGEMENT, AND REQUEST FOR EXTENSION OF THE ARRANGEMENT AND WAIVERS OF APPLICABILITY OF END-MARCH PERFORMANCE CRITERIA

## EXECUTIVE SUMMARY


**The near-term outlook continues to improve and program implementation remains on track.** Activity and employment have turned out better than expected, supported by reduced economic uncertainty and benign market conditions in the region. The authorities have scaled up their pre-financing strategy, successfully tapping the bond market at lengthening maturities. The end-December 2013 quantitative PCs were met by a significant margin, supported by strong revenue performance, and the authorities are on track to meet the end-March 2014 targets.

**While risks to the near term outlook are now more evenly balanced, Portugal still faces important challenges.** The authorities have built a strong track record of program implementation. Nevertheless, sustained fiscal discipline, in the face of still significant legal and other risks, remains critical for debt sustainability and market confidence. Further structural reform efforts are also needed to support the ongoing rebalancing of the economy. These need to be complemented by stepped up efforts to complete balance sheet repair of banks and advance corporate debt restructuring.

**Discussions focused on program implementation and the authorities' medium-term strategy.** The review assessed progress with budget implementation, the authorities' medium-term fiscal commitments, and the status of ongoing reforms under the program. Discussions were initiated on the main pillars of the medium-term strategy to support growth, anchor debt sustainability, and secure durable market access.

**Staff supports the authorities' request for completion of the eleventh review, for extension of the arrangement, and for waivers of applicability of the end-March PCs.** The purchase released upon completion of this review would be in an amount equivalent to SDR 760 million.

Approved By
**Poul M. Thomsen and Sean Nolan**

Discussions took place in Lisbon during February 20–28, 2014. The staff team comprised S. Lall (head), D. Gershenson, M. Goretti, and S. Roudet (all EUR); R. Vermeulen (SPR); M. Poplawski-Ribeiro (FAD); C. Verkoren (MCM); H. Pham (LEG); S. Nardin (COM); and A. Jaeger and M. Souto (RRs). Ms. Lopes (OED) participated in key meetings. U. Niman, P. Hernandez, and J. Scott (all EUR) assisted the mission from headquarters.

## CONTENTS

**INTRODUCTION** 4

**ECONOMIC AND FINANCIAL DEVELOPMENTS AND OUTLOOK** 4
A. Recent Developments 5
B. Outlook 5

**ADVANCING FISCAL CONSOLIDATION** 6
A. Recent Fiscal Developments 6
B. Policy Discussions 8

**BOOSTING COMPETITIVENESS AND GROWTH** 10
A. Background 10
B. Policy Discussions 13
C. Background 15
D. Policy Discussions 16

**SAFEGUARDING FINANCIAL STABILITY** 17
A. Recent Financial Developments 17
B. Policy Discussions 18

**FINANCING, RISKS, AND PROGRAM MODALITIES** 19

**STAFF APPRAISAL** 21

**BOXES**
1. External Adjustment and the Consumption Overhang 24
2. Halting Arrears in the Health Sector 25
3. The Portuguese Pension System: Sustainability and Equity Considerations 26
4. Structural Reforms to Underpin External Sustainability and Boost Growth 27
5. Rethinking the Corporate Debt Restructuring Strategy 29

## FIGURES

1. High Frequency Indicators ____ 30
2. Labor Market Indicators ____ 31
3. Balance of Payments Developments, 2006-13 ____ 32
4. Financing of the Economy, 2009-13 ____ 33
5. Financial Indicators ____ 34
6. External Debt Sustainability: Bound Tests, 2008-2019 ____ 35

## TABLES

1. Selected Economic Indicators ____ 36
2a. General Government Accounts ____ 37
2b. General Government Accounts ____ 38
3. General Government Stock Position ____ 39
4. General Government Financing Requirements and Sources ____ 40
5. Balance of Payments, 2010-19 ____ 41
6. External Financing Requirements and Sources, 2010-19 ____ 42
7. Selected Financial Indicators of the Banking System, 2008-13Q3 ____ 43
8. Monetary Survey, 2011-19 ____ 44
9. External Debt Sustainability Framework, 2009-19 ____ 45
10. Access and Phasing Under the Extended Arrangement, 2011-14 ____ 46
11. Indicators of Fund Credit ____ 46

## ANNEXES

I. Public Debt Sustainability Analysis ____ 47
II. Letter of Intent ____ 56
Attachment I. Memorandum of Economic and Financial Policies ____ 59
Attachment II. Technical Memorandum of Understanding ____ 72

# INTRODUCTION

**1. The near-term outlook continues to improve and the program remains on track.** Activity continues to gather momentum, fueled by both exports and domestic demand. Stronger than expected revenues led to a sizable budgetary over-performance in 2013. Meanwhile, efforts are underway to complete public administration and structural reforms and to prepare the banking system for the forthcoming Comprehensive Assessment by the European Central Bank (ECB). These developments are framed within the context of continuously improving market conditions, with sovereign spreads at their lowest level since mid-2010.

**2. Despite the considerable progress thus far, Portugal's challenges remain significant.** Notwithstanding the significant adjustment undertaken under the program, fiscal consolidation and financing needs remain sizable. While declining, unemployment still remains unacceptably high. Moreover, while a large number of structural reforms have been legislated, they have yet to translate conclusively into effective outcomes. Excessive rents in the non-tradable sector continue to prevent the decline in input costs necessary for sustained improvements in competitiveness, increasing the burden of adjustment to be borne by labor. Remaining labor market inefficiencies raise the risk of a "job-light" recovery as the economy gathers momentum. High corporate debt is weighing on banks' balance sheets, preventing resources from being reallocated to new sectors of growth. Finally, despite the large current account reversal in recent years, the economy's net international investment position remains sizably negative, highlighting the need for a durable rebalancing of the economy.

**3. In light of the above, a broad-based commitment to fiscal discipline and deepening structural reforms is critical to successfully anchor Portugal's medium term strategy.** Reaching a broad political understanding that fiscal discipline and structural reform efforts have to continue would anchor the restoration of full and sustainable market financing and pave the way for a steady decline in fiscal and external vulnerabilities.

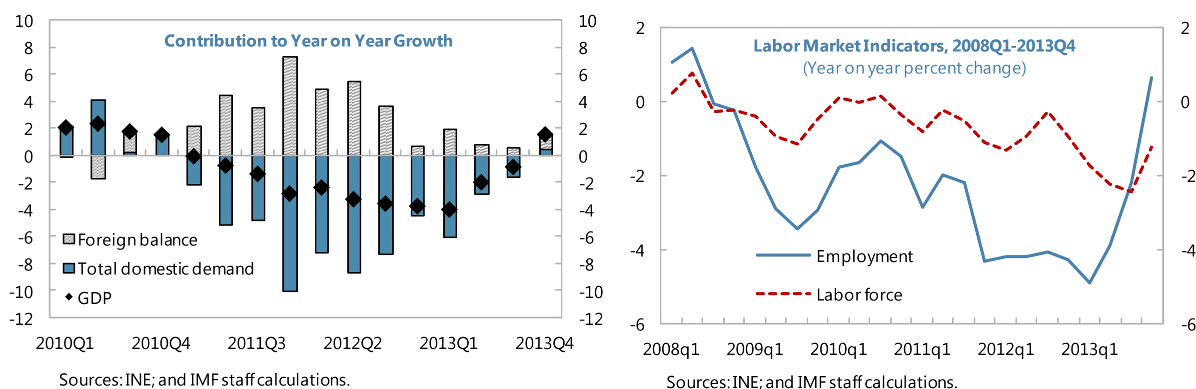
**4. Discussions took stock of program implementation and reviewed the key pillars of the authorities' medium term strategy.** Discussions encompassed the authorities' budgetary plans for 2015 and the medium term, the completion of ongoing structural reforms under the program, the next steps to improve the functioning of the labor and product markets, and ways to foster rapid—yet orderly—corporate deleveraging. Staff also discussed the supervisory efforts by Banco de Portugal (BdP) to strengthen the resilience of the banking sector and reduce financial fragmentation.

# ECONOMIC AND FINANCIAL DEVELOPMENTS AND OUTLOOK

*The recovery in activity is driven by strong exports and a rebound in domestic demand, in the context of improved consumer and business confidence. Near-term prospects continue to improve, although the baseline remains subject to significant risks.*

## A. Recent Developments

**5. Activity and employment have continued to exceed expectations**. Higher-than expected growth in the final quarter of 2013 helped limit the contraction last year to 1.4 percent in 2013 (0.2 percentage points better than projected at the time of the tenth review). The ongoing recovery is underpinned by exports, domestic consumption and, more recently, investment. The sustained pick-up in activity is associated with an appreciable decline in the unemployment rate—to 15.3 percent in 2013Q4 from its 17.7 percent peak in 2013Q1.



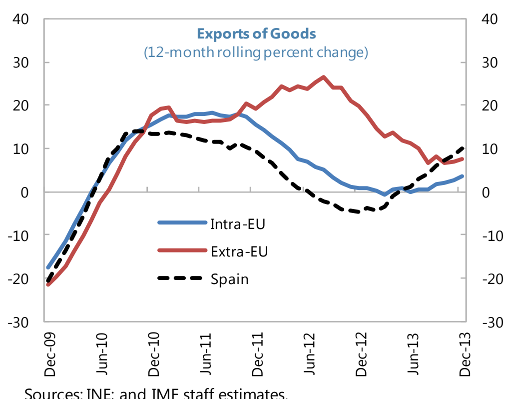

**6. Sovereign bond yields have declined sharply, buoyed by the improved economic outlook and increased investor appetite for higher yielding southern European debt.** Long-term bond spreads have narrowed by about 150 basis points since the beginning of the year to their lowest level since August 2010. The sovereign has taken advantage of improved conditions to tap the bond market at lengthening maturities, with successful issuances in both January and February. The investor base has also continued to broaden, with strong demand from real money non-resident investors. To reduce gross debt levels and carry costs associated with the higher cash buffer, the government also stepped up its buyback program.

## B. Outlook

**7. With a broadening and deepening of the recovery, the growth outlook continues to improve.** Growth in 2014 has been revised up by 0.4 percentage points to 1.2 percent, reflecting somewhat stronger consumption, a recovery in investment—especially in equipment and machinery—and strong export growth. Reflecting the strengthening in activity, unemployment is now projected to decline to 15 percent by 2015 (1.5 percentage points lower than assumed at the time of the tenth review). Looking to the medium-term, the outlook remains broadly unchanged, with annual growth expected to gradually rise to 1.8 percent.

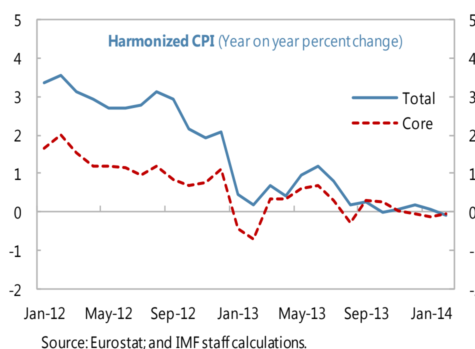
**8. As domestic demand rebounds, the adjustment in the external current account is expected to moderate.** Robust nominal export growth of 5½ percent helped move the current account to a surplus of ½ percent of GDP in 2013—an improvement of 2½ percentage points relative to 2012. This was largely driven by a strong increase in services (mainly tourism), as well as exports of fuel products, capital and consumption goods. Portuguese exports recorded

furthermarket share gains amid a recovery in demand from other EU economies—notably Spain—and continued robust demand from non-EU trading partners. While the recent export performance is expected to be sustained, the current account surplus in 2014 (projected at about 1 percent of GDP) will be tempered by the strengthening of imports. Over the medium-term, the current account is projected to gradually improve to over 2 percent of GDP, provided that the rebalancing of the economy is successful (Box 1).



Sources: INE; and IMF staff estimates.

**9. The risks to the outlook have become more balanced, but remain tilted to the downside.** The recent upturn in domestic demand remains susceptible to changes in market sentiment and any renewed policy uncertainty. In particular, while investor sentiment in the region has been supportive in recent months, it could reverse course in the context of tighter global financial conditions or heightened turbulence in emerging markets. Renewed political tensions and further adverse Constitutional Court rulings could also increase policy uncertainty, especially if the government were to have to resort to lower-quality and less growth-friendly fiscal measures to close any resulting budgetary gaps. Beyond the program period, further structural reforms are needed to realize growth, employment, and export objectives; failure to move on this front would have lasting adverse effects on productivity and long-term unemployment._With Portuguese inflation hovering around zero, the risk of a protracted period of low or negative inflation remains elevated. If it were to materialize, this could further impede the repair of already-weak public and private balance-sheets while generating significant headwinds to the recovery.



Source: Eurostat; and IMF staff calculations.

# ADVANCING FISCAL CONSOLIDATION

*The authorities' steadfast commitment to fiscal discipline, notwithstanding repeated legal hurdles, remains critical to anchor debt sustainability and support market confidence over the medium-term. The discussions focused on progress in budget implementation, reforms of pensions and public administration, ongoing efforts to minimize fiscal risks, notably from state-owned enterprises, and halting the accumulation of new arrears.*

## A. Recent Fiscal Developments

**10. The authorities' ongoing fiscal consolidation efforts are underscored by a strong fiscal over-performance in 2013.** The end-December quantitative performance criteria on the general government cash balance and debt were met by a sizable margin (MEFP, Table 1). Preliminary

estimates suggest that the ESA95 general government deficit was successfully reduced to about 4.5 percent of GDP (excluding BANIF recapitalization costs) in 2013, compared to the target of 5.5 percent of GDP. This over-performance was largely driven by strong tax collection, on the back of positive macroeconomic developments and continued efforts to strengthen tax compliance, as well as prudent expenditure control and one-off revenues from the (tax and social security) debt recovery scheme. However, the indicative target on non-accumulation of arrears continues to be missed, due to new arrears in SOE hospitals and other entities (Box 2).

**11. Nevertheless, close monitoring of budget implementation remains critical.** The authorities are on track to meet the deficit target of 4 percent of GDP in 2014,[1] as newly identified pressures from lower social security revenues and higher transfers to state-owned hospitals are expected to be offset by the positive 2013 carryover and the payoff from an improved macroeconomic outlook. The implementation of the 2014 budget by line ministries is being closely monitored, with new programs aimed at reducing over-employment in specific sub-sectors recently launched or previous ones extended and most of the supporting legislation necessary to implement additional measures in the budget also being finalized (MEFP ¶5).[2] Nevertheless, the risk of new legal challenges remains high, pending a decision by the Constitutional Court on the articles of the 2014 budget law sent in January for review by the opposition, and that have been estimated to yield around ½ percent of GDP in savings.

**12. The PPP renegotiations are advancing well, helping minimize fiscal risks and securing significant savings through 2019.** Cumulative savings from road PPP concessions are expected to reach over €2.8 billion in current prices by 2019 for the nine concessions under renegotiation, with €140 million already achieved in 2013. As part of this process, the authorities are also finalizing the revision of the regulatory framework for the road and rail sectors in line with EU standards and with the objective of minimizing fiscal risks. Moreover, with a negotiation team appointed last February, the renegotiation of the PPP contract on National Security and Emergency (SIRESP) is also expected to generate further permanent savings in 2014 through a reduction in its internal rate of return and optimization of the network.

**13. The operational performance of state-owned enterprises (SOEs) continues to improve, while the privatization program advances.** The consolidated operational balance of SOEs remained in surplus in 2013, although legacy debt burdens continue to weigh on the financial results of most firms, notably in the transport sector.[3] Further progress has been made in the privatization program since the last review, with privatization receipts exceeding program targets. Following the successful IPO of the post company CTT in December, agreement was reached on the

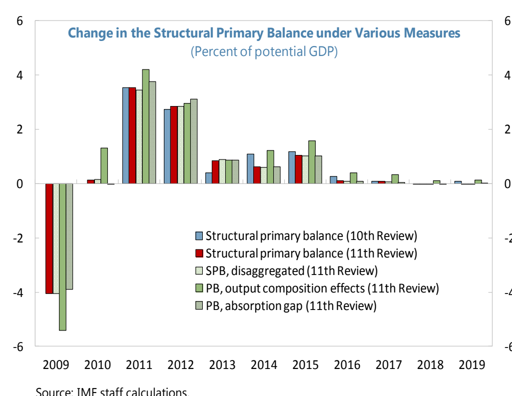
[1] While final data is not yet available to assess observance of the end-March 2014 performance criteria, these appear within reach.
[2] Following the President's veto on the decree-law on the increase in civil servants' contribution to their health insurance systems (ADSE, SAD, ADM)—approved as a prior action for the tenth review, the authorities have submitted the legislation unchanged to Parliament for approval, consistently with the Portuguese legal framework.
[3] When excluding the reinstatement of the 13th and 14th month salaries and severance payments, the underlying operational balance of transport SOEs has improved significantly.

sale of the insurance arm of state-owned CGD in February. Binding offers for the sale of the waste management company EGF are expected by end-June 2014, while opening water concessions to private capital and management is expected to take longer (MEFP ¶14).

**14. Despite stronger cash buffers, the debt outlook remains fragile.** Preliminary estimates suggest that public debt reached about 128.8 percent of GDP in 2013, against an initial projection at the time of the tenth review of 129.4 percent of GDP. The improvement in the debt profile was largely due to the improved fiscal cash deficit and upward revision in nominal GDP. Starting in 2014, under the programmed fiscal path, debt is expected to start gradually declining to reach about 114 percent of GDP by 2019, partly supported by use of cash deposits as well as the ongoing reallocation of the Social Security portfolio from foreign assets to government securities. Thanks to the authorities' pre-financing strategy, central government cash balances continue to strengthen, with net debt projected below 120 percent of GDP by end-2014. Nevertheless, debt dynamics remain highly vulnerable to macro-fiscal as well as contingent liabilities shocks, notably from SOEs outside the general government perimeter (see Annex I).

## B. Policy Discussions

**15. The authorities reaffirmed their commitment to the 4 percent deficit target for 2014.** Staff discussed progress in the implementation of the budget, including the status of the new voluntary separation schemes and new emerging pressures expected from social security and SOE hospitals (see below). Notwithstanding the sizable 2013 revenue over-performance, the authorities agreed with staff's call for continued prudence in budget implementation, given the uncertainties surrounding the permanent nature of the carryover and the notable budgetary risks ahead. With reference to the forthcoming decision by the Constitutional Court on some of the 2014 budget measures currently under review, the authorities renewed their commitment to implement, in the event of an adverse ruling, compensatory measures of high quality to meet the agreed deficit targets (MEFP ¶5) as has been done in the past. In this context, staff stressed the importance of rebalancing the adjustment effort toward expenditure-led measures, less harmful to growth and employment, as identified by the authorities' Public Expenditure Review and the ongoing reform of public administration.



Source: IMF staff calculations.

**16. Discussions also focused on the medium-term budgetary plans necessary to align Portugal's fiscal consolidation efforts with the authorities' medium term objectives.** With a still sizable structural adjustment ahead (of around 1 percent of GDP in 2015), staff discussed progress on the reform of public administration and the ongoing preparation of the 2014 Fiscal Strategy Document (FSD), expected to be submitted by end-April with a view to underpinning the authorities' medium-term budgetary plans. Discussions focused on the pension measures currently under discussion as well as the ongoing reform of public remunerations:

- *Pensions*. Further efforts are needed to improve the affordability and sustainability of the Portuguese pension system in an equitable manner (see Box 3). To this purpose, the recently appointed Pension Reform Committee is developing new comprehensive pension measures, based on clear demographic and economic criteria as well as progressivity principles, in line with the recent Constitutional Court ruling on the CGA convergence reform. The measures, which are part of the authorities' broader reform of the pension system, are expected to be finalized by the time of the twelfth review (MEFP ¶6).

- *Reform of public wages and supplements*. Building on their comprehensive review of wage supplements, the authorities are also working on draft proposals aimed at standardizing and rationalizing existing supplements by key categories, to be discussed with staff and finalized by the time of the twelfth review mission. In parallel, the authorities are advancing their review of public sector remunerations and careers and developing proposals for a new single wage scale for public employees.

The specification of the measures necessary to meet the 2.5 percent of GDP target in 2015 has been set as a *prior action* for completion of the current review.

**17. The authorities' determination to arrest any further accumulation of domestic arrears is welcome.** Following the identification of specific public entities with structural financial imbalances, including twelve State Owned Enterprise (SOE) hospitals and the railroad company *Comboios de Portugal* (CP) last January, the authorities are now finalizing targeted programs to underpin the financial sustainability of these entities. Specifically, the strategy to halt new arrears in SOE hospitals envisages for 2014 the use of additional budgetary funds to close the operational imbalances and fully fund the investment needs of these hospitals to ensure appropriate delivery of healthcare services (see Box 2). Regarding CP, a new debt management strategy is being developed, which is expected to be discussed in more detail at the time of the twelfth review. Beyond these specific programs, staff discussed the ongoing work on the full enforcement of the commitment control law by the recently established unit within the Ministry of Finance responsible to address arrears in the public sector.

**18. Additional measures are also being implemented to complete the fiscal structural agenda under the program:**

- *Public Financial Management*. Staff discussed the new text of the Budget Framework Law (BFL) finalized last March to comply with the transposition of the European Treaty on Stability, Coordination, and Governance and other EU legislation. The next step in the BFL reform aims at streamlining the budget appropriation structure, strengthening accountability standards, and broadening the focus and analysis of fiscal risks.[4] As part of these efforts, staff initiated

[4] With support from IMF-FAD technical assistance, the authorities are also committed to ensure adequate fiscal accounting and reporting through the implementation of the International Public Sector Accounting Standards (MEFP ¶9).

preparatory work with the authorities to undertake an IMF Fiscal Transparency Evaluation by the end of the program.

- *Revenue Administration*. Recent steps by the authorities to curb tax evasion and improve compliance included hiring approximately 1,000 new tax auditors and making the Compliance Risk Management Unit fully operational last February. Next steps going forward involve the authorities' plan to establish a dedicated Taxpayer Services Department in 2014, with the goal of unifying most taxpayer services and improving the taxpayers' relationship with the tax administration.

- *Anti-money laundering (AML).* The authorities are committed to strengthen their AML legal and regulatory framework to tackle more effectively money laundering and its underlying crimes, including tax ones. On the latter, key reforms areas have been identified, with support from IMF-LEG technical assistance, to improve the exchange of information between tax and anti-money laundering authorities, in line with international best practices. A multidisciplinary working group has been also set up to carry out a national AML/CFT risk assessment.

- *Regional and Local Governments.* The budgetary coordination council between the central and subnational governments is becoming operational in April, with a view to establish a more effective inter-governmental fiscal framework. New initiatives to improve governance in municipalities and the design of the forthcoming insolvency procedure for local governments were also discussed. As regards the program for local governments' arrears settlement (PAEL), only nine municipalities remain to be cleared by the Court of Auditors.

# BOOSTING COMPETITIVENESS AND GROWTH

*With a long roster of reforms having been enacted during the course of the program and as it now approaches completion, the focus should be on ensuring that tangible outcomes are being realized and on identifying and tackling remaining impediments to competitiveness and growth. Policy discussions focused in particular on next steps to improve the functioning of labor and product markets and foster rapid—yet orderly—corporate deleveraging, areas where evidence of the full effect of past reforms remains elusive. In particular, it was emphasized that product market reforms are necessary to increase potential growth and ensure the burden of adjustment to gain external competitiveness does not fall unduly on labor.*

## *Tackling Rigidities in Product and Labor Markets and Improving the Business Climate*

### A. Background

**19. Significant progress has been made on structural reforms since the beginning of the program.** Steps have been taken to make the labor and product markets more flexible; the competition framework and regulatory environment have been revamped to foster competition and reduce rents; and, efforts have been made to improve the business environment, including by

cutting red tape and raising the efficiency of the judicial system. Reflecting a wide array of legislative changes, indices of EPL restrictiveness, business environment and overall competitiveness are showing encouraging progress.[5]

**20. The criticality of raising potential growth and promoting a durable rebalancing of the economy toward the tradable sector needs to remain the objective of reforms for the foreseeable future.** Since Portugal's investment position vis-à-vis the rest of the world is unusually high and negative—currently above 110 percent of GDP—and tilted toward debt, growth will need to be generated while maintaining external surpluses (see Box 4). This requires investment to recover from currently low levels and to be targeted to the tradable sector and to be financed by higher domestic savings. In turn, this also requires that the tradable sector's prospects continue to improve, underpinned by competitiveness gains that make it an attractive destination for investment. This would require both lower input costs than currently prevail and sustained productivity improvements. The evaluation of structural reforms thus needs to be viewed in the context of whether these two components of competitiveness are improving on a sustained basis as a result of reforms broadly encompassing product markets, labor reforms and the business climate.

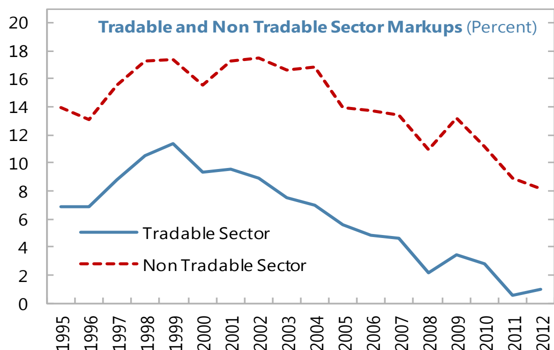
**21. Evidence based on outcomes suggests that important bottlenecks remain in the above key areas, hindering Portuguese companies' ability to attract investment in the tradable sector and compete globally.**

- *Product market rigidities*. Despite past reforms, evidence suggests that excessive rents in the non-tradable sector, particularly network industries, continue to weigh on input prices for the tradable sector. For example, guaranteed returns in the electricity sector irrespective of demand conditions generate upward pressure on electricity prices.[6] The benefits of the reforms in the ports sector have yet to be fully passed through to the prices charged to end users.[7] More generally, while some measures of relative prices are moving in the right direction, relative mark-ups still point to a significant premium for the nontradable sectors. Rents in the nontradable sectors have also allowed for wages to grow in excess of productivity, hampering tradable sector firms' ability to attract high productivity skilled workers at a faster pace, limiting the ability of new opportunities to take root.

[5] See Country Report No. 14/56 for a recent stock-taking exercise.

[6] With the electricity system costs determined independently from demand—through contracts with generators that hedge the sale price from the market price—and with end-user prices below these costs, the electricity system is generating a "tariff deficit." In the absence of new measures to better balance the adjustment burden between the various stakeholders, including by tackling producer rents more forcefully, large electricity price increases will be necessary to eliminate the electricity system's debt.

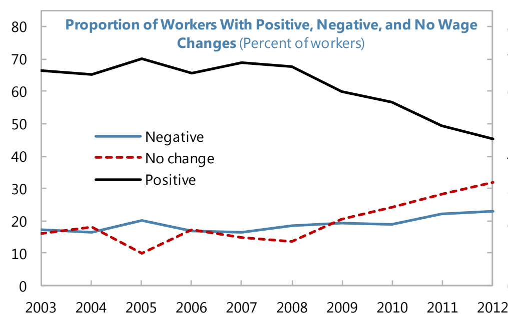
[7] In the absence of renegotiation of existing concession contracts, the benefits from the new Port Works Law (mainly from additional flexibility in work arrangements) would accrue mainly to existing concessionaires.



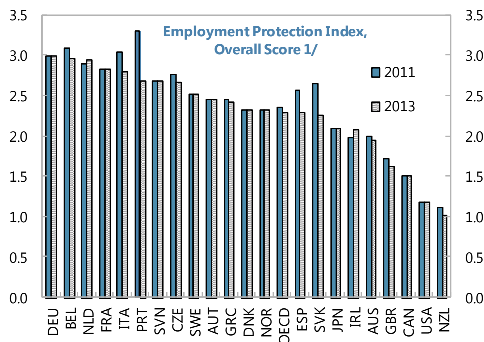

Sources: INE; Eurostat; and IMF staff estimates.

Sources: Eurostat; and IMF staff calculations.
1/ Tradable sector refers to Industry excluding construction. Other refers to Agriculture, Forestry & Fishing; Professional, Science & Tech..; Trade, Travel, Accomodation & Food. Non-tradable sector refers to the rest of the economy.

- *Labor market rigidities*. Despite decreasing in recent months, the unemployment rate remains troublingly high. While unit labor costs have decreased in the private sector, evidence indicates this was driven in large part by the rapid recession-induced labor shedding rather than wage declines (see Box 4). Firms have adjusted through lower hours worked and non-wage labor costs, but downward nominal wage rigidity has remained high. For example, while the proportion of workers benefiting from wage increases has dropped during the crisis, this has not been matched by a commensurate rise in the proportion of workers affected by wage declines. Instead, the share of wage freezes has increased. Wage flexibility would ensure more rapid creation of jobs in the tradable sector as the economy improves, and where wages can in the future rise in line with productivity. Notwithstanding the labor code changes made under the program, employment protection remains high relative to other OECD countries. Dismissing




Source: Social security data and calculations from Banco de Portugal.




Source: OECD.
1/ A higher value corresponds to a greater level of employment protection. The 2013 index includes the regulations in force on Jan 1, 2013, and as such do not take account of the most recent reduction in severance payments in Portugal. The cut in severance pay entered into force in October in Portugal should lead to a further improvement in the index.

individual workers is in practice difficult, even though legally it has been made easier, highlighting the importance of ensuring that reforms translate into effective change by identifying the remaining impediments and addressing them swiftly.

- *Business climate*. While recognizing improvements in this area, it is evident there remains room for convergence toward European best performers, which should be the goal given Portugal's

greater adjustment needs than that of the average European economy. Burdensome administrative procedures and lack of a business-friendly public administration remain important impediments to business activity and investment.

## B. Policy Discussions

**22. Staff stressed the need to complete the reforms underway to rebalance the economy.** Full implementation of the wide-ranging structural reforms already adopted under the program is expected to have a positive impact on growth and job creation over the coming years. To support effective implementation, staff suggested setting up a formal mechanism to ensure that the legislated changes deliver the desired results. Staff also noted how a strong commitment to expand the process of structural reform into the medium term would be essential in attracting more foreign direct investment to the tradable sectors. The authorities acknowledged that turning to a durable export-led growth model would be a lengthy process. They agreed on the need to better focus on reform outcomes and continue to work toward identifying the remaining policy distortions and other potential priority areas which will be tackled in the next phase of reforms. Accordingly, they intend to prepare a medium-term reform strategy, to be adopted by the end of the program (MEFP ¶24).

**23. The emphasis on completion of ongoing reforms focused on the following areas:**

- *Competition.* The government is taking steps to ensure the effective functioning and sustainability of the Competition Authority's (CA) financing model (MEFP ¶25), including by ensuring that potentially higher funding needs over the medium term can be accommodated. Staff also encouraged the government to support the CA's developing role in evaluating public policies.

- *Regulatory environment.* Following enactment in early 2013 of a new framework law for the functioning of regulators—which among other objectives aimed at strengthening their independence and promoting market efficiency, the government is finalizing the amendment of the corresponding bylaws of the sectoral National Regulatory Authorities. The last revised drafts are expected to be approved by end-April 2014.

- *Renegotiation of port concessions.* Staff welcomed the government's initiative to eliminate the port user fee (*TUP-Carga*), as of January 2014, to further reduce port costs for exporters. The authorities are about to launch renegotiations of existing port concessions (end-April structural benchmark; MEFP ¶27). The objective is to foster full transmission of the lower labor costs generated by the new Ports Work Law to end-users of port services.

- *Liberalization of services.* The authorities are committed to complete the amendments of the remaining 5 (out of 68) sector-specific legislations, aligning them with the EU Services Directive, for adoption by end-May. Following the publication last year of the new legal framework aimed at improving the functioning of the regulated professions, the 18 professional bodies' statutes

are being amended for final approval in the next few weeks. These new legislations will eliminate unjustified restrictions to activity.

- *Business environment*. Further steps are still needed to complete the ongoing reforms aimed at streamlining licensing and cutting red tape (MEFP ¶30). These include finalizing the ongoing inventory of burdensome regulations, preparing a roadmap for regulatory simplification, and making fully operational the Point of Single Contact, an e-government portal which allows administrative procedures to be conducted online.

- *Judiciary*. All key pieces of legislation have already been enacted and statistics, including those on clearance rates and disposition time,[8] show an improvement in both the productivity of the court system and the efficiency of enforcement. In this context, staff encouraged the government to ensure full implementation of the recent reforms, particularly the reorganization of the court system—which would help improve effectiveness and efficiency of the court system—and the roll-out of the new supervisory framework for enforcement agents and insolvency administrators, CAAJ.

**24. In terms of pushing the reform agenda ahead in other areas, the authorities agreed to formulate by the time of the next review specific reforms in two important areas**:

- *Electricity*. The government has already taken significant measures in order to facilitate the elimination of tariff debt by 2020. However, to achieve this objective, annual real electricity-price increases of some 1.9 percent will still be necessary. The authorities are developing specific additional measures to reduce costs and further reduce rents in the electricity sector, hence limiting future price increases, to be presented by the time of the twelfth review (*end-April structural benchmark*).

- *Labor market*. The authorities are also working on a package of additional measures aimed at improving collective bargaining, further softening employment protection legislation, and strengthening activation policies, to be specified by the time of the next review (MEFP ¶28). The options already discussed with staff include:

    i. *Options to revive collective bargaining and foster agreements more consistent with economic conditions:* (i) reforming the expiration and survival of collective agreements to encourage more frequent bargaining; (ii) depending on progress on the latter, introducing mutually agreed and temporary suspensions of collective agreements when warranted by economic conditions; and (iii) adjusting the minimum representation threshold (currently 50 percent of employees in the sector) for extending collective agreements, taking into account the representativeness of SMEs in the various sectors. While this could help foster more active

[8] Since 2012Q4, the number of resolved enforcement cases has exceeded the number of new cases (clearance rate). In addition, the speed at which pending enforcement cases were resolved (disposition time) doubled between 2011 and 2013.

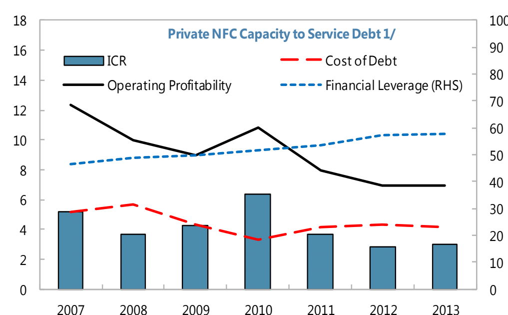
collective bargaining, staff warned not to undo the past reforms aimed at avoiding adverse economic consequences from extensions.

ii. *Reducing severance pay for unfair dismissals*. Incentives to challenge fair individual dismissals in court are likely to have been reinforced by the recent new reduction in severance pay for fair dismissals—as it generated a concurrent widening of the gap between severance pay for fair (12 days per year of service) and unfair (up to 45 days per year of service) dismissals—raising uncertainty for potential employers. Any change in this area should strike a balance between limiting incentives to challenge fair dismissals in court and adequately penalizing unfair dismissals, particularly in case of discrimination.

## *Promoting Orderly Corporate Deleveraging*

### C. Background

**25. Addressing Portugal's private sector indebtedness remains critical to underpin a sustainable investment-led recovery and to help safeguard financial stability.** At the end of 2013, corporate debt amounted to around 60 percent of assets, with debt levels of many Portuguese companies—notably small and medium enterprises (SMEs)—remaining well above sustainable thresholds identified in the literature. Moreover, decreased capacity to generate positive cash flows have eroded corporate equity—with debt-to-equity ratios remaining at very high levels, notwithstanding ongoing deleveraging—and impaired companies' ability to service the outstanding debt. Against this backdrop, more needs to be done to address the private sector debt overhang and, in doing so, ensure healthy bank balance-sheets and financial stability.[9]



Source: Banco de Portugal.
1/ Interest coverage ratio (ICR) is defined as EBITDA over interest payments in number of times, cost of debt is defined as interest paid over total financial debt, in percent . Financial leverage is defined as financial debt over total assets in percent. Operating profitability is defined as total assets over EBITDA, in percent

**26. However, progress toward corporate sector deleveraging faces impediments.** The authorities have implemented a broad range of measures to strengthen the framework for debt restructuring and (corporate) insolvency, by introducing, *inter alia*, new in-court and out-of-court workout procedures. However, the new restructuring tools and other measures face several constraints which have hampered their ability to materially contribute to the corporate sector deleveraging process (Box 5), while financial indicators continue to deteriorate across most industry segments and sizes, notably SMEs.

[9] Please refer to *IMF Country Report 13/19,* and Goretti and Souto, IMF WP/13/154 for a review of the literature and an analysis of the impact of corporate debt overhang on investment.

## D. Policy Discussions

**27. With support from recent IMF technical assistance, staff discussed possible options to foster more effective corporate debt restructuring.** The limited effect of the current debt restructuring tools points to the need for a reinforced debt restructuring program that is better tailored to the needs of the Portuguese corporate sector. Specifically,

- Building on past episodes of large-scale corporate debt restructuring, staff stressed that the development of efficient out-of-court workouts with standardized restructuring terms [10] for large numbers of distressed but viable SMEs would be advisable to provide meaningful relief to firms, while encouraging bank-led and time-bound negotiations, supported by stronger mechanisms to foster creditor coordination (e.g., inter-creditor agreements), for larger companies.

- To enhance its effectiveness, the restructuring program should (i) be subject to oversight by, and enhanced reporting to a reputable and well-qualified entity; (ii) incorporate time-bound arbitration procedures to settle disputes among creditors or between creditors and debtors; and (iii) include financing support for viable companies undergoing restructuring as an incentive for firms to enter into restructuring before their viability is in jeopardy.

The authorities agreed to develop a strategic plan to deal with the corporate debt overhang, especially of SMEs. The plan, which will need to balance the interests of distressed companies with the capacity of the banking system to absorb additional losses, will be discussed with staff during the twelfth review mission (MEFP ¶20).

**28. In parallel, more clarity is needed regarding a key policy instrument—the Development Financial Institution (DFI).** The authorities intend to consolidate all government supported funding initiatives under a new DFI, to explore synergies and improve their management. A task force of banking professionals has been recently established to work on the business model and by-laws of the DFI. The draft business model and by-laws will be discussed with staff at the time of the twelfth review mission (MEFP ¶21). In staff's view, (i) the sole purpose of the DFI should be to address market failures in the financing of private nonfinancial corporations, notably SMEs; (ii) the DFI should not accept deposits or other repayable funds from the public, nor engage in direct lending; and (iii) its final design should be consistent with a consolidation within the general government, in line with national accounts rules.

**29. The authorities have made significant progress in enhancing government-supported initiatives that seek to facilitate access to credit and orderly deleveraging.** Important improvements were made in the mutual guarantee system towards more transparent and efficient guarantee pricing, better governance, and a better risk management framework. Moreover, the Ministry of Economy recently announced a new guaranteed credit line (2014 *PME Crescimento*) of €2 billion, to be directed to viable SMEs via the commercial banks, in line with similar initiatives in 2012

[10] These could include pre-agreed grace periods on principal repayment, capitalization of interest in arrears, and extension of loan maturities.

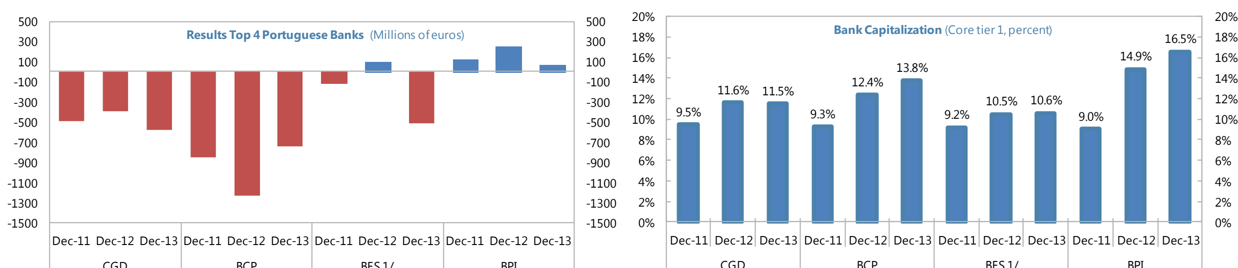
and 2013. Agreed enhancements to the Central Credit Registry aiming at reducing information asymmetries and providing access to companies' historical information are also proceeding apace, with key legislative amendments expected to be submitted to the Council of Ministers by end-April. Going forward, further efforts to foster a lasting change in the funding mix of companies are also necessary, gradually reducing the reliance on debt with a stronger focus on equity financing.

# SAFEGUARDING FINANCIAL STABILITY

*Steps taken under the program, including policies to boost banks' liquidity and capital positions, have helped to maintain financial stability. However, difficult operating conditions and still limited access to capital markets continue to weigh on the banking system. In this context, discussions focused on BdP's continued supervisory efforts—including ongoing actions to further strengthen bank capital, also in light of the Comprehensive Assessment conducted in the context of the Single Supervisory Mechanism.*

## A. Recent Financial Developments

**30. The banking system continues to operate in a highly challenging environment.** Non-performing loan (NPL) ratios for the banking system remain high, while high impairment costs, compressed margins and reduced business volumes continue to erode bank profitability, resulting in annual losses for the eight largest banks of €1.9 billion (up from €1.1 billion in 2012)—with positive contributions from international activities being unable to offset domestic losses. Nevertheless, quarter-on-quarter data point to some sign of stabilization, as the larger banks are showing a modest recovery in net interest income and end-of-year NPL ratios (although the latter might be partly explained by demonstrated seasonality in the evolution of NPL ratios). Sizeable deleveraging and RWA optimization continue to support bank capital levels (including on a forward-looking basis) while aided banks remain focused on further rationalizing their commercial footprint, consolidating their domestic branch network, and gradually disposing of non-core assets. Nevertheless, continued monitoring and decisive policy responses remain necessary to provide a shield against ongoing vulnerabilities, including the risk of further credit quality deterioration.

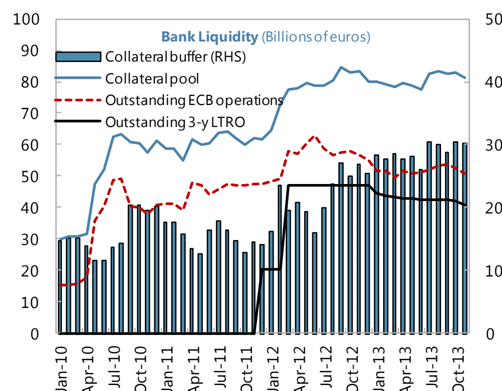



Sources: Banks' financial statements.
1/ Consolidated data for EFSG has not been published yet for 2013. The data reported in the chart refers to BES, SA.

**31. Banks deleveraging is progressing, with credit continuing to rebalance towards tradable sectors.** Loan-to-deposit ratios in the eight largest banks continue to decline, with most of them now below 120 percent, largely due to continuous net credit contraction. Liquidity conditions remains comfortable—with collateral buffers of about €30 billion covering over one year of banks'

refinancing needs, benefiting from modest growth in customer deposits and continued support by the Eurosystem refinancing operations. Even though credit conditions remain difficult, especially for small and medium enterprises, lending continues to rebalance towards the tradable sectors: loans to construction and wholesale/retail-trade firms have diminished considerably, while credit to exporting firms continues to recover (Figure 4).

**32. Going forward, Eurosystem liquidity support remains crucial.** Aided by favorable market conditions and interbank platforms established with BdP support, banks are gradually expanding their access to financial markets funding, in turn contributing to a declining utilization of Eurosystem refinancing operations. Nonetheless, total outstanding operations with the Eurosystem, notably via the three-year long-term refinancing operations, remain sizable— in February 2014 accounting for around €46.5 billion, or 11 percent of banking system assets—underscoring the pivotal role played by the Eurosystem support while financial markets normalize. This would be especially important in the post-program period. With the completion of the program, the extraordinary collateral rules by the ECB suspending the application of the minimum credit rating threshold for marketable debt instruments issued or fully guaranteed by the Portuguese government will cease to be in force.[11] While the withdrawal of the ECB waiver is not expected to impact the Portuguese banking system given the long-term rating currently assigned by rating agency DBRS to the sovereign, banks' collateral availability will become highly sensitive to future rating decisions, calling for renewed efforts to strengthen collateral buffers, including through contingency plans in the event of a ratings downgrade.




## B. Policy Discussions

**33. Discussions focused on the BdP's continued efforts to closely scrutinize banks' balance sheets, also in light of the Comprehensive Assessment that has been initiated in anticipation of the start of the Single Supervisory Mechanism:**

Building on past impairment reviews, the BdP has conducted targeted audits of provisioning levels of the eight largest banks for exposures that relate to a selected number of large non-financial groups—where necessary, based on an IFRS incurred loss basis, resulting in further impairment

[11] According to the Guideline of the ECB of March 20, 2013 on additional temporary measures relating to Eurosystem refinancing operations and eligibility of collateral, "The Eurosystem's credit quality threshold shall not apply to marketable debt instruments issued or fully guaranteed by the central governments of euro area Member States under a European Union/International Monetary Fund program, unless the Governing Council decides that the respective Member State does not comply with the conditionality of the financial support and/or the macroeconomic program".

reinforcement at end-2013. Going forward, recurrent impairment reviews, targeting vulnerable (subsets of) banks' portfolios will remain necessary, even though the near-term focus will be determined by the work that is related to the Comprehensive Assessment and the roll-out of the euro area's Single Supervisory Mechanism.

- In parallel, the recent publication of guidelines on measuring credit portfolio impairment and disclosure of asset quality and risk management practices helps advance conservative impairment standards across the banking system, including for smaller institutions that have not been included in the coverage of earlier impairment reviews.

- Finally, the BdP continues to conduct quarterly stress tests, incorporating the results in its supervisory program and requiring banks, where necessary, to mitigate identified vulnerabilities via remedial actions. Where possible, the modalities of the quarterly stress tests are being aligned to those of the forthcoming EU-wide stress test, including via the application of similar thresholds (7 percent Common Equity Tier 1 for the baseline plus an add-on of 1 percentage point for the four banks participating in the EU-wide stress test, and a 5.5 percent Common Equity Tier 1 for the adverse scenario).

**34. Staff discussed with the authorities their current views on the possibility of strengthening bank capital via a change in the treatment of deferred tax assets (DTA).** In light of past initiatives in Italy and Spain, the Portuguese authorities are assessing the implications of a possible amendment of the treatment of DTAs to counteract their mandatory deduction, to be phased-in over a period of ten years, under the Fourth Capital Requirements Directive and accompanying Capital Requirements Regulation (together referenced to as the CRD IV package). Such an amendment would have clear benefits for the banking system, particularly in anticipation of the Comprehensive Assessment. To maximize externalities, any potential change in the treatment of DTAs should be made contingent on actions to be taken by the banks, including additional provisioning and accelerated restructuring or disposal of distressed assets. Nevertheless, the authorities recognize that the benefits of a revised DTA treatment will need to be carefully weighed against the program's objective of ensuring fiscal sustainability.

# FINANCING, RISKS, AND PROGRAM MODALITIES

**35. The near-term financing outlook continues to improve.** The authorities have taken advantage of compressing yields to conduct a debt swap, bond issuances, and buybacks, building up a sizable cash buffer of over €15 billion in February (excluding the dedicated BSSF account of €6.4 billion). Coupled with remaining program disbursements and retail issuances, this would be sufficient to cover financing needs up to March next year. More bond issues are expected in the coming months—possibly with a return to regular auctions—with a view to prefund 2015 financing needs. Prospects for this remain good, as government bond yields continue to come down despite

recent volatility in emerging markets. Accordingly, financing assurances over the next 12 months remain in place under baseline assumptions.[12]

**36. Despite the improved redemption schedule, medium-term financing challenges remain sizable.** While the recent debt swap and bond buybacks, including through the reverse auction in late February and in March, have helped smooth the 2014-15 redemption profile, a large bond redemption is due in October 2015, with Fund repurchases starting in November 2015. Although the authorities have already started pre-financing 2015, close to €16 billion remain to be raised to cover financing needs through end-2015, with rising amortization schedules in the outer years. Sustained fiscal discipline and structural reform effort to anchor debt sustainability and support medium-term growth remain critical to secure market confidence and durable market access of the magnitude needed to cover these funding needs.

**37. The program continues to meet the criteria for exceptional access.** Notwithstanding the recent improvement in financing conditions for the public and private sectors, exceptional access under the program remains critical to addressing Portugal's funding needs (Criterion 1). While staff considers public debt to be sustainable over the medium term, this 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). Barring a reversal in the recent improvements in market sentiment, for instance resulting from tighter global financial conditions and related market volatility, prospects for sustaining market access within the period that Fund resources are outstanding remain good, although the potential scale of market access is still uncertain. 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 political and legal risks, prospects for program success remain reasonably strong, given the authorities' demonstrated implementation capacity and commitment to the program objectives (Criterion 4).

**38. Capacity to repay the Fund remains adequate.** The Fund's exposure to Portugal is projected to rise to 15.8 percent of GDP this year. Debt service is expected to peak at 5.3 percent of exports of goods and services or 2.5 percent of GDP in 2018. Nevertheless, the authorities' tested track-record of fiscal discipline and reform effort—in line with the agreed commitments under the program and despite several adverse constitutional rulings—together with the observed turnaround of external imbalances provide assurance that adequate resources will be available to repay the Fund.

**39. The authorities request a waiver of applicability of end-March 2014 performance criteria.** The controlling performance criteria for the eleventh review are those set for end-March

[12] Even without additional issuance, financing needs through mid next year can still be met with additional net retail issuances, limited bond purchases by the social security fund in the primary market, or, if needed, net T-bill issuance, while leaving the resources available in the BSSF intact.

2014. The authorities, however, request a waiver of applicability, since (i) the final data to assess performance for end-March is not yet available and (ii) there is no clear evidence suggesting that the performance criteria might not be observed.

**40. The authorities' request an extension of the arrangement to June 30, 2014.** A short extension of about six weeks is needed to allow sufficient time to assess the end-March performance criteria, complete the final review, and enable the final purchase under the arrangement.

# STAFF APPRAISAL

**41. Program implementation is on track, underpinned by improved growth prospects and a sizable budgetary over-performance in 2013.** The short-term outlook for the Portuguese economy continues to improve, with the ongoing recovery driven by both external and domestic sources of growth. Unemployment has begun to decline, although from still unacceptably high levels. Supported by strong tax collection and prudent expenditure control, the end-December 2013 performance criteria were met by a wide margin. The authorities have renewed their commitment to the fiscal targets and the end-March 2014 performance criteria appear within reach. Moreover, efforts are ongoing to complete unfinished reforms under the program and further strengthen banks' balance sheets.

**42. Nevertheless, Portugal still needs to address important challenges.** While prospects for a firming of the recovery appear positive, the outlook is clouded by a number of risks, especially in the medium term. Notwithstanding the significant fiscal adjustment already achieved under the program, fiscal consolidation and financing needs remain large. Critical measures in the 2014 budget are currently under review by the Constitutional Court and renewed policy uncertainty in the event of adverse rulings could negatively affect business confidence and market sentiment, especially if the government were to have to resort to less growth-friendly fiscal measures. Most importantly, excessive rents in the non-tradable sector and remaining inefficiencies in labor markets, if left unaddressed, would further delay the necessary rebalancing of the economy towards the tradable sector, and would continue to force the burden of adjustment to be borne excessively by labor. The repair of Portugal's weak private balance sheets also needs to start in earnest to unlock credit toward the productive segments of the economy and to support growth. However, with Portuguese inflation hovering around zero, a protracted period of low or negative inflation could further delay and exacerbate the ongoing deleveraging process.

**43. A broad-based political commitment to fiscal discipline remains critical to anchor debt sustainability and support market confidence.** The authorities' fiscal consolidation efforts continue apace, with high quality expenditure-oriented measures underpinning the 2014 budget. Close monitoring of budget implementation, however, remains critical in view of the still significant budgetary risks ahead. The authorities' solid track record provides assurances that they will promptly implement compensatory measures in the event of adverse legal rulings. Progress in the reform of

pensions and public administration is also critical given the still sizable fiscal adjustment needed to firmly set debt on a downward trajectory. Most importantly, broad political consensus is essential to anchor Portugal's medium-term budgetary plans and resist any future pressures to increase expenditures or reduce taxation outside the committed budget envelopes.

**44. Fiscal consolidation efforts need to be supported by further progress in the fiscal structural agenda.** The authorities' revamped strategy to address the structural financial imbalances of transport and hospital SOEs is critical to arrest any further accumulation of domestic arrears and minimize attendant fiscal risks. The enhancements to the budget framework law and the review of the underlying PFM processes are also an important step forward in this direction, together with sustained efforts in further strengthening revenue administration, renegotiating PPPs, and restructuring SOEs.

**45. Raising Portugal's growth potential hinges critically on a deepening of the medium-term structural reform strategy.** Although significant progress has been made on the program structural agenda, reforms have yet to translate into effective change in many areas, with evidence of remaining bottlenecks to competitiveness and growth. Beyond completing the ongoing reforms under the program, a new medium-term strategy is necessary to deepen the structural rebalancing of the economy. Further steps are needed to tackle remaining rigidities in product and labor markets, while improving the business climate. In particular, while further labor market flexibility remains a key element going forward, renewed efforts to tackle rents in the non-tradable sectors are also needed to reduce input costs for exporters and ensure the burden of adjustment does not fall excessively on labor. In light of this, staff urges the authorities to follow through on commitments to specify and implement new reforms in these areas in the weeks ahead. New measures to promote orderly corporate deleveraging are also essential to underpin a sustainable investment-led recovery and help safeguard financial stability.

**46. Continued vigilance remains necessary in the financial sector.** Financial stability has been successfully maintained throughout the program, also thanks to the pivotal role played by Eurosystem's liquidity support. Nevertheless, banks continue to face a challenging operating environment, with high impairment costs, compressed margins, and reduced business volumes. In this context, continued efforts are needed to address the stock of non-performing loans and decisively mitigate any identified vulnerabilities in banks' balance sheets via remedial actions. The banks' targeted audits, the recent publication of guidelines on measuring credit portfolio impairment, and the ongoing efforts to further strengthen the banks' quarterly stress tests are all important initiatives by the BdP in this direction, also in light of the Comprehensive Assessment initiated by the European Central Bank.

**47. Portugal's economic policy strategy needs to be supported by effective institutional reforms and resolute crisis management initiatives at the euro-area level.** While strong implementation of the program commitments remains a necessary condition to restore full and durable market access, strong policy support at the euro area level is also essential to help Portugal remain resilient to shocks. In view of still substantial medium-term financing challenges, the

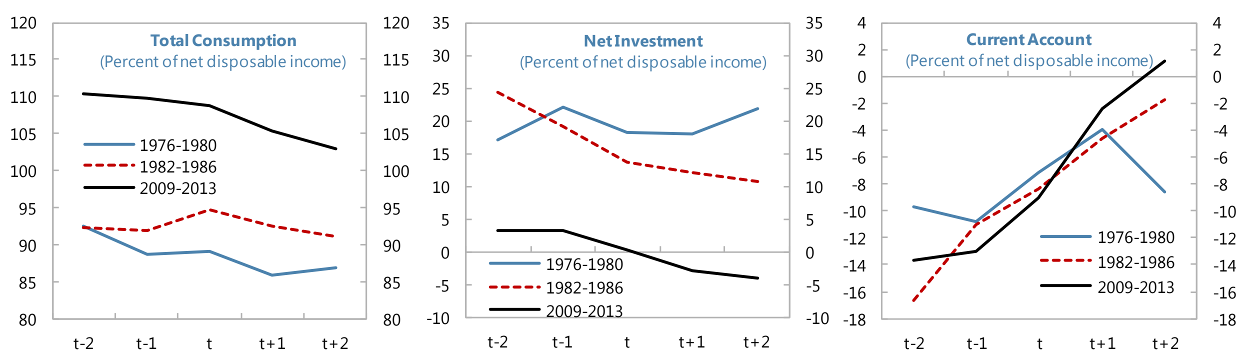
commitment by European leaders to support Portugal until full market access is restored, provided that program implementation is on track, continues to provide valuable financing assurances.

**48. Staff recommends completion of the eleventh review, and the granting of an extension of the arrangement and of waivers of applicability of end-March 2014 performance criteria.**

## Box 1. Portugal: External Adjustment and the Consumption Overhang

**External adjustment requires a durable rebalancing of savings-investment patterns.** The recent adjustment of Portugal's external current account has taken place at a faster than expected pace. In order to lock in the current account adjustment achieved so far and to facilitate medium-term growth and job creation, a significant increase in net investment will have to be accommodated by an offsetting decline in the share of consumption, as below.

**The external current account is the balance between the economy's disposable income and its spending on consumption and investment.** The sum of the economy's total consumption (private plus public consumption), total net investment (gross investment minus depreciation), and the current account position has to be equal to the economy's net disposable income. If the economy spends more than its disposable income on consumption and investment, which include imports, it has to run a current account deficit, and vice versa. The text chart compares Portugal's three external adjustment episodes under IMF-supported programs during the 1970s, the 1980s, and 2009-2013 (in the chart, all variables were scaled by the economy's net disposable income).



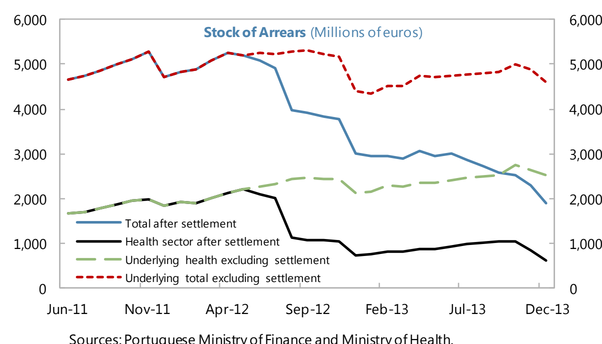

Sources: INE; AMECO; and IMF staff estimates.

**Under all three programs the external gaps were closed rapidly, but in the present one, this was also accompanied by the economy's net investment turning negative**. In response to both policies and generalized uncertainty, spending on both consumption and net investment declined relative to the economy's disposable income, resulting in a reversal of the current account deficit. However, compared with the two earlier programs, consumption was at much higher initial levels prior to the present program. This "consumption overhang" was mirrored by very low initial levels of net investment. As a result, as private and public sectors adjusted through cuts in spending on investments, also in part by cutting back imported investment goods, the already exceptionally low net investment level turned negative in 2012, i.e. the capital stock started to shrink. While the shrinking capital stock reflected primarily low investment in housing and the public sector, investment levels in the corporate sector were also abnormally low.

**To avoid reverting to large current account deficits, policies will need to continue to support the rebalancing of consumption and investment.** Looking ahead, reviving investment to more normal levels to underpin sustainable medium-term growth and job creation without running large current account deficits will only be possible if the economy's consumption overhang is curtailed further. This suggests that apart from continued tight fiscal policies to reduce public consumption and increase public savings, the private sector—both corporations and households—will have to be incentivized to boost their savings rates. On a positive note, the 2014 investment survey already suggests that firms plan to cover a significantly higher share of their investments through retained earnings, effectively increasing their savings rates. At the same time, the increase in the private household savings rate came to a halt and started to reverse in 2013, indicating that a cyclical recovery accompanied by falling household savings rates will go uneasily with the medium-term requirement of rebalancing consumption and investment over the next few years. Overall, the above considerations underscore the need for Portugal to make investment in the tradable sector a more attractive alternative to current consumption, which will help boost the economy's potential growth and help make it more sustainable. Further structural reforms are essential to this end.

## Box 2. Halting Arrears in the State-owned Hospitals

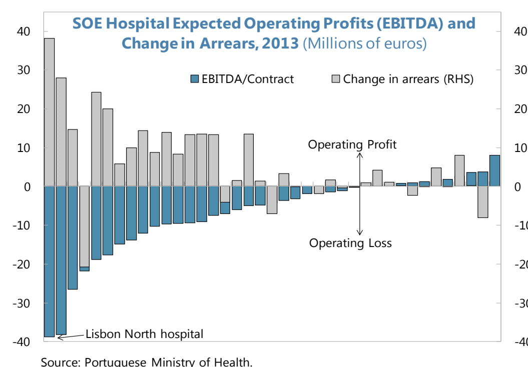
**Despite the commitment control law (CCL) and the progression of the arrears clearance, new arrears continue to accumulate.** In 2013, total underlying arrears (excluding the debt settlement programs, DSPs) increased by about €221 million or 0.1 percent of GDP. In particular, in the health sector, underlying arrears went up by about €307 million (0.2 percent of GDP), excluding the DSPs, due to operating losses from SOE hospitals, unfunded investments, and the shortening of the period of payables from 180 days to 90 days, an EC directive. The hospitals already classified within the central government (CG), in general, do not accumulate arrears, as they receive sufficient transfers to equilibrate their operational balance.



Sources: Portuguese Ministry of Finance and Ministry of Health.

**The health sector has already undergone a number of reforms since 2011, resulting in significant savings.** By increasing efficiency and reducing waste, in 2013, expenditure in the National Health Sector is likely to be about 15 percent lower than in 2010 (€1.5 billion in savings). Most cost categories were reduced, while preserving the quality of healthcare with the consolidated deficit of the sector (CG plus SOEs) declining from €833 million in 2010 to an estimated €126 million in 2013.

**The continuing operating losses of SOE hospitals appear related to budgeting policy and efficiency problems.** Most of the health sector funding is public (around 70 percent) and less than 20 percent of the population is covered by private voluntary health insurance. The services provided by these SOE hospitals generally exceed the production agreed with the NHS. The price received for the services is usually lower than the cost of producing them. Other operational costs are also relevant. The majority of the losses are concentrated in four large hospitals, accounting for two-thirds of the arrears accumulation. Moreover, in 12 hospitals the new arrears exceed 10 percent of their total revenue. The SOE hospitals are also incurring around €50 million of arrears a year in unfinanced investment expenditures, which is currently not budgeted for in the government system, albeit all parties recognize their need in order to maintain buildings and equipments.



Source: Portuguese Ministry of Health.

**To address this accumulation of new arrears in the health sector, the government has recently taken key steps.** It has strengthened monitoring and oversight of arrears by creating a central unit in the MOF, which reports to the Secretary of State for the Budget on the stock of arrears and coordinate actions to enforce the CCL in full. It has identified and isolated the 12 SOE hospitals with significant structural financial imbalances, putting them into an agreed program, and providing additional transfers from the 2014 budget to close any remaining operational losses and investment needs and ensure that the quality of healthcare is not compromised.

## Box 3. The Portuguese Pension System: Sustainability and Equity Considerations

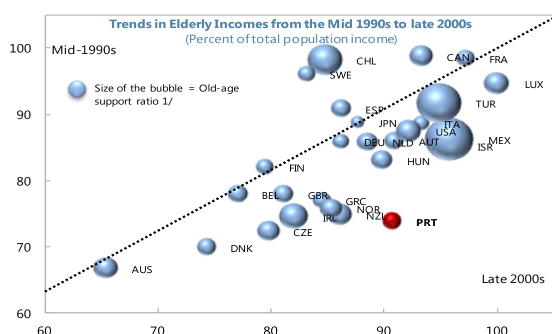
**While pensions account for the largest share of public spending in Portugal, there is scope for improving their equity and efficiency.** Public pension expenditure in Portugal more than doubled relative to national income over the last 20 years, with changes only in part justified by demographic developments.[1] In 2012, social benefit spending—of which pensions account for over 80 percent—stood well above European and euro area averages. However, while the relative income of the elderly (of which 73 percent is generated by public transfers) has significantly increased over time, old-age poverty levels remain broadly in line with peers, with Portugal standing out as one of the OECD countries with the lowest progressivity indices.

**Public Expenditure by Economic Activity, 2012**
**(Percent of GDP)**

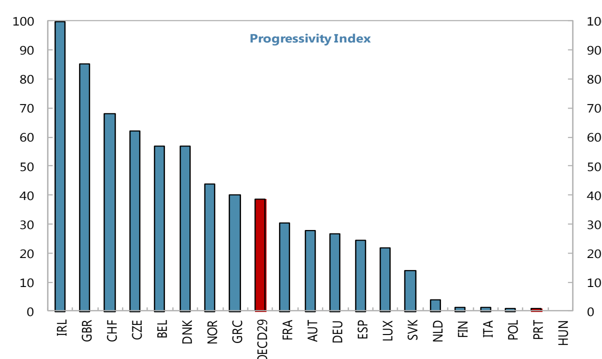
| | PRT | EA | EU |
|---|---|---|---|
| Gross capital formation | 2.6 | 2.5 | 2.9 |
| Compensation of employees | 11.4 | 11.4 | 11.2 |
| Subsidies | 0.7 | 1.3 | 1.3 |
| **Social benefits** | **22.0** | **20.4** | **18.0** |
| Intermediate consumption | 4.7 | 5.9 | 6.6 |
| Other current transfers | 2.6 | 2.2 | 2.2 |
| Capital transfers | 1.4 | 1.4 | 1.4 |

Sources: Eurostat and IMF staff estimates.

**In recent years, the authorities have taken significant steps to promote the long-term sustainability of the pension system.** These have included the suspension of early retirement, changes in the benefit formulas in line with lifetime average earnings and life expectancy, as well as less generous indexation of higher pensions and better means-testing of safety-net benefits. Moreover, the 2014 budget introduced important new reforms, including an effective increase of the retirement age to 66 years and means-testing of survivor pensions.




Sources: OECD, Pensions at a Glance 2013 and staff estimates.
1/ Number of people of working age (20-64) relative to number of people of retirement age (65+).




Sources: OECD pension models; OECD Earnings Distribution database.
1/ The index of progressivity is 100 minus the ratio of the Gini coefficient of pension entitlements divided by the Gini coefficient of earnings, on both cases weighted by the national earnings distribution.

**However, the differences in benefits for workers in the private and public sectors—at the root of the inefficacy of public pension spending—are proving difficult to tackle.** The civil servants' regime (CGA) weighs heavily on pension spending, with beneficiaries receiving disproportionately higher old-age pensions than in the general social security regime (GCR)—even after accounting for wage differences—and often under early retirement. However, these acquired benefits are proving hard to tackle, as evidenced by past legal rulings, including the most recent one on the CGA convergence measure in the 2014 budget. While the authorities expanded the coverage of the Extraordinary Solidarity Contribution (CES) to meet the fiscal targets, a broader reform of the CGA remains critical to enhance the affordability and fairness of the overall pension system.

**Portugal: Public and General Regime, 2012**

| | CGA | GCR |
|---|---|---|
| Spending (percent of GDP) | 5 | 9 |
| Pensioners (thousand) | 603 | 2,968 |
| Average annual benefits (euro) | 13,218 | 4,793 |
| Average benefit to wage of contributors | 59 | 45 |
| Percent of new pensioners < age 60 | 55 | 17 |

Sources: National authorities, IMF Country Report 13/19.

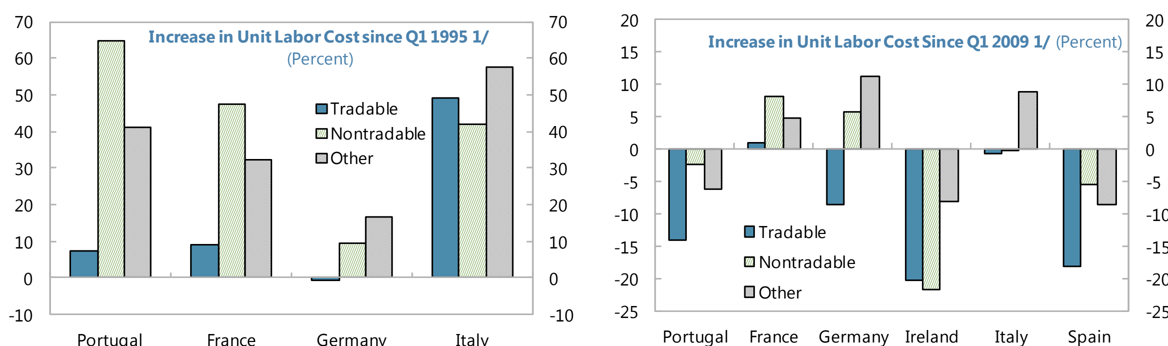
______________

[1]Please also refer to Portugal: Rethinking the State—Selected Expenditure Reform Options, IMF Country Report No. 13/6, the 2013 OECD Pensions at a Glance Report. and the SIP "Growth-Friendly, Equitable, and Sustainable Fiscal Reform in Portugal", IMF Country Report No. 13/19.

## Box 4. Structural Reforms to Underpin External Sustainability and Boost Growth

**In order to safeguard external sustainability, Portugal will need to reduce and rebalance its negative IIP position.** Portugal's IIP currently stands at over 110 percent of GDP, with debt liabilities comprising some 75 percent of total external liabilities against only 20 percent for FDI. Accordingly, Portugal needs to shift the composition of its foreign liabilities from an overreliance on debt to a more balanced composition, including more FDI, as well as to generate current account surpluses for the foreseeable future to reduce vulnerabilities to external funding shocks.

**Since tradable sectors are price takers in the international market, Portugal has no option but to improve its competitiveness to boost export growth durably.** This requires continued efforts to contain input costs while increasing productivity. Since input costs comprise both labor and other factors, the reduction of excessive rents in, for example, network industries and nontradable sectors can yield substantial declines in the costs of inputs and improve competitiveness. These can complement efforts to improve productivity. In the absence of efforts to reduce rents and non-wage input costs, improving competitiveness would require higher wage adjustment.. Indeed, in Portugal, unit labor costs seem to have fallen more in the tradable sectors than in the nontradable sectors since 2009.[1/] In Ireland, on the contrary, unit labor costs in the nontradable sectors appear to have declined more than in the tradable sectors.



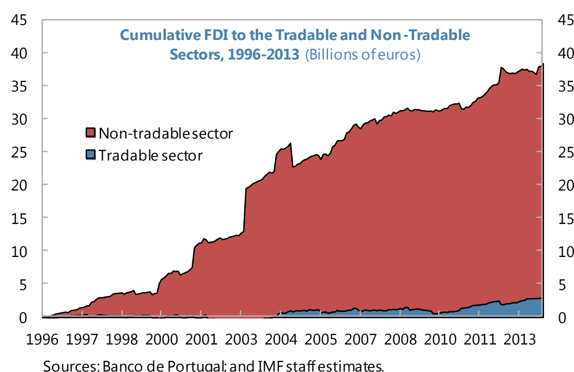

Sources: Eurostat; and IMF staff calculations.
1/ Tradable sector refers to Industry excluding Construction (includes Manufacturing). Other refers to Agriculture, Forestry & Fishing; Professional, Science & Tech..; Trade, Travel, Accomodation & Food. Non-tradable sector refers to the rest of the economy. Productivity is gross value added divided by employment.

**More competition and reducing rents (including to labor) would foster a reallocation of resources toward tradables.** Wages in the nontradable sectors in Portugal are have been higher than the opportunity cost of labor because excessive rents in these sectors have been shared between employers and employees. As a result, the more skilled workers have tended to favor nontradable sectors that could offer higher wages. This has hampered the ability of the tradable sectors to attract high-skilled workers (see chart) If competition and regulatory reforms can effectively reduce rents from the nontradables, this would act as a "push" factor and encourage high-skilled workers to move to the tradable sectors.

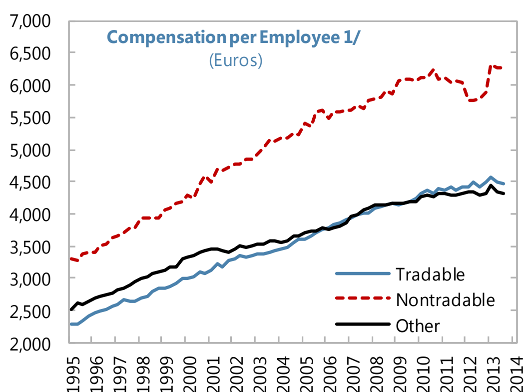
[1/] This assumes, however, that tradable sectors are essentially industrial sectors (excluding construction). A more comprehensive coverage—for example to include tourism-related activities, featured mainly in the "other" category for the purpose of this analysis—would likely lead to a less pronounced divergence.

## Box 4. Structural Reforms to Underpin External Sustainability and Boost Growth (concluded)

Tackling rents in the nontradable sectors would also increase relative profitability in the tradable sectors, hence addressing the lopsided incentives for investment in these sectors (see FDI chart). Overall, these developments would facilitate the needed rebalancing of the economy.




Sources: Banco de Portugal; and IMF staff estimates.



Sources: Eurostat, Statistics Portugal, Labour Force Survey; and IMF staff estimates.

1/ Tradable sector refers to Industry excluding Construction (includes Manufacturing). Other refers to Agriculture, Forestry & Fishing; Professional, Science & Tech..; Trade, Travel, Accomodation & Food. Non-tradable sector refers to the rest of the economy.

2/ Low = ISCED 0-2 (No formal, primary and lower second education), Medium = ISCED 3-4 (Upper second and post secondary education), High = ISCED 5-6 (Tertiary and Postgraduate education).

3/ For Portugal, tradable sector refers to manufacturing, mining and quarrying. In addition, for Ireland, tradable sector includes agriculture and selected service activities.

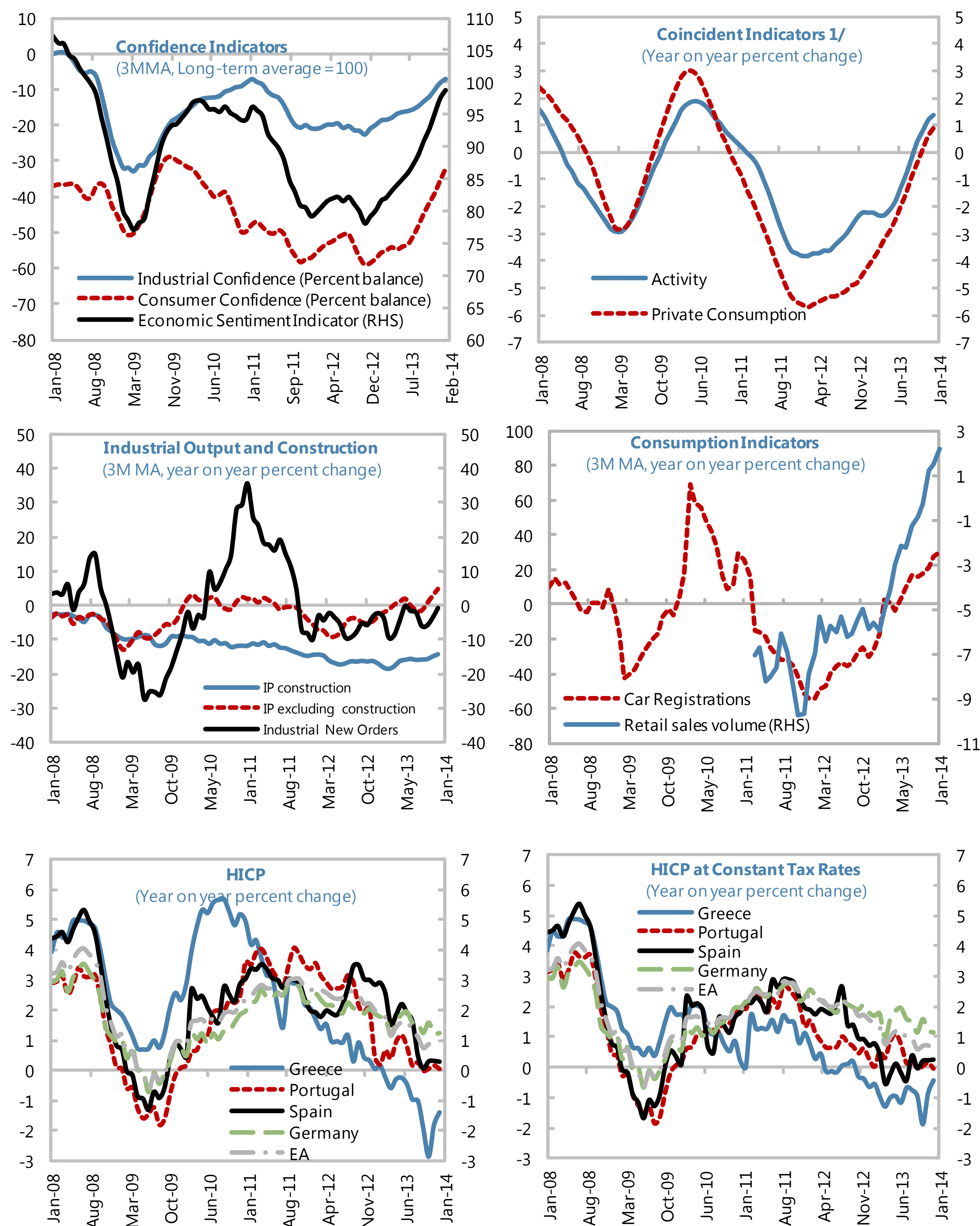
### Box 5. Rethinking the Corporate Debt Restructuring Strategy

**Addressing Portugal's sizable private sector indebtedness has been from the outset one of the key objectives under the program.** In September 2011, the Guidelines to promote the use of out-of-court debt restructurings were adopted. In May 2012, the authorities introduced a new in-court process for debt restructurings (*Processo Especial de Revitalização*, PER) that allow "fast-track" court approval of restructuring plans that are supported by the debtor and a requisite majorities of creditors and can bind minority creditors ("cram down"), followed in September 2012 by a regime for out-of-court debt workouts (*Sistema de Recuperação de Empresas por Via Extrajudicial*, SIREVE), focused primarily on SMEs. In parallel, the insolvency law was amended to simplify and shorten insolvency procedures. These and other initiatives aimed at facilitating a market-based approach to restructuring, allowing viable but distressed firms to shore up their financial position.

**However, the new restructuring tools and measures have yet to materially contribute to facilitate the deleveraging process:**

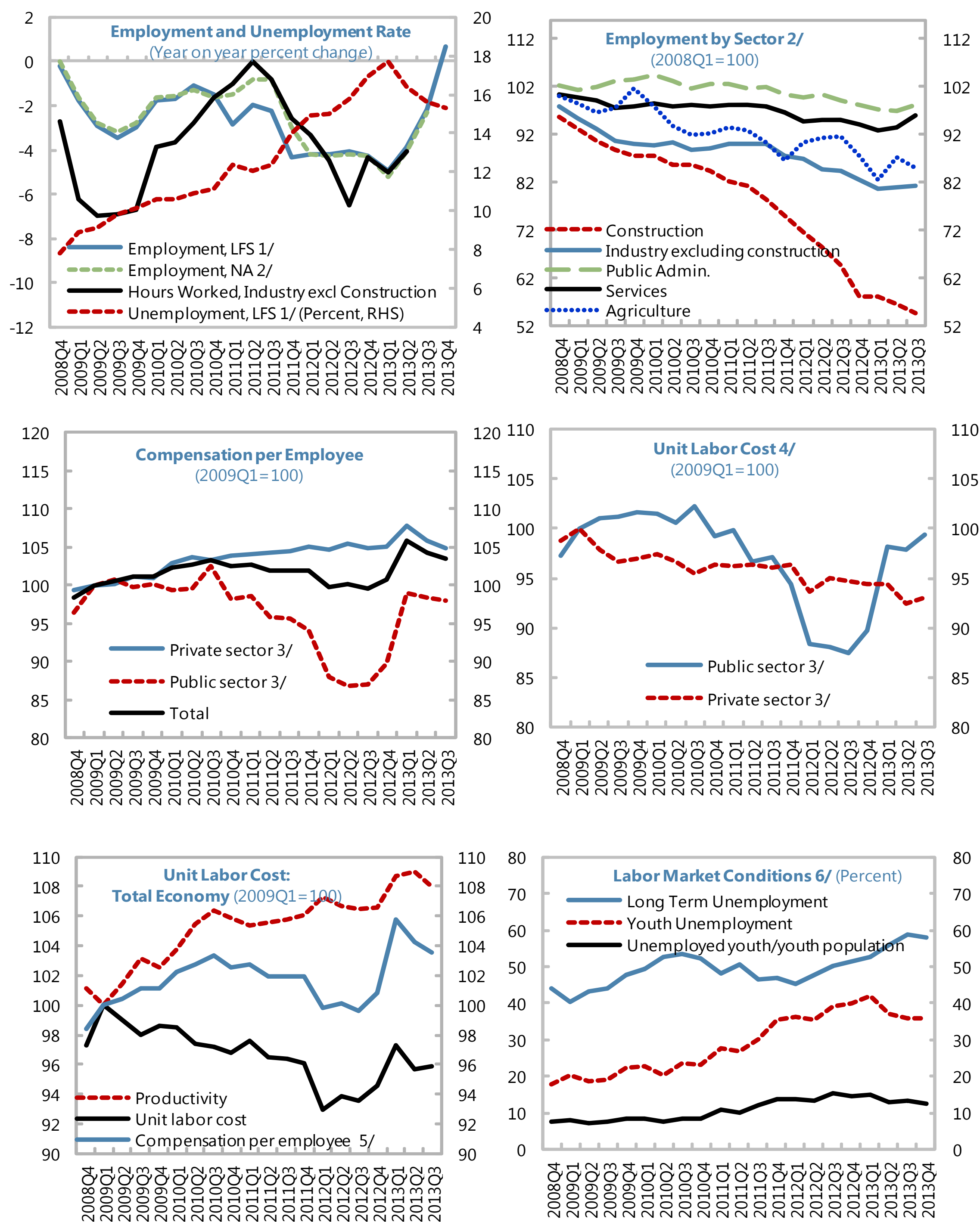
- **PER**, while perceived by stakeholders as very useful, it has been sometimes utilized by insolvent companies that are seeking to delay traditional insolvency proceedings. Its effectiveness also suffers from sluggish creditor coordination, lack of new financing, weak insolvency administration, and an overburdened judicial system.
- **SIREVE** does not provide a viable out-of-court alternative, mainly because of the capacity constraints of the government agency (IAPMEI) that is mandated to facilitate utilization of the instrument**.**
- **Informal out-of-court restructurings** are taking place but are also hindered by lack of creditor coordination and new financing.
- **Both creditors and debtors tend to delay restructuring**, waiting for a recovery, and appear to agree on restructuring plans to sustain the debtor entities with little or no debt reduction, operational restructuring or new financing.
- In addition, **oversight of the corporate debt restructuring** process is generally weak, with data sources being fragmented and insufficient data points to allow for an analysis of the effectiveness and sustainability of loan modifications.

**To better address the mounting corporate sector weaknesses, a better tailored approach to corporate debt restructuring appears necessary at this juncture.** In particular, the strategy needs to reflect the relative importance of micro and SMEs, accounting for 99 percent of the over 350,000 companies in Portugal, about 70 percent of GVA and almost 80 percent of labor force in the corporate sector. At the same time, the credit profile of this segment has deteriorated rapidly, with loans (provided by the eight largest banks) that are overdue for more than 1 year having more than doubled since end-2011 to 7.4 billion (as per end-September 2013). Moreover, many Portuguese companies have credit outstanding with a large number of banks, underscoring the importance of creditor coordination in debt restructuring processes, facilitated by a reputable institution.



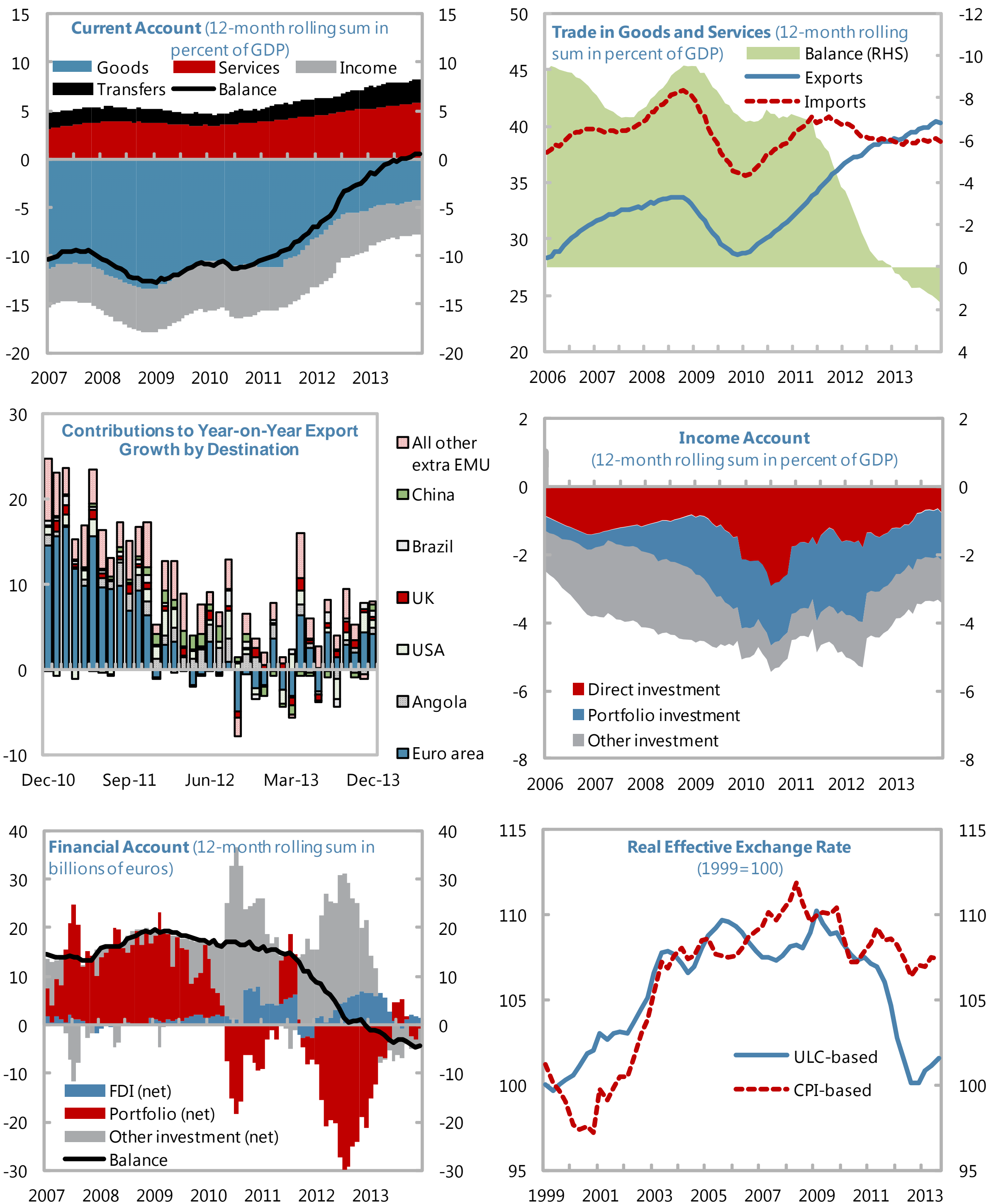

Source: Statistical Office of the European Communities; European Commission; Bank of Portugal; and Fund staff calculations.
1/ Calculated by the Bank of Portugal.

## Figure 2. Portugal: Labor Market Indicators



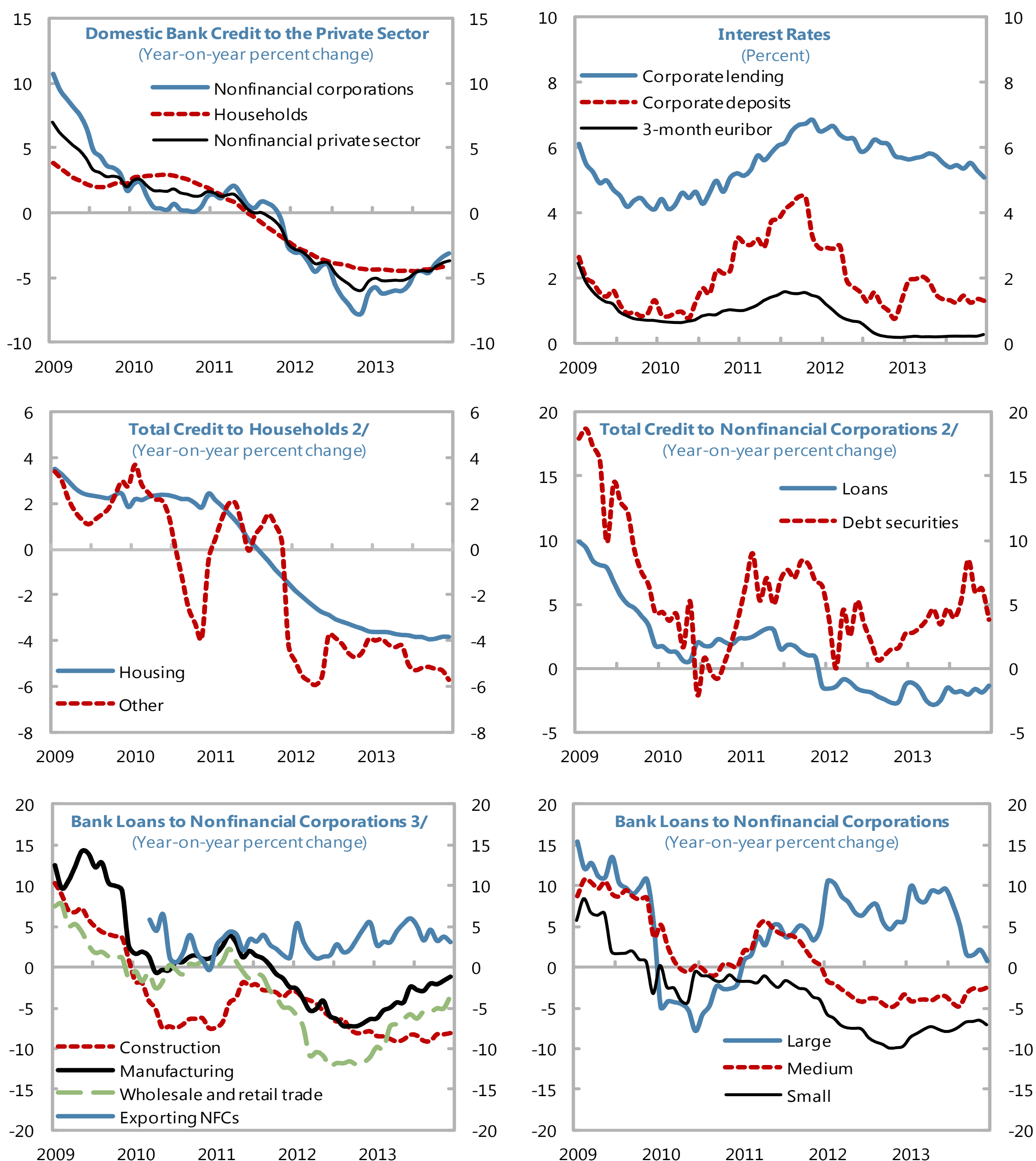

Source: Statistical Office of the European Communities; European Commission; Bank of Portugal; and Fund staff calculations and estimates.
1/ Labor Force Survey.
2/ National Accounts.
3/ Public sector refers to public administration, education, and social work. Private sector refers to the rest of the 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, 2006-13




Sources: INE; Bank of Portugal; Eurostat; and IMF staff calculations.

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

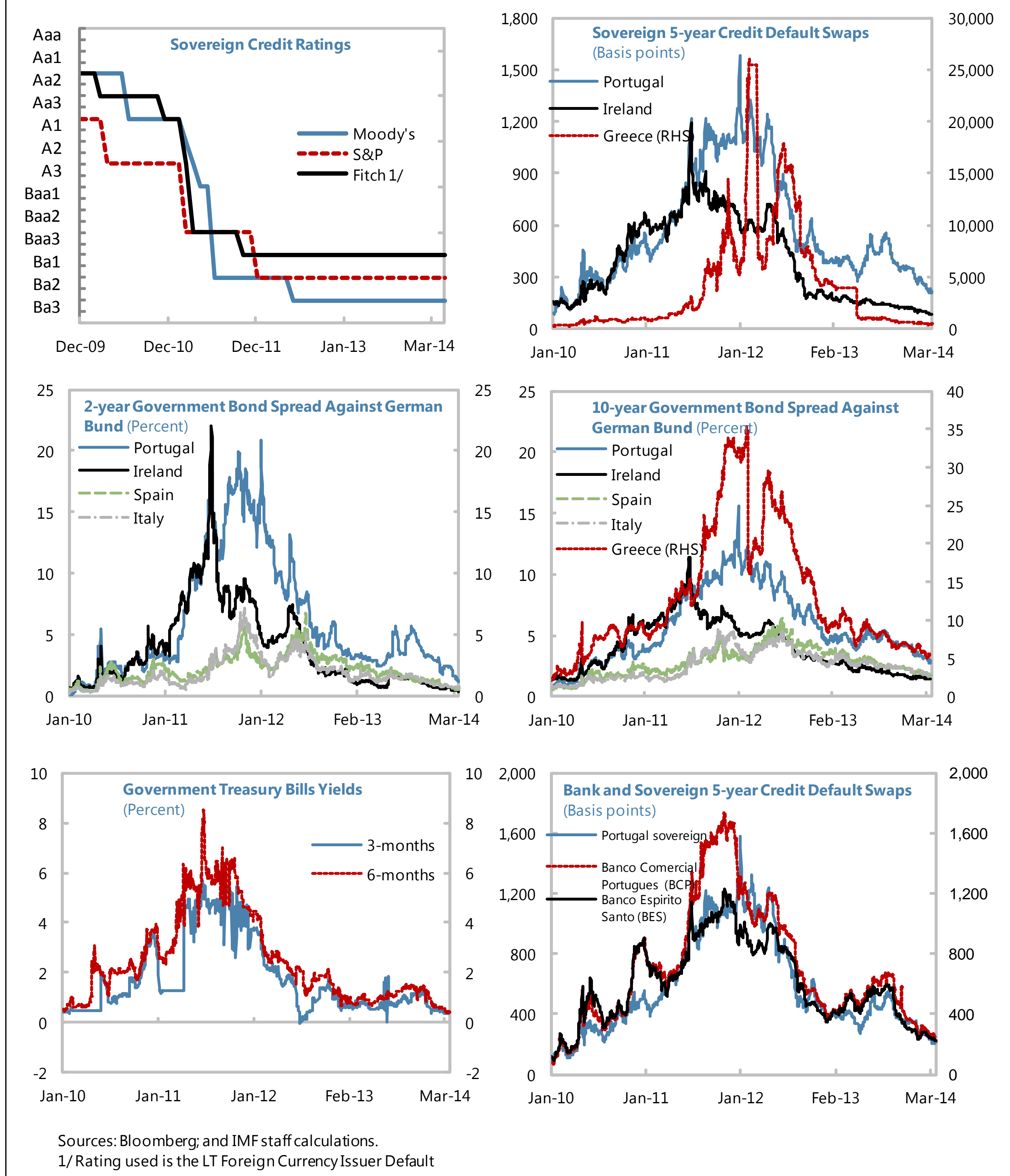



Source: Bank of Portugal.

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.

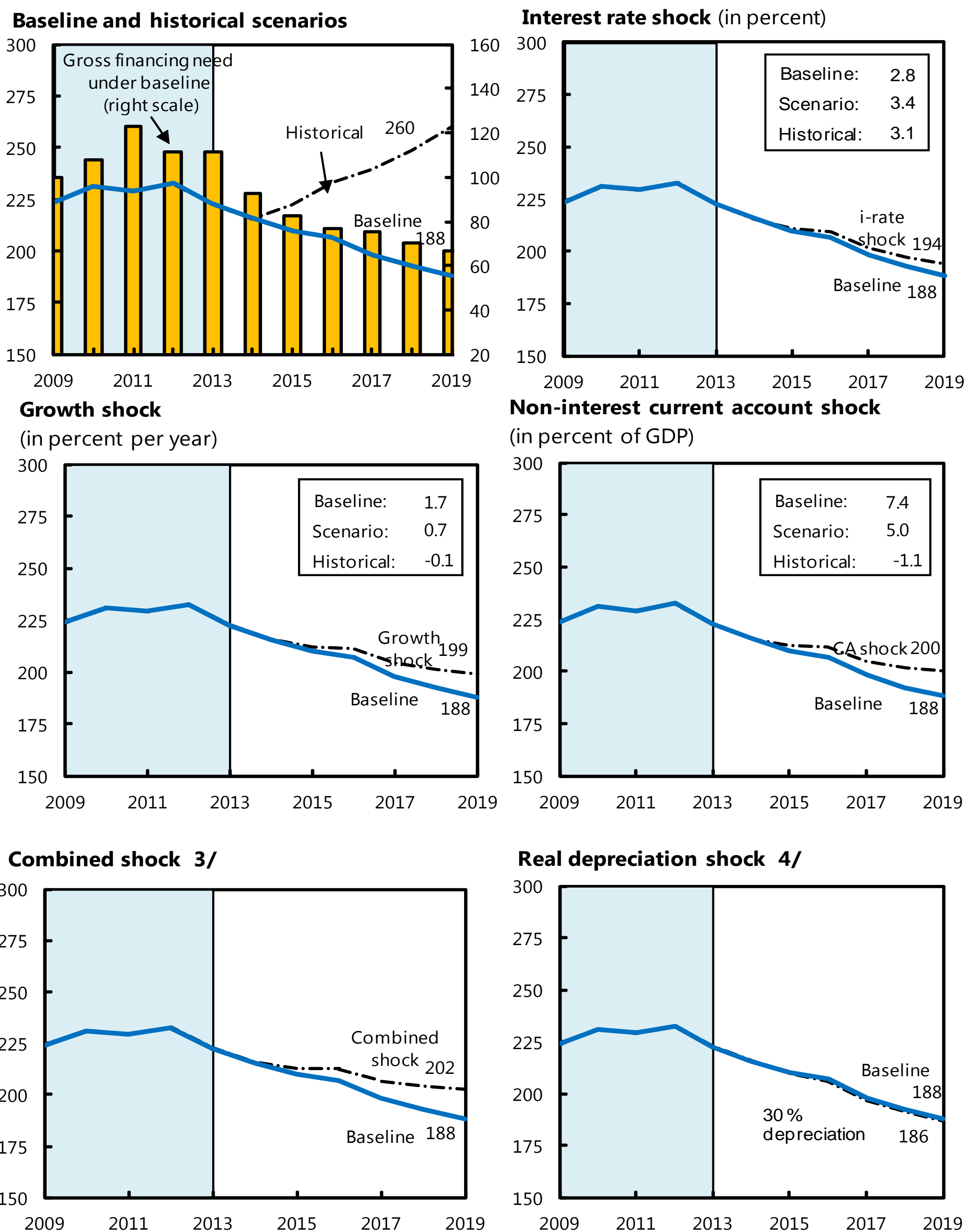
3/ Private-owned exporting companies, defined as: a) companies that export more than 50% of the turnover; or b) companies that export more than 10% of the turnover and the total amount exceeds 150 thousand euro (with both criteria met in the last 3 years).




Sources: Bloomberg; and IMF staff calculations.
1/ Rating used is the LT Foreign Currency Issuer Default

## Figure 6. Portugal: External Debt Sustainability: Bound Tests, 2008-2019 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.

## Table 1. Portugal: Selected Economic Indicators

(Year on year percent change, unless otherwise indicated)

| | | | | | Projections | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2011 | 2012 | 2013 | | 2014 | | 2015 | 2016 | 2017 | 2018 | 2019 |
| | | | 10th rev | 11th rev | 10th rev | 11th rev | | | | | |
| Real GDP | -1.3 | -3.2 | -1.6 | -1.4 | 0.8 | 1.2 | 1.5 | 1.7 | 1.8 | 1.8 | 1.8 |
| Total domestic demand | -5.1 | -6.6 | -2.7 | -2.5 | 0.0 | 0.7 | 0.8 | 1.2 | 1.4 | 1.4 | 1.2 |
| Private consumption | -3.3 | -5.4 | -1.8 | -1.6 | 0.1 | 0.7 | 0.7 | 0.8 | 0.8 | 0.8 | 0.8 |
| Public consumption | -5.0 | -4.7 | -2.0 | -1.6 | -2.5 | -1.6 | -1.5 | 1.2 | 1.1 | 0.8 | 0.4 |
| Gross fixed investment | -10.5 | -14.3 | -8.0 | -6.5 | 1.2 | 3.1 | 3.8 | 4.0 | 4.3 | 3.8 | 3.8 |
| Private | -5.2 | -11.4 | -9.7 | -6.2 | 2.6 | 2.7 | 4.8 | 4.7 | 5.0 | 4.2 | 4.2 |
| Government | -32.9 | -31.4 | 4.6 | -8.7 | -7.6 | 6.6 | -4.2 | -2.0 | -1.5 | -0.1 | 0.0 |
| Exports | 6.9 | 3.2 | 5.8 | 5.9 | 5.0 | 5.5 | 5.5 | 5.3 | 5.0 | 5.0 | 5.0 |
| Imports | -5.3 | -6.6 | 2.6 | 2.8 | 3.0 | 4.0 | 4.0 | 4.3 | 4.2 | 4.2 | 3.9 |
| Contribution to Growth | | | | | | | | | | | |
| Total domestic demand | -5.5 | -6.9 | -2.7 | -2.5 | 0.0 | 0.7 | 0.8 | 1.2 | 1.4 | 1.4 | 1.2 |
| Private consumption | -2.2 | -3.5 | -1.1 | -1.0 | 0.1 | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 |
| Public consumption | -1.1 | -1.0 | -0.4 | -0.3 | -0.5 | -0.3 | -0.3 | 0.2 | 0.2 | 0.2 | 0.1 |
| Gross fixed investment | -2.1 | -2.6 | -1.3 | -1.0 | 0.2 | 0.5 | 0.6 | 0.6 | 0.7 | 0.6 | 0.6 |
| Foreign balance | 4.4 | 3.7 | 1.2 | 1.1 | 0.8 | 0.6 | 0.7 | 0.5 | 0.4 | 0.5 | 0.6 |
| Savings-investment balance (percent of GDP) | | | | | | | | | | | |
| Gross national savings | 11.3 | 14.8 | 15.9 | 16.0 | 16.5 | 16.7 | 17.6 | 18.1 | 19.1 | 20.2 | 21.4 |
| Private | 16.2 | 19.8 | 19.9 | 19.3 | 18.8 | 19.0 | 18.3 | 18.5 | 19.1 | 20.0 | 21.0 |
| Public | -4.9 | -5.1 | -4.0 | -3.3 | -2.3 | -2.2 | -0.8 | -0.4 | 0.0 | 0.2 | 0.4 |
| Gross domestic investment | 18.4 | 16.7 | 15.4 | 15.5 | 15.7 | 15.9 | 16.4 | 16.6 | 17.3 | 18.1 | 18.8 |
| Private | 15.8 | 14.8 | 13.5 | 13.8 | 13.8 | 14.0 | 14.6 | 14.9 | 15.6 | 16.4 | 17.1 |
| Public | 2.7 | 1.9 | 2.0 | 1.7 | 1.9 | 1.9 | 1.8 | 1.7 | 1.7 | 1.7 | 1.7 |
| Resource utilization | | | | | | | | | | | |
| Potential GDP | -0.2 | -0.8 | -0.9 | -0.6 | -0.4 | -0.4 | 0.2 | 0.9 | 1.1 | 1.1 | 1.1 |
| Output Gap (% of potential) | -1.3 | -3.7 | -4.3 | -4.4 | -3.2 | -2.9 | -1.7 | -0.9 | -0.2 | 0.5 | 1.2 |
| Employment | -1.5 | -4.2 | -3.2 | -2.9 | -0.4 | 0.7 | 0.7 | 0.6 | 0.6 | 0.6 | 0.6 |
| Unemployment rate (%) 1/ | 12.7 | 15.7 | 16.5 | 16.3 | 16.8 | 15.7 | 15.0 | 14.5 | 14.0 | 13.4 | 12.9 |
| Prices | | | | | | | | | | | |
| GDP deflator | 0.3 | -0.3 | 1.7 | 1.7 | 0.9 | 0.8 | 1.0 | 1.7 | 1.8 | 1.8 | 1.8 |
| Consumer prices (harmonized index) | 3.6 | 2.8 | 0.4 | 0.4 | 0.8 | 0.7 | 1.2 | 1.5 | 1.5 | 1.5 | 1.5 |
| Compensation per worker (whole economy) | -0.6 | -2.0 | 2.7 | 3.5 | -0.9 | -0.9 | 1.0 | 1.2 | 1.2 | 1.2 | 1.2 |
| Labor productivity | 0.3 | 1.1 | 1.6 | 1.6 | 1.1 | 0.5 | 0.7 | 1.1 | 1.2 | 1.2 | 1.2 |
| Unit labor costs (whole economy) | -0.9 | -3.1 | 1.1 | 1.8 | -1.9 | -1.3 | 0.3 | 0.1 | 0.0 | 0.0 | 0.0 |
| Money and credit (end of period, percent change) | | | | | | | | | | | |
| Private sector credit | -1.5 | -6.5 | -4.4 | -5.2 | -3.0 | -3.0 | -0.3 | 1.0 | 1.5 | 1.8 | 1.8 |
| Broad money | -1.3 | -6.2 | 0.0 | 0.2 | 1.7 | 2.0 | 2.5 | 3.4 | 3.6 | 3.7 | 3.7 |
| Interest rates (percent) | | | | | | | | | | | |
| Short-term deposit rate | 3.5 | 3.0 | 2.3 | 2.3 | 2.7 | 2.7 | 3.0 | 3.5 | 3.8 | 3.8 | 3.8 |
| Government bond rate, 10-year | 10.2 | 10.6 | 6.5 | 6.5 | 6.1 | 6.1 | 5.5 | 5.0 | 5.1 | 5.3 | 5.5 |
| Fiscal indicators (percent of GDP) | | | | | | | | | | | |
| General government balance 2/ | -4.3 | -6.5 | -5.9 | -4.9 | -4.0 | -4.0 | -2.5 | -2.0 | -1.6 | -1.4 | -1.2 |
| Revenues | 45.0 | 40.9 | 43.2 | 43.3 | 42.8 | 42.8 | 42.8 | 42.6 | 42.2 | 41.7 | 41.2 |
| Expenditures | 49.3 | 47.4 | 49.1 | 48.2 | 46.8 | 46.9 | 45.3 | 44.6 | 43.8 | 43.1 | 42.4 |
| Primary government balance | -0.3 | -2.1 | -1.6 | -0.7 | 0.3 | 0.3 | 1.9 | 2.4 | 2.8 | 3.1 | 3.3 |
| General government debt | 108.2 | 124.1 | 129.4 | 128.8 | 126.6 | 126.7 | 124.8 | 122.6 | 119.1 | 116.6 | 113.8 |
| External sector (percent of GDP) | | | | | | | | | | | |
| Trade balance (goods) | -8.3 | -5.4 | -4.4 | -4.3 | -3.6 | -3.5 | -3.0 | -2.7 | -2.5 | -2.3 | -1.9 |
| Trade balance (G&S) | -3.8 | -0.1 | 1.7 | 1.7 | 3.0 | 3.0 | 3.8 | 4.4 | 4.8 | 5.1 | 5.6 |
| Current account balance | -7.0 | -2.0 | 0.4 | 0.5 | 0.8 | 0.8 | 1.2 | 1.4 | 1.8 | 2.1 | 2.6 |
| Net international investment position | -104.8 | -116.1 | -113.4 | -118.7 | -108.7 | -113.7 | -107.8 | -101.1 | -94.1 | -86.9 | -79.6 |
| REER based on ULC (1999=100) | 106.7 | 101.1 | 102.7 | 103.3 | 100.4 | 101.4 | 102.1 | 102.0 | 101.7 | 101.1 | 100.1 |
| (rate of growth) | -1.2 | -5.3 | 1.5 | 2.2 | -2.2 | -1.8 | 0.7 | -0.1 | -0.3 | -0.6 | -1.0 |
| REER based on CPI (1999=100) | 108.7 | 107.3 | 106.6 | 107.4 | 106.0 | 107.2 | 107.3 | 107.6 | 107.8 | 107.9 | 107.7 |
| (rate of growth) | 0.9 | -1.3 | -0.6 | 0.1 | -0.5 | -0.1 | 0.1 | 0.2 | 0.2 | 0.1 | -0.2 |
| Nominal GDP (billions of euro) | 171.1 | 165.1 | 165.3 | 165.6 | 168.2 | 168.9 | 173.1 | 179.0 | 185.5 | 192.3 | 199.3 |

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. In 2013, includes the increase in the share capital of Banif (0.4 percent of GDP).

## Table 2a. Portugal: General Government Accounts 1/

(Billions of euros)

| | | | Projections 2/ | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2011 | 2012 | 2013 10th Review | 2013 | 2014 10th Review | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
| Revenue | 77.0 | 67.6 | 71.5 | 71.7 | 71.9 | 72.4 | 74.2 | 76.2 | 78.3 | 80.2 | 82.1 |
| Taxes | 40.4 | 38.1 | 40.4 | 41.7 | 41.2 | 41.8 | 43.2 | 44.4 | 45.7 | 46.9 | 48.1 |
| Taxes on production and imports | 23.5 | 22.5 | 21.9 | 22.3 | 22.6 | 22.9 | 23.7 | 24.3 | 24.9 | 25.4 | 25.9 |
| Current taxes on income, wealth, etc. and capital taxes | 16.9 | 15.5 | 18.5 | 19.4 | 18.7 | 18.9 | 19.5 | 20.1 | 20.8 | 21.5 | 22.2 |
| Current taxes on income, wealth, etc. | 16.9 | 15.3 | 18.5 | 19.4 | 18.7 | 18.9 | 19.5 | 20.1 | 20.8 | 21.5 | 22.2 |
| Capital taxes | 0.0 | 0.3 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Social contributions | 21.0 | 19.1 | 19.9 | 20.0 | 19.6 | 19.8 | 19.8 | 20.2 | 20.6 | 20.8 | 21.1 |
| Grants and other revenue | 15.6 | 10.4 | 11.2 | 9.9 | 11.1 | 10.8 | 11.2 | 11.6 | 12.0 | 12.4 | 12.9 |
| Property income | 1.2 | 1.2 | 1.4 | 1.2 | 1.4 | 1.3 | 1.4 | 1.4 | 1.5 | 1.5 | 1.6 |
| Sales of goods and services | 4.3 | 4.6 | 4.8 | 4.8 | 4.6 | 4.6 | 4.7 | 4.8 | 5.0 | 5.2 | 5.4 |
| Other current revenue | 2.3 | 2.3 | 3.1 | 2.0 | 3.3 | 3.0 | 3.2 | 3.3 | 3.5 | 3.6 | 3.7 |
| Capital transfers and investment grants | 7.8 | 2.2 | 1.9 | 1.9 | 1.8 | 1.9 | 1.9 | 2.0 | 2.0 | 2.1 | 2.2 |
| | | | | | | | | | | | |
| Expenditure 3/ | 84.4 | 78.2 | 81.2 | 79.8 | 78.7 | 79.1 | 78.4 | 79.9 | 81.3 | 82.9 | 84.4 |
| Expense | 83.9 | 79.7 | 82.2 | 81.2 | 79.8 | 80.2 | 79.7 | 81.3 | 82.9 | 84.4 | 86.1 |
| Compensation of employees | 19.4 | 16.5 | 17.5 | 17.6 | 15.8 | 15.6 | 15.1 | 15.4 | 15.7 | 15.9 | 16.2 |
| Use of goods and services | 7.9 | 7.4 | 7.9 | 7.3 | 7.8 | 7.8 | 7.7 | 7.8 | 7.9 | 8.0 | 8.2 |
| Consumption of fixed capital | 3.9 | 3.9 | 4.1 | 4.1 | 4.1 | 4.1 | 4.2 | 4.4 | 4.5 | 4.7 | 4.8 |
| Interest (ESA95) | 6.9 | 7.2 | 7.2 | 7.0 | 7.3 | 7.3 | 7.6 | 7.9 | 8.2 | 8.6 | 9.0 |
| Subsidies | 1.2 | 1.0 | 1.2 | 1.1 | 1.3 | 1.2 | 1.2 | 1.2 | 1.3 | 1.3 | 1.3 |
| Social benefits | 37.8 | 37.1 | 38.4 | 38.5 | 38.3 | 38.1 | 38.0 | 38.6 | 39.2 | 39.7 | 40.3 |
| Grants and other expense | 6.9 | 6.6 | 6.0 | 5.6 | 5.3 | 6.1 | 5.8 | 6.0 | 6.1 | 6.2 | 6.3 |
| Other current expense | 4.4 | 4.2 | 4.5 | 4.1 | 4.8 | 5.6 | 5.1 | 5.2 | 5.2 | 5.3 | 5.4 |
| Capital transfers | 2.4 | 2.3 | 1.5 | 1.5 | 0.5 | 0.5 | 0.8 | 0.8 | 0.9 | 0.9 | 0.9 |
| Net acquisition of nonfinancial assets | 0.5 | -1.4 | -1.0 | -1.4 | -1.1 | -1.1 | -1.3 | -1.5 | -1.5 | -1.6 | -1.6 |
| Gross fixed capital formation | 4.5 | 2.5 | 3.1 | 2.7 | 3.0 | 3.0 | 2.9 | 2.9 | 3.0 | 3.1 | 3.2 |
| (-) Consumption of fixed capital | -3.9 | -3.9 | -4.1 | -4.1 | -4.1 | -4.1 | -4.2 | -4.4 | -4.5 | -4.7 | -4.8 |
| 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 | 0.0 |
| | | | | | | | | | | | |
| Gross Operating Balance | -3.0 | -8.2 | -6.7 | -5.4 | -3.8 | -3.8 | -1.4 | -0.7 | -0.1 | 0.4 | 0.9 |
| Net lending (+)/borrowing (–) (ESA95) | -7.4 | -10.7 | -9.8 | -8.1 | -6.8 | -6.8 | -4.3 | -3.6 | -3.1 | -2.7 | -2.3 |
| Net lending (+)/borrowing (–) (EDP notification) | -7.4 | -10.6 | -9.8 | -8.1 | -6.8 | -6.8 | -4.3 | -3.6 | -3.1 | -2.7 | -2.3 |
| Net lending (+)/borrowing (–) (program) 4/ | -6.8 | -7.8 | -9.1 | -7.4 | -6.8 | -6.8 | -4.3 | -3.6 | -3.1 | -2.7 | -2.3 |
| | | | | | | | | | | | |
| 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 | -2.6 | -1.1 | 0.5 | 0.5 | 3.4 | 4.3 | 5.1 | 5.9 | 6.6 |
| Interest (EDP notification) | 6.9 | 7.1 | 7.2 | 7.0 | 7.3 | 7.3 | 7.6 | 7.9 | 8.2 | 8.6 | 9.0 |
| Debt at face value (EDP notification) | 185.2 | 204.8 | 213.9 | 213.4 | 212.9 | 214.0 | 216.1 | 219.3 | 220.9 | 224.1 | 226.9 |
| Nominal GDP | 171.1 | 165.1 | 165.3 | 165.6 | 168.2 | 168.9 | 173.1 | 179.0 | 185.5 | 192.3 | 199.3 |

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)

| | 2011 | 2012 | Projections 2/ 2013 10th Review | 2013 | 2014 10th Review | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Revenue | 45.0 | 40.9 | 43.2 | 43.3 | 42.8 | 42.8 | 42.8 | 42.6 | 42.2 | 41.7 | 41.2 |
| Taxes | 23.6 | 23.1 | 24.5 | 25.2 | 24.5 | 24.7 | 24.9 | 24.8 | 24.6 | 24.4 | 24.1 |
| Taxes on production and imports | 13.7 | 13.7 | 13.3 | 13.5 | 13.4 | 13.6 | 13.7 | 13.6 | 13.4 | 13.2 | 13.0 |
| Current taxes on income, wealth, etc. and capital taxes | 9.9 | 9.4 | 11.2 | 11.7 | 11.1 | 11.2 | 11.3 | 11.2 | 11.2 | 11.2 | 11.1 |
| Current taxes on income, wealth, etc. | 9.9 | 9.3 | 11.2 | 11.7 | 11.1 | 11.2 | 11.3 | 11.2 | 11.2 | 11.2 | 11.1 |
| Capital taxes | 0.0 | 0.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Social contributions | 12.3 | 11.6 | 12.0 | 12.1 | 11.6 | 11.7 | 11.4 | 11.3 | 11.1 | 10.8 | 10.6 |
| Grants and other revenue | 9.1 | 6.3 | 6.8 | 6.0 | 6.6 | 6.4 | 6.5 | 6.5 | 6.5 | 6.5 | 6.5 |
| Property income | 0.7 | 0.7 | 0.8 | 0.7 | 0.8 | 0.8 | 0.8 | 0.8 | 0.8 | 0.8 | 0.8 |
| Sales of goods and services | 2.5 | 2.8 | 2.9 | 2.9 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 |
| Other current revenue | 1.3 | 1.4 | 1.9 | 1.2 | 2.0 | 1.8 | 1.9 | 1.9 | 1.9 | 1.9 | 1.9 |
| Capital transfers and investment grants | 4.6 | 1.4 | 1.2 | 1.2 | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 |
| Expenditure 3/ | 49.3 | 47.4 | 49.1 | 48.2 | 46.8 | 46.9 | 45.3 | 44.6 | 43.8 | 43.1 | 42.4 |
| Expense | 49.0 | 48.3 | 49.7 | 49.0 | 47.5 | 47.5 | 46.1 | 45.4 | 44.7 | 43.9 | 43.2 |
| Compensation of employees | 11.3 | 10.0 | 10.6 | 10.6 | 9.4 | 9.3 | 8.7 | 8.6 | 8.5 | 8.3 | 8.1 |
| Use of goods and services | 4.6 | 4.5 | 4.8 | 4.4 | 4.6 | 4.6 | 4.4 | 4.4 | 4.3 | 4.2 | 4.1 |
| Consumption of fixed capital | 2.3 | 2.4 | 2.5 | 2.5 | 2.4 | 2.4 | 2.4 | 2.4 | 2.4 | 2.4 | 2.4 |
| Interest (ESA95) | 4.0 | 4.3 | 4.3 | 4.2 | 4.4 | 4.3 | 4.4 | 4.4 | 4.4 | 4.5 | 4.5 |
| Subsidies | 0.7 | 0.6 | 0.7 | 0.7 | 0.8 | 0.7 | 0.7 | 0.7 | 0.7 | 0.7 | 0.7 |
| Social benefits | 22.1 | 22.5 | 23.2 | 23.3 | 22.8 | 22.6 | 22.0 | 21.6 | 21.1 | 20.7 | 20.2 |
| Grants and other expense | 4.0 | 4.0 | 3.6 | 3.4 | 3.2 | 3.6 | 3.4 | 3.4 | 3.3 | 3.2 | 3.2 |
| Other current expense | 2.6 | 2.6 | 2.7 | 2.4 | 2.8 | 3.3 | 2.9 | 2.9 | 2.8 | 2.8 | 2.7 |
| Capital transfers | 1.4 | 1.4 | 0.9 | 0.9 | 0.3 | 0.3 | 0.4 | 0.5 | 0.5 | 0.5 | 0.5 |
| Net acquisition of nonfinancial assets | 0.3 | -0.9 | -0.6 | -0.8 | -0.6 | -0.6 | -0.8 | -0.8 | -0.8 | -0.8 | -0.8 |
| Gross fixed capital formation | 2.6 | 1.5 | 1.9 | 1.6 | 1.8 | 1.8 | 1.7 | 1.6 | 1.6 | 1.6 | 1.6 |
| (-) Consumption of fixed capital | -2.3 | -2.4 | -2.5 | -2.5 | -2.4 | -2.4 | -2.4 | -2.4 | -2.4 | -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 | 0.0 |
| Gross Operating Balance | -1.8 | -5.0 | -4.0 | -3.3 | -2.3 | -2.2 | -0.8 | -0.4 | 0.0 | 0.2 | 0.4 |
| Net lending (+)/borrowing (–) (ESA95) | -4.3 | -6.5 | -5.9 | -4.9 | -4.0 | -4.0 | -2.5 | -2.0 | -1.6 | -1.4 | -1.2 |
| Net lending (+)/borrowing (–) (EDP notification) | -4.3 | -6.4 | -5.9 | -4.9 | -4.0 | -4.0 | -2.5 | -2.0 | -1.6 | -1.4 | -1.2 |
| Net lending (+)/borrowing (–) (program) 4/ | -4.0 | -4.7 | -5.5 | -4.5 | -4.0 | -4.0 | -2.5 | -2.0 | -1.6 | -1.4 | -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 | -1.6 | -0.7 | 0.3 | 0.3 | 1.9 | 2.4 | 2.8 | 3.1 | 3.3 |
| Structural balance (Percent of potential GDP) | -6.6 | -4.1 | -3.7 | -3.1 | -2.6 | -2.7 | -1.7 | -1.6 | -1.5 | -1.6 | -1.7 |
| Structural primary balance (Percent of potential GDP) | -2.7 | 0.1 | 0.5 | 0.9 | 1.6 | 1.6 | 2.6 | 2.8 | 2.9 | 2.9 | 2.9 |
| Interest (EDP notification) | 4.0 | 4.3 | 4.3 | 4.2 | 4.4 | 4.3 | 4.4 | 4.4 | 4.4 | 4.5 | 4.5 |
| Debt at face value (EDP notification) | 108.2 | 124.1 | 129.4 | 128.8 | 126.6 | 126.7 | 124.8 | 122.6 | 119.1 | 116.6 | 113.8 |

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 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 Position
(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)

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|---|---|
| Gross borrowing need | 59.2 | 66.2 | 56.2 | 45.5 | 42.6 | 42.4 | 43.2 | 45.7 | 51.7 |
| Overall balance | 7.4 | 10.7 | 8.1 | 6.8 | 4.3 | 3.6 | 3.1 | 2.7 | 2.3 |
| Amortization | 40.7 | 38.5 | 38.0 | 41.9 | 38.7 | 39.1 | 41.6 | 42.5 | 48.9 |
| M< | 12.8 | 18.7 | 18.8 | 21.6 | 14.3 | 12.7 | 14.2 | 14.5 | 20.6 |
| Residents | 3.9 | 11.5 | 3.8 | 10.5 | 7.2 | 7.1 | 7.2 | 9.8 | 13.2 |
| *Of which within general government* | 0.4 | 3.2 | 0.6 | 1.1 | 0.9 | 1.0 | 1.8 | 1.9 | 0.7 |
| Non-residents | 8.9 | 7.2 | 15.0 | 11.1 | 7.1 | 5.6 | 7.1 | 4.8 | 7.4 |
| ST 2/ | 27.9 | 18.8 | 19.2 | 17.3 | 23.9 | 23.9 | 23.9 | 23.9 | 23.9 |
| Residents | 16.9 | 17.0 | 18.3 | 16.4 | 20.4 | 19.6 | 19.6 | 19.6 | 19.6 |
| *Of which within general government* | 3.3 | 4.7 | 5.6 | 4.2 | ... | ... | ... | ... | ... |
| Non-residents | 11.0 | 1.8 | 0.9 | 0.9 | 3.6 | 4.4 | 4.4 | 4.4 | 4.4 |
| EU and IMF 3/ | 0.0 | 1.0 | 0.0 | 3.0 | 0.5 | 2.5 | 3.5 | 4.1 | 4.3 |
| Other (net) 4/ | 11.0 | 17.0 | 10.1 | -3.2 | -0.4 | -0.4 | -1.5 | 0.5 | 0.5 |
| *Of which within general government* | 3.9 | 5.0 | 7.5 | ... | ... | ... | ... | ... | ... |
| | | | | | | | | | |
| Gross financing sources | 23.9 | 38.6 | 46.2 | 37.7 | 42.6 | 42.4 | 43.2 | 45.7 | 51.7 |
| Privatization receipts | 0.6 | 2.2 | 1.4 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Market access | 36.8 | 36.3 | 45.8 | 34.7 | 40.8 | 42.4 | 43.2 | 45.7 | 51.7 |
| M< | 18.0 | 17.1 | 28.5 | 10.8 | 16.9 | 18.5 | 19.3 | 21.8 | 27.8 |
| Residents | 13.7 | 15.2 | 18.6 | 4.3 | 6.5 | 7.1 | 7.5 | 8.7 | 11.0 |
| *Of which from general government* | 6.1 | 6.2 | 7.4 | ... | ... | ... | ... | ... | ... |
| Non-residents | 4.3 | 1.9 | 9.9 | 6.5 | 10.4 | 11.3 | 11.8 | 13.1 | 16.8 |
| ST 2/ | 18.8 | 19.2 | 17.3 | 23.9 | 23.9 | 23.9 | 23.9 | 23.9 | 23.9 |
| Residents | 17.0 | 18.3 | 16.4 | 20.4 | 19.6 | 19.6 | 19.6 | 19.6 | 19.6 |
| *Of which from general government* | 4.7 | 5.6 | 4.2 | ... | ... | ... | ... | ... | ... |
| Non-residents | 1.8 | 0.9 | 0.9 | 3.6 | 4.4 | 4.4 | 4.4 | 4.4 | 4.4 |
| Use of deposits 5/ | -13.5 | 0.0 | -1.0 | 2.9 | 1.8 | 0.0 | 0.0 | 0.0 | 0.0 |
| *Of which intra-government* | -3.2 | 1.2 | -0.3 | ... | ... | ... | ... | ... | ... |
| | | | | | | | | | |
| Financing under the program 3/ | 35.3 | 28.5 | 10.0 | 7.8 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| European Union | 22.2 | 20.4 | 6.6 | 5.1 | ... | ... | ... | ... | ... |
| IMF | 13.1 | 8.2 | 3.4 | 2.6 | ... | ... | ... | ... | ... |
| | | | | | | | | | |
| Net placement (market access-amortization) | -3.9 | -2.1 | 7.8 | -7.2 | 2.1 | 3.3 | 1.6 | 3.2 | 2.8 |
| Residents | 9.9 | 5.0 | 12.9 | -2.2 | -1.7 | -1.2 | -1.4 | -3.1 | -3.3 |
| M< | 9.8 | 3.7 | 14.8 | -6.2 | -0.9 | -1.2 | -1.4 | -3.1 | -3.3 |
| ST (net increase) | 0.1 | 1.3 | -1.9 | 4.0 | -0.8 | 0.0 | 0.0 | 0.0 | 0.0 |
| Non-residents | -13.8 | -6.1 | -5.1 | -2.0 | 3.8 | 4.5 | 3.0 | 6.3 | 6.1 |
| M< | -4.6 | -5.3 | -5.1 | -4.7 | 3.0 | 4.5 | 3.0 | 6.3 | 6.1 |
| ST (net increase) | -9.2 | -0.9 | 0.0 | 2.7 | 0.8 | 0.0 | 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).

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, 2010-19

| | 2010 | 2011 | 2012 | Est. 2013 | Projections 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|---|---|---|
| | (Billions of euro) | | | | | | | | | |
| Current account | -18.3 | -12.0 | -3.3 | 0.9 | 1.4 | 2.0 | 2.5 | 3.3 | 4.0 | 5.2 |
| Balance of goods and services | -12.5 | -6.5 | -0.1 | 2.8 | 5.0 | 6.5 | 7.9 | 8.9 | 9.9 | 11.2 |
| Trade balance | -19.2 | -14.2 | -8.8 | -7.1 | -5.9 | -5.2 | -4.8 | -4.5 | -4.4 | -3.8 |
| Exports fob | 37.4 | 43.1 | 45.4 | 47.7 | 49.9 | 53.0 | 55.9 | 58.8 | 61.8 | 65.4 |
| Imports fob | 56.6 | 57.3 | 54.3 | 54.7 | 55.8 | 58.1 | 60.7 | 63.4 | 66.2 | 69.2 |
| Services, net | 6.7 | 7.7 | 8.7 | 9.9 | 10.9 | 11.7 | 12.7 | 13.4 | 14.3 | 15.0 |
| Exports | 17.6 | 19.2 | 19.1 | 20.6 | 21.9 | 23.3 | 24.9 | 26.3 | 27.9 | 29.2 |
| Imports | 10.9 | 11.5 | 10.4 | 10.6 | 11.0 | 11.6 | 12.2 | 12.9 | 13.7 | 14.2 |
| *Of which:* | | | | | | | | | | |
| Tourism | 4.6 | 5.2 | 5.7 | 6.1 | 6.6 | 7.1 | 7.6 | 8.1 | 8.6 | 9.0 |
| Exports | 7.6 | 8.1 | 8.6 | 9.2 | 9.8 | 10.5 | 11.2 | 11.8 | 12.6 | 13.1 |
| Imports | 3.0 | 3.0 | 2.9 | 3.1 | 3.2 | 3.4 | 3.6 | 3.8 | 4.0 | 4.2 |
| Income, net | -7.9 | -8.5 | -6.9 | -5.9 | -7.4 | -8.3 | -9.2 | -9.3 | -9.4 | -9.5 |
| Current transfers, net | 2.2 | 3.0 | 3.8 | 4.0 | 3.8 | 3.8 | 3.8 | 3.6 | 3.6 | 3.5 |
| Private remittances, net | 2.2 | 2.4 | 2.8 | 3.3 | 3.1 | 3.1 | 3.1 | 3.1 | 3.3 | 3.4 |
| Official transfers, net | -0.1 | 0.6 | 1.0 | 0.6 | 0.7 | 0.7 | 0.7 | 0.5 | 0.3 | 0.1 |
| Capital account | 1.9 | 2.1 | 3.9 | 3.4 | 3.2 | 3.2 | 3.2 | 3.2 | 3.2 | 3.2 |
| Financial account | 15.6 | -24.2 | -27.7 | -14.4 | -12.4 | -5.3 | -5.8 | -6.5 | -7.3 | -8.4 |
| Direct investment | 7.7 | -2.7 | 6.6 | 1.3 | 2.9 | 2.9 | 2.9 | 2.2 | 2.2 | 2.2 |
| Portuguese investment abroad | 5.7 | -10.7 | -0.5 | -1.1 | -1.1 | -1.1 | -1.2 | -2.0 | -2.0 | -2.1 |
| Foreign investment in Portugal | 2.0 | 8.0 | 7.0 | 2.3 | 4.0 | 4.0 | 4.1 | 4.2 | 4.2 | 4.3 |
| Portfolio investment, net | -9.7 | -4.6 | -21.5 | -0.9 | -0.1 | 7.6 | 9.6 | 7.6 | 11.3 | 12.4 |
| Financial derivatives | 0.4 | 0.5 | 0.1 | -1.0 | -1.0 | -1.0 | -1.0 | -1.0 | -1.0 | -1.0 |
| Other investment, net | 18.2 | -18.6 | -12.6 | -13.3 | -14.2 | -14.8 | -17.3 | -15.3 | -19.7 | -22.0 |
| Reserve assets | -1.0 | 1.2 | -0.2 | -0.4 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Errors and omissions | 0.8 | 0.1 | -0.5 | 0.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Program financing | … | 33.9 | 27.7 | 10.0 | 7.8 | … | … | … | … | … |
| European Union | … | 20.9 | 19.4 | 6.6 | 5.1 | … | … | … | … | … |
| IMF | … | 13.1 | 8.2 | 3.4 | 2.6 | … | … | … | … | … |
| *Memorandum items:* | | | | | | | | | | |
| Net international investment position 1/ | -185.2 | -179.4 | -191.7 | -196.6 | -192.0 | -186.7 | -180.9 | -174.4 | -167.2 | -158.7 |
| Direct investment, net | -33.6 | -30.6 | -33.1 | -33.8 | -36.7 | -39.5 | -42.5 | -44.7 | -46.9 | -49.1 |
| Portfolio investment, net | -52.1 | -31.7 | -24.6 | -27.8 | -27.7 | -35.3 | -44.9 | -52.5 | -63.8 | -76.1 |
| Financial derivatives | -1.1 | -2.4 | -3.6 | -3.1 | -2.1 | -1.1 | -0.1 | 1.0 | 2.0 | 3.0 |
| Other investment, net | -114.1 | -131.2 | -147.5 | -144.7 | -138.3 | -123.5 | -106.2 | -91.0 | -71.2 | -49.2 |
| Reserve assets | 15.7 | 16.5 | 17.2 | 12.7 | 12.7 | 12.7 | 12.7 | 12.7 | 12.7 | 12.7 |
| Nominal GDP | 172.9 | 171.1 | 165.1 | 165.6 | 168.9 | 173.1 | 179.0 | 185.5 | 192.3 | 199.3 |
| | (Percentage of GDP) | | | | | | | | | |
| Current account | -10.6 | -7.0 | -2.0 | 0.5 | 0.8 | 1.2 | 1.4 | 1.8 | 2.1 | 2.6 |
| Current account (including capital transfers) | -9.5 | -5.8 | 0.3 | 2.6 | 2.8 | 3.0 | 3.2 | 3.5 | 3.8 | 4.2 |
| *Of which:* Balance of goods and services | -7.2 | -3.8 | -0.1 | 1.7 | 3.0 | 3.8 | 4.4 | 4.8 | 5.1 | 5.6 |
| Net international investment position 1/ | -107.2 | -104.8 | -116.1 | -118.7 | -113.7 | -107.8 | -101.1 | -94.1 | -86.9 | -79.6 |
| Direct investment, net | -19.5 | -17.9 | -20.1 | -20.4 | -21.7 | -22.8 | -23.7 | -24.1 | -24.4 | -24.6 |
| Portfolio investment, net | -30.1 | -18.5 | -14.9 | -16.8 | -16.4 | -20.4 | -25.1 | -28.3 | -33.2 | -38.2 |
| Financial derivatives | -0.7 | -1.4 | -2.2 | -1.9 | -1.2 | -0.6 | 0.0 | 0.5 | 1.0 | 1.5 |
| Other investment, net | -66.0 | -76.7 | -89.4 | -87.4 | -81.9 | -71.4 | -59.4 | -49.0 | -37.0 | -24.7 |
| Reserve assets | 9.1 | 9.6 | 10.4 | 7.7 | 7.5 | 7.4 | 7.1 | 6.9 | 6.6 | 6.4 |

Sources: Bank of Portugal; and IMF staff calculations.

1/ End-of-period data.

## Table 6. Portugal: External Financing Requirements and Sources, 2010-19

(Billions of euros)

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|---|---|---|
| GROSS FINANCING REQUIREMENTS | 186.4 | 210.4 | 183.9 | 184.6 | 156.4 | 142.7 | 137.1 | 139.4 | 135.9 | 133.0 |
| Current account deficit | 18.3 | 12.0 | 3.3 | -0.9 | -1.4 | -2.0 | -2.5 | -3.3 | -4.0 | -5.2 |
| Medium- and long-term debt amortization | 28.9 | 29.6 | 32.8 | 43.9 | 33.5 | 25.8 | 25.2 | 27.0 | 29.9 | 31.8 |
| Public sector | 7.1 | 8.9 | 7.2 | 15.0 | 11.1 | 7.1 | 5.6 | 7.1 | 4.8 | 7.4 |
| Banks | 18.5 | 16.7 | 18.6 | 19.5 | 16.9 | 13.2 | 14.2 | 15.7 | 19.8 | 20.1 |
| Other private | 3.3 | 4.1 | 7.0 | 9.4 | 5.4 | 5.5 | 5.4 | 4.3 | 5.3 | 4.3 |
| Short-term debt amortization | 139.3 | 168.8 | 147.8 | 141.5 | 124.4 | 118.4 | 111.9 | 112.1 | 105.9 | 102.1 |
| Public sector | 40.6 | 71.1 | 63.8 | 67.0 | 60.5 | 55.7 | 43.0 | 31.8 | 27.6 | 25.4 |
| Central Bank | 23.4 | 59.9 | 61.0 | 66.1 | 59.6 | 52.1 | 38.6 | 27.4 | 23.2 | 21.0 |
| General government and SOEs | 17.1 | 11.2 | 2.9 | 0.9 | 0.9 | 3.6 | 4.4 | 4.4 | 4.4 | 4.4 |
| Banks | 79.5 | 76.6 | 57.4 | 47.7 | 39.5 | 39.5 | 41.1 | 42.7 | 44.5 | 46.3 |
| Other private | 19.2 | 21.1 | 26.6 | 26.9 | 24.4 | 23.2 | 27.8 | 37.6 | 33.8 | 30.5 |
| EU and IMF 1/ | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.5 | 2.5 | 3.5 | 4.1 | 4.3 |
| | | | | | | | | | | |
| SOURCES OF FINANCING | 186.4 | 176.5 | 156.3 | 174.6 | 148.6 | 142.7 | 137.1 | 139.4 | 135.9 | 133.0 |
| Capital account (net) | 1.9 | 2.1 | 3.9 | 3.4 | 3.2 | 3.2 | 3.2 | 3.2 | 3.2 | 3.2 |
| Foreign direct investment (net) | 7.7 | -2.7 | 6.6 | 1.3 | 2.9 | 2.9 | 2.9 | 2.2 | 2.2 | 2.2 |
| Inward | 2.0 | 8.0 | 7.0 | 2.3 | 4.0 | 4.0 | 4.1 | 4.2 | 4.2 | 4.3 |
| New borrowing and debt rollover | 193.2 | 157.7 | 153.1 | 158.1 | 145.8 | 143.9 | 146.3 | 139.9 | 142.7 | 143.0 |
| Medium and long-term borrowing | 24.6 | 10.9 | 11.5 | 33.8 | 27.5 | 32.0 | 34.2 | 34.0 | 40.6 | 43.6 |
| General Government | 15.1 | 4.3 | 1.9 | 9.9 | 6.5 | 10.4 | 11.3 | 11.8 | 13.1 | 16.8 |
| Banks | 2.8 | 1.2 | 2.2 | 6.3 | 16.1 | 15.0 | 15.5 | 17.1 | 21.1 | 21.7 |
| Other private | 6.7 | 5.4 | 7.3 | 17.6 | 4.9 | 6.6 | 7.3 | 5.1 | 6.4 | 5.1 |
| Short-term borrowing | 168.6 | 146.7 | 141.5 | 124.4 | 118.4 | 111.9 | 112.1 | 105.9 | 102.1 | 99.4 |
| Public sector | 71.0 | 62.8 | 67.0 | 60.5 | 55.7 | 43.0 | 31.8 | 27.6 | 25.4 | 23.8 |
| Central Bank | 59.9 | 61.0 | 66.1 | 59.6 | 52.1 | 38.6 | 27.4 | 23.2 | 21.0 | 19.5 |
| General government | 11.0 | 1.8 | 0.9 | 0.9 | 3.6 | 4.4 | 4.4 | 4.4 | 4.4 | 4.4 |
| Banks | 76.6 | 57.4 | 47.7 | 39.5 | 39.5 | 41.1 | 42.7 | 44.5 | 46.3 | 48.2 |
| Other private | 21.1 | 26.6 | 26.9 | 24.4 | 23.2 | 27.8 | 37.6 | 33.8 | 30.5 | 27.4 |
| Other (includes asset operations) | -16.4 | 19.4 | -7.2 | 11.8 | -3.3 | -7.4 | -15.4 | -5.9 | -12.3 | -15.5 |
| *Of which:* Net errors and omissions | 0.8 | 0.1 | -0.5 | 0.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| | | | | | | | | | | |
| FINANCING GAP | 0.0 | 33.9 | 27.7 | 10.0 | 7.8 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| European Union (2/3 of total) 1/ | ... | 20.9 | 19.4 | 6.6 | 5.1 | ... | ... | ... | ... | ... |
| IMF (1/3 of total) 2/ | ... | 13.1 | 8.2 | 3.4 | 2.6 | ... | ... | ... | ... | ... |
| | | | | | | | | | | |
| ROLLOVER RATES | | | | | | | | | | |
| General government | 108.1 | 30.4 | 28.4 | 68.0 | 83.3 | 138.0 | 157.5 | 141.3 | 191.8 | 179.6 |
| Private | 88.9 | 76.5 | 76.8 | 84.8 | 97.1 | 111.3 | 116.5 | 100.2 | 100.8 | 101.3 |
| Banks | 80.9 | 62.8 | 65.7 | 68.1 | 98.7 | 106.5 | 105.3 | 105.3 | 104.8 | 105.2 |
| Other private | 123.5 | 127.0 | 102.0 | 115.6 | 94.1 | 120.0 | 135.0 | 93.1 | 94.1 | 93.7 |

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, 2008-13Q3

(Percent)

| | 2008 | 2009 | 2010 | 2011 | 2012 | | | | 2013 | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | Mar. | Jun. | Sep. | Dec. | Mar. | Jun. | Sep. |
| 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 | 13.1 | 13.4 |
| 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 | 11.7 | 12.0 |
| Capital to assets 1/ | 5.8 | 6.5 | 6.7 | 5.3 | 5.8 | 6.2 | 6.6 | 6.7 | 6.9 | 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 | 10.6 | 11.0 |
| Sectoral distribution of loans | | | | | | | | | | | |
| Residents | 83.7 | 83.6 | 83.3 | 84.0 | 83.2 | 82.4 | 82.5 | 83.3 | 83.2 | 83.9 | 86.7 |
| Deposit-takers | 6.2 | 5.8 | 5.3 | 6.5 | 6.8 | 7.3 | 6.3 | 7.7 | 7.2 | 6.2 | 6.6 |
| Central bank | 1.3 | 1.2 | 0.5 | 0.9 | 0.4 | 0.4 | 0.7 | 1.1 | 0.8 | 0.5 | 0.4 |
| Other financial corporations | 3.6 | 3.7 | 3.9 | 2.9 | 2.7 | 2.7 | 2.7 | 2.4 | 2.3 | 2.3 | 2.3 |
| General government | 1.6 | 1.7 | 2.9 | 2.6 | 3.2 | 2.7 | 2.7 | 2.2 | 2.2 | 2.3 | 2.4 |
| Nonfinancial corporations | 31.6 | 31.5 | 30.7 | 31.0 | 30.6 | 30.0 | 30.3 | 30.2 | 30.5 | 31.5 | 32.2 |
| Other domestic sectors | 39.5 | 39.6 | 39.9 | 40.1 | 39.6 | 39.2 | 39.8 | 39.8 | 40.1 | 41.1 | 42.9 |
| Nonresidents | 16.3 | 16.4 | 16.7 | 16.0 | 16.8 | 17.6 | 17.5 | 16.7 | 16.8 | 16.1 | 13.3 |
| Earnings and profitability | | | | | | | | | | | |
| Return on assets | 0.3 | 0.4 | 0.5 | -0.3 | 0.5 | 0.1 | 0.0 | -0.3 | -0.3 | -0.5 | -0.5 |
| Return on equity | 5.6 | 7.3 | 7.5 | -5.5 | 8.2 | 2.5 | 0.3 | -5.4 | -3.7 | -8.0 | -7.5 |
| Interest margin to gross income | 59.5 | 53.8 | 52.3 | 57.5 | 51.3 | 47.9 | 46.6 | 46.7 | 41.7 | 43.4 | 46.0 |
| Noninterest expenses to gross income | 58.0 | 58.3 | 58.9 | 63.9 | 58.2 | 55.0 | 57.0 | 59.6 | 66.2 | 66.7 | 68.5 |
| Liquidity | | | | | | | | | | | |
| Liquid assets to total assets 3/ | 12.8 | 13.2 | 19.0 | 13.8 | 11.2 | 12.7 | 13.7 | 14.8 | 14.8 | 16.0 | 15.7 |
| Liquid assets to short-term liabilities 3/ | 67.7 | 84.5 | 86.2 | 85.4 | 90.5 | 101.5 | 123.2 | 140.0 | 149.5 | 150.7 | 155.1 |
| Loans to deposits 4/ | 160.3 | 161.5 | 157.8 | 140.2 | 136.9 | 136.3 | 133.3 | 127.9 | 124.0 | 122.6 | 122.6 |
| Foreign-currency-denominated liabilities to total liabilities 5/ | 5.8 | 5.1 | 5.1 | 4.1 | 3.9 | 3.9 | 4.0 | 4.2 | 4.5 | 4.4 | 4.4 |

Source: Bank of Portugal.

1/ On accounting basis; consolidated.

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

3/ Three-month residual maturity.

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

5/ 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, 2011-19

(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 | Dec-19 |
|---|---|---|---|---|---|---|---|---|---|
| | | | Projections | | | | | | |
| Aggregated Balance Sheet of Monetary Financial Institutions (MFIs) 1/ | | | | | | | | | |
| Assets | 472,496 | 457,423 | 427,422 | 411,343 | 409,946 | 415,175 | 417,818 | 422,961 | 427,472 |
| Cash | 1,606 | 1,605 | 1,622 | 805 | 811 | 817 | 823 | 829 | 835 |
| Claims on Bank of Portugal | 5,692 | 8,136 | 8,030 | 4,549 | 3,527 | 2,736 | 2,121 | 1,645 | 1,276 |
| Claims on other FIs | 53,526 | 46,870 | 46,916 | 41,169 | 39,378 | 41,169 | 39,378 | 39,969 | 39,819 |
| Claims on non MFIs | 307,347 | 296,034 | 282,455 | 274,387 | 273,059 | 275,255 | 278,568 | 283,043 | 287,489 |
| General government | 32,309 | 38,759 | 38,675 | 37,957 | 37,278 | 37,116 | 36,857 | 36,981 | 36,998 |
| Central government (excluding SOEs) | 19,115 | 27,109 | 27,668 | 26,940 | 26,408 | 26,604 | 26,723 | 26,855 | 26,880 |
| loans | 38 | 464 | 594 | 594 | 589 | 585 | 580 | 579 | 578 |
| securities | 19,078 | 26,645 | 27,074 | 26,346 | 25,819 | 26,019 | 26,143 | 26,276 | 26,302 |
| Bonds | 10,307 | 16,078 | 22,210 | 19,636 | 19,508 | 19,708 | 19,832 | 19,965 | 19,991 |
| Tbills (up to 1 year maturity) | 8,770 | 10,567 | 4,865 | 6,711 | 6,311 | 6,311 | 6,311 | 6,311 | 6,311 |
| Regional and local government (excl SOEs) | 6,405 | 5,592 | 5,496 | 5,496 | 5,496 | 5,496 | 5,496 | 5,557 | 5,618 |
| SOEs | 6,797 | 6,067 | 5,519 | 5,521 | 5,374 | 5,016 | 4,638 | 4,569 | 4,500 |
| Private sector | 275,038 | 257,275 | 243,780 | 236,430 | 235,781 | 238,139 | 241,711 | 246,062 | 250,491 |
| Claims on non-residents | 96,585 | 88,380 | 71,950 | 73,659 | 75,976 | 77,426 | 78,509 | 79,049 | 78,957 |
| Other assets | 7,740 | 16,398 | 16,449 | 16,776 | 17,195 | 17,773 | 18,419 | 18,426 | 19,095 |
| Liabilities | 472,496 | 457,423 | 427,422 | 411,343 | 409,946 | 415,175 | 417,818 | 422,961 | 427,472 |
| Liabilities to Bank of Portugal | 46,928 | 53,724 | 48,810 | 41,332 | 27,822 | 16,688 | 12,463 | 10,220 | 8,709 |
| Liabilities to other FIs | 60,888 | 46,542 | 43,133 | 42,650 | 40,693 | 41,692 | 39,719 | 40,117 | 40,919 |
| Deposits of non MFIs | 176,290 | 170,955 | 174,522 | 169,002 | 173,621 | 180,293 | 184,209 | 188,986 | 191,689 |
| General government | 12,279 | 13,218 | 10,111 | 3,253 | 1,464 | 1,464 | 1,464 | 1,464 | 1,464 |
| Private sector | 164,011 | 157,737 | 164,411 | 165,748 | 172,157 | 178,829 | 182,745 | 187,522 | 190,225 |
| Securities other than capital | 53,345 | 46,342 | 37,858 | 34,896 | 36,330 | 36,286 | 36,141 | 35,685 | 35,355 |
| Liabilities to non-residents | 105,130 | 89,474 | 70,093 | 71,363 | 74,218 | 77,187 | 80,351 | 83,646 | 87,109 |
| Other | -10,690 | 326 | 305 | 309 | 291 | 301 | 312 | 324 | 336 |
| Capital and reserves | 40,606 | 50,061 | 52,701 | 51,791 | 56,971 | 62,728 | 64,622 | 63,983 | 63,355 |
| Money and Credit | | | | | | | | | |
| Broad Money (M3) | 172,547 | 161,855 | 162,178 | 165,396 | 169,530 | 175,232 | 181,597 | 188,267 | 195,183 |
| Intermediate money (M2) | 169,872 | 156,877 | 157,367 | 160,489 | 164,500 | 170,033 | 176,209 | 182,682 | 189,392 |
| Narrow money (M1) | 67,504 | 65,785 | 64,909 | 66,196 | 67,851 | 70,133 | 72,681 | 75,350 | 78,118 |
| Private sector credit | 275,038 | 257,275 | 243,780 | 236,430 | 235,781 | 238,139 | 241,711 | 246,062 | 250,491 |
| Public sector credit | 32,309 | 38,759 | 38,675 | 37,957 | 37,278 | 37,116 | 36,857 | 36,981 | 36,998 |
| | | | | (Percent of GDP) | | | | | |
| Broad Money | 100.8 | 98.0 | 97.9 | 97.9 | 97.9 | 97.9 | 97.9 | 97.9 | 97.9 |
| Private sector credit | 160.7 | 155.8 | 147.2 | 140.0 | 136.2 | 133.1 | 130.3 | 128.0 | 125.7 |
| Public sector credit | 18.9 | 23.5 | 23.4 | 22.5 | 21.5 | 20.7 | 19.9 | 19.2 | 18.6 |
| | | | | (Percentage change) | | | | | |
| Broad Money | -1.3 | -6.2 | 0.2 | 2.0 | 2.5 | 3.4 | 3.6 | 3.7 | 3.7 |
| Private sector credit | -1.5 | -6.5 | -5.2 | -3.0 | -0.3 | 1.0 | 1.5 | 1.8 | 1.8 |
| Public sector credit | -4.5 | 20.0 | -0.2 | -1.9 | -1.8 | -0.4 | -0.7 | 0.3 | 0.0 |
| Memo items: | | | | | | | | | |
| ECB access (% assets) | 9.9 | 11.7 | 11.4 | 10.0 | 6.8 | 4.0 | 3.0 | 2.4 | 2.0 |
| Credit to deposits (%) 2/ | 146.1 | 148.9 | 140.1 | 133.2 | 129.3 | 126.7 | 126.4 | 125.7 | 125.6 |
| Loan to deposits (%) 2/ | 140.6 | 145.0 | 133.4 | 134.8 | 133.4 | 130.0 | 130.5 | 129.3 | 129.0 |
| Wholesale market funding (% assets) 3/ | 29.5 | 26.0 | 21.4 | 22.5 | 23.4 | 23.7 | 24.1 | 24.4 | 24.7 |

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, 2009-19

(Percent of GDP, unless otherwise indicated)

| | Actual | | | | Est. | Projections | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | Debt-stabilizing non-interest current account 6/ |
| Baseline: External debt | 223.8 | 231.0 | 229.2 | 232.7 | 222.6 | 215.8 | 210.0 | 206.9 | 198.2 | 192.6 | 188.2 | -2.6 |
| | | | | | | | | | | | | |
| Change in external debt | 22.9 | 7.3 | -1.8 | 3.5 | -10.1 | -6.8 | -5.7 | -3.1 | -8.8 | -5.5 | -4.4 | |
| Identified external debt-creating flows (4+8+9) | 13.3 | 0.4 | 13.5 | 9.5 | -1.5 | -5.2 | -6.6 | -7.1 | -7.2 | -7.4 | -7.7 | |
| Current account deficit, excluding interest payments | 4.8 | 5.3 | 0.6 | -4.9 | -6.0 | -6.2 | -6.5 | -6.8 | -7.3 | -7.8 | -8.5 | |
| Deficit in balance of goods and services | 7.0 | 7.2 | 3.8 | 0.1 | -1.7 | -3.0 | -3.8 | -4.4 | -4.8 | -5.1 | -5.6 | |
| Exports | 28.7 | 31.8 | 36.4 | 39.1 | 41.2 | 42.5 | 44.0 | 45.2 | 45.9 | 46.7 | 47.4 | |
| Imports | 35.7 | 39.0 | 40.2 | 39.2 | 39.5 | 39.6 | 40.3 | 40.8 | 41.1 | 41.5 | 41.8 | |
| Net non-debt creating capital inflows (negative) | -1.8 | -4.6 | 4.2 | -0.9 | -0.3 | -1.8 | -2.3 | -2.3 | -1.8 | -1.8 | -1.7 | |
| Automatic debt dynamics 1/ | 10.2 | -0.3 | 8.8 | 15.2 | 4.8 | 2.9 | 2.3 | 2.0 | 1.9 | 2.2 | 2.5 | |
| Contribution from nominal interest rate | 6.1 | 5.3 | 6.4 | 6.9 | 5.5 | 5.4 | 5.3 | 5.4 | 5.5 | 5.7 | 5.9 | |
| Contribution from real GDP growth | 6.0 | -4.2 | 2.9 | 7.7 | 3.1 | -2.5 | -3.1 | -3.4 | -3.6 | -3.5 | -3.4 | |
| Contribution from price and exchange rate changes 2/ | -1.8 | -1.4 | -0.6 | 0.7 | -3.9 | ... | ... | ... | ... | ... | ... | |
| Residual, incl. change in gross foreign assets (2-3) 3/ | 9.7 | 6.8 | -15.3 | -6.0 | -8.6 | -1.7 | 0.8 | 4.0 | -1.6 | 1.8 | 3.3 | |
| | | | | | | | | | | | | |
| External debt-to-exports ratio (in percent) | 780.1 | 726.3 | 630.3 | 595.4 | 540.4 | 507.3 | 476.9 | 458.0 | 431.5 | 412.7 | 396.8 | |
| | | | | | | | | | | | | |
| Gross external financing need (in billions of Euros) 4/ | | | | 183.9 | 184.6 | 156.4 | 142.7 | 137.1 | 139.4 | 135.9 | 133.0 | |
| in percent of GDP | | | | 111.4 | 111.4 | 92.6 | 82.4 | 76.6 | 75.2 | 70.7 | 66.7 | |
| | | | | | | | | | | | | |
| Scenario with key variables at their historical averages 5/ | | | | | | 215.8 | 222.3 | 233.4 | 239.3 | 248.9 | 260.3 | 3.0 |
| | | | | | | | | | | | | |
| Key Macroeconomic Assumptions Underlying Baseline | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| Real GDP growth (in percent) | -2.9 | 1.9 | -1.3 | -3.2 | -1.4 | 1.2 | 1.5 | 1.7 | 1.8 | 1.8 | 1.8 | |
| GDP deflator in Euros (change in percent) | 0.9 | 0.6 | 0.3 | -0.3 | 1.7 | 0.8 | 1.0 | 1.7 | 1.8 | 1.8 | 1.8 | |
| Nominal external interest rate (in percent) | 3.0 | 2.4 | 2.8 | 2.9 | 2.4 | 2.5 | 2.5 | 2.7 | 2.8 | 3.0 | 3.2 | |
| Growth of exports (Euros, in percent) | -15.3 | 13.7 | 13.2 | 3.7 | 5.7 | 5.3 | 6.1 | 6.1 | 5.3 | 5.4 | 5.4 | |
| Growth of imports (Euros, in percent) | -18.1 | 12.2 | 1.8 | -5.9 | 1.1 | 2.2 | 4.3 | 4.6 | 4.6 | 4.7 | 4.4 | |
| Current account balance, excluding interest payments | -4.8 | -5.3 | -0.6 | 4.9 | 6.0 | 6.2 | 6.5 | 6.8 | 7.3 | 7.8 | 8.5 | |
| Net non-debt creating capital inflows | 1.8 | 4.6 | -4.2 | 0.9 | 0.3 | 1.8 | 2.3 | 2.3 | 1.8 | 1.8 | 1.7 | |

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator, 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 | November 8, 2013 | Observation of end-June 2013 performance criteria; completion of eighth and ninth reviews | 1679 | 163.1 |
| Tenth review | February 12, 2014 | 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.

## 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 | 8,220 | 3,407 | 2,648 | … | … | … | … | … |
| (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 | 664 | 1,507 | 3,461 | 4,286 | 4,746 | 4,787 |
| Interest and charges | 14 | 152 | 171 | 664 | 987 | 937 | 809 | 656 | 482 |
| Repayments | 0 | 0 | 0 | 0 | 520 | 2,524 | 3,477 | 4,090 | 4,304 |
| Total debt service, in percent of | | | | | | | | | |
| Exports of goods and services | 0.0 | 0.2 | 0.3 | 0.9 | 2.0 | 4.3 | 5.0 | 5.3 | 5.1 |
| GDP | 0.0 | 0.1 | 0.1 | 0.4 | 0.9 | 1.9 | 2.3 | 2.5 | 2.4 |
| (Projected level of credit outstanding based on existing and prospective drawings) | | | | | | | | | |
| Outstanding stock | 13,052 | 22,788 | 24,464 | 26,609 | 25,881 | 23,159 | 19,504 | 15,286 | 10,981 |
| in percent of quota | 1,117.1 | 1,857.4 | 2,076.2 | 2,305.7 | 2,260.3 | 2,038.2 | 1,729.8 | 1,364.6 | 980.4 |
| in percent of GDP | 7.6 | 13.8 | 14.8 | 15.8 | 14.9 | 12.9 | 10.5 | 8.0 | 5.5 |
| *Memorandum Items (in billions of euros)* | | | | | | | | | |
| Exports of goods and services | 62 | 65 | 68 | 72 | 76 | 81 | 85 | 90 | 95 |
| GDP | 171 | 165 | 166 | 169 | 173 | 179 | 185 | 192 | 199 |

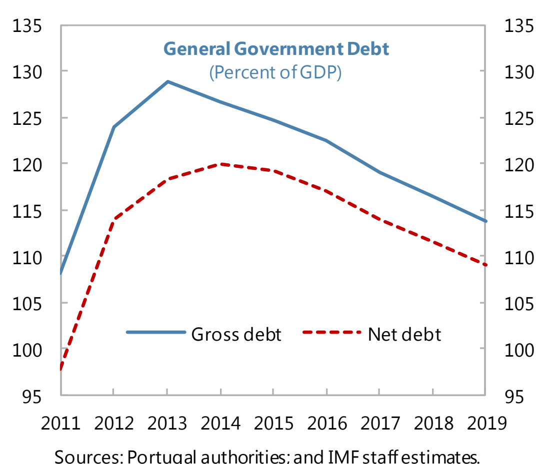
Source: Fund staff projections. Exchange rate forecasts against the SDR as per WEO assumptions.

# Annex I. Public Debt Sustainability Analysis (DSA)

*Staff's analysis, applying the Public DSA framework for Market-Access Countries, suggests that Portugal's gross debt trajectory remains sustainable under the program's baseline assumptions which envisage further fiscal consolidation in 2015 and the introduction of additional growth-supporting structural reforms in the post-program period. Nevertheless, given the country's sizable debt burden and gross financing needs, debt dynamics remain highly vulnerable to adverse yet plausible macro-fiscal and contingent liabilities shocks.*

## Baseline Scenario

**Under the baseline, debt is expected to have peaked at 128.8 percent of GDP in 2013** (Figure AI.3 and AI.4). The improvement in the debt ratio vis-à-vis an initial projection at the time of the tenth review of 129.4 percent of GDP was largely due to the lower fiscal cash deficit and upward revision in nominal GDP. Looking forward, under the programmed fiscal path, debt is expected to start declining gradually, with a projected debt ratio of 126¾ percent of GDP in 2014, partly driven by recent buybacks, further use of cash deposits, as well as the ongoing reallocation of the Social Security portfolio from foreign assets to government securities. Portugal's debt net of government deposits—which is a better approximation of the net worth of the public sector given the increasing central government cash buffers—is projected below 120 percent of GDP by end-2014.



Sources: Portugal authorities; and IMF staff estimates.

**Portugal's sizable debt burden and gross financing needs continue to pose significant risks to debt sustainability.** As presented in Figure AI.1, Portugal's debt ratio exceeds the debt burden benchmark for advanced economies of 85 percent of GDP already under the baseline scenario..The same applies to Portugal's public financing needs, which are also above the relevant benchmark of 20 percent of GDP under the baseline scenario.[1] However, 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 nonresidents. Moreover, in the case of Portugal, since bank vulnerabilities are below the relevant thresholds identified by the MAC DSA template, the standardized contingent liabilities shock does not apply.[2] Nevertheless, this is replaced by a customized shock given still

[1] The total (public and private) external financing requirements significantly exceed the relevant benchmark already under the baseline. However, in the case of Portugal, the figure includes, among others, non-residents bank deposits, accounting for about 45 percent of GDP.

[2] BSSF resources for €6.4 billion remain available under the program to support the banking sector and are already built into the debt baseline projections.

significant risks posed by the materialization of contingent liabilities from SOEs, including due to possible reclassifications, and PPPs (please refer to the stress test customized scenario).

## Realism of Baseline Assumptions and Alternative Scenarios

**The attainment of potential growth assumed under the program has important implications for the debt adjustment path.** 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 AI.2). Nevertheless, staff's analysis suggests that achieving a growth rate of 1.8 percent over the medium term is a realistic objective for Portugal, consistent with moderate growth convergence, as structural reforms start bearing fruit and the economy successfully rebalances from the nontradable to the tradable sectors.[3] Moreover, growth has so far surprised on the upside, with a better outturn for 2013 than expected at the time of the tenth review and positive carry over effects for the outer years. That said, if growth were to turn out lower than currently projected, the rate of debt decline would significantly slow down, as also shown in Figure AI.4 and AI.5. Similarly, risks from a protracted period of low or negative inflation in Portugal remain elevated and could further impede the repair of already-weak private and public balance sheets.

**Portugal's primary balance exceeds its debt-stabilizing threshold over the projection period, largely reflecting the sizable fiscal effort already achieved under the program.** Under staff's baseline scenario,[4] the fiscal primary balance is expected to reach about 3¼ percent of GDP by 2019. As estimated in Figure AI.2, the 3-year change in the cyclically-adjusted primary balance identified 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 the outer years, Portugal's debt profile remains vulnerable to a primary balance shock (Figure AI.4 and AI.5). This is also highlighted by the asymmetric fan chart analysis in Figure AI.1, which shows the risks to the debt outlook if only negative shocks to the primary balance were to materialize. Moreover, the authorities' medium-term fiscal strategy targets an even more ambitious adjustment path than staff's baseline, consistent with the European Treaty on Stability, Coordination, and Governance framework which establishes a minimum structural adjustment effort of ½ percent of GDP per year, until the medium term objective is achieved.

## Stress Tests

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

[3] Staff's potential growth estimates under the baseline scenario are based on an augmented growth-accounting framework, as discussed in Country Report No. 13/18.

[4] In line with the WEO guidelines and past practice under the program, medium-term assumptions that are not backed up by well-defined fiscal measures or go well beyond the program period are not incorporated by the team under the baseline scenario.

- Under a *growth shock* that lowers output by over 4 percentage points in 2015–16 (and in turn inflation by a cumulative 1 percentage point), debt would peak at 132¼ percent of GDP in 2016, around 9 percentage points higher compared with the 2016 baseline.

- A sustained interest rate shock of 200 bps throughout the projection period 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 2019 the debt-to-GDP ratio is about 2½ points higher compared with the baseline.

- A sizable realization of contingent liabilities would also have important implications for Portugal's debt dynamics. Contingent liabilities risks from the banking sector are mitigated by the additional resources available in the BSSF to backstop potential banking sector costs, which are already built into the debt baseline projections. Nevertheless, staff's updated assessment of fiscal risks suggests that, under a severe scenario, contingent liabilities could potentially materialize, for about 9 percent of GDP, due to SOEs, PPPs, State guarantees, as well as broader reclassification issues.[5] A contingent liabilities shock of this magnitude would immediately push the 2015 debt ratio to close to 134 percent of GDP, with debt at 123½ percent of GDP by 2019.

- A severe combined shock that incorporates all of the adverse scenarios mentioned above would significantly compromise the country's debt dynamics, with debt peaking at 140 percent of GDP in 2016 and declining only slowly to 135 percent of GDP by 2019.

## Authorities' views

**The authorities broadly agreed with staff's analysis, while taking the position that there was scope for enhancing the MAC DSA risk assessment to better capture Portugal's specific circumstances.** The authorities highlighted the significant achievements under the program to secure the debt trajectory on a downward path, noting that recent increases in gross debt have been largely due to the sustained build-up of central government cash balances. Nevertheless, they also acknowledged the risks to debt dynamics posed by the potential materialization of contingent liabilities from SOEs and stressed that efforts are ongoing to mitigate them. The authorities also highlighted how applying a standardized DSA framework, while enhancing cross-country comparability, did not allow to fully capture Portugal's specific circumstances. In particular, they stressed how the heat map for the risk assessment module did not adequately show the sensitivity of Portugal's debt burden and financing needs to alternative shocks, since Portugal already exceeded the relevant thresholds under the baseline scenario (and as a result any specific shock, regardless of its size, was also reported as red in the heat map). With specific reference to the

[5] Staff's assumptions for the adverse contingent liabilities scenario include (i) staff's estimate of potential contingent liabilities from PPPs based on financial rebalancing requests by concessionaires; (ii) the hypothetical settlement of the outstanding stock of arrears; (iii) staff's estimate of the potential net impact of the planned SOE debt reclassification due to the introduction of the ESA2010 rules, applying preliminary estimates as of end-2012; (iv) 20 percent of the total amount of direct credit guarantees from the State; (v) staff's estimate of potential contingent liabilities from other non-bank debt directly guaranteed by the State and/or classified outside the general government perimeter.

exchange rate shock, they also highlighted Portugal's negligible and fully hedged foreign-denominated public debt.

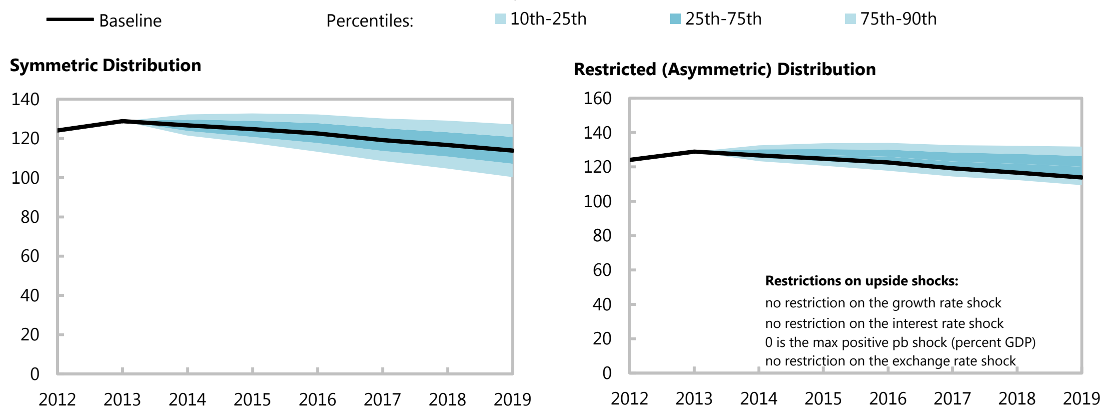
## Figure AI.1. Portugal: Public DSA – Risk Assessment, 2012-19

### 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 |

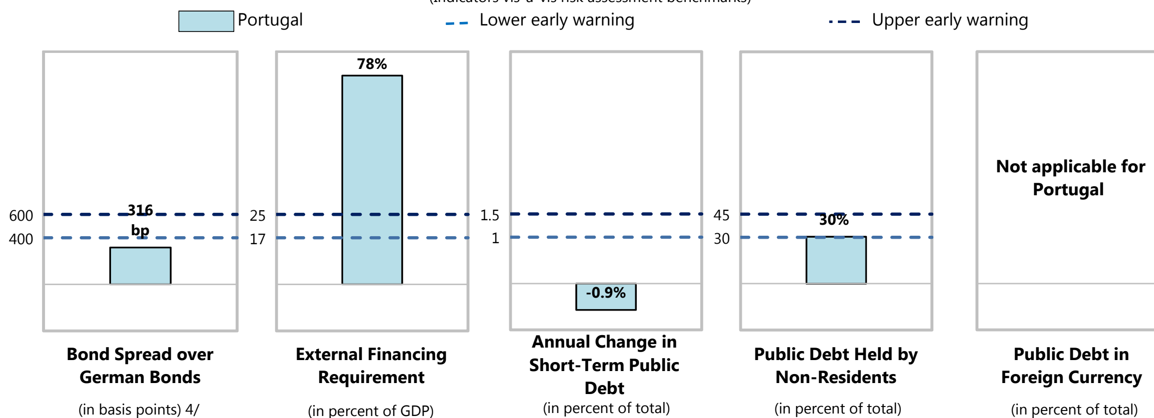
### Evolution of Predictive Densities of Gross Nominal Public Debt

(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, the benchmark is already exceeded under the baseline (implying that any specific shock, regardless of its size, is reported as red). Moreover, the standardized contingent liabilities shock of the MAC DSA template (based on bank vulnerabilities and below the relevant threshold for Portugal) is replaced by a customized shock based on contingent liabilities risks 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.

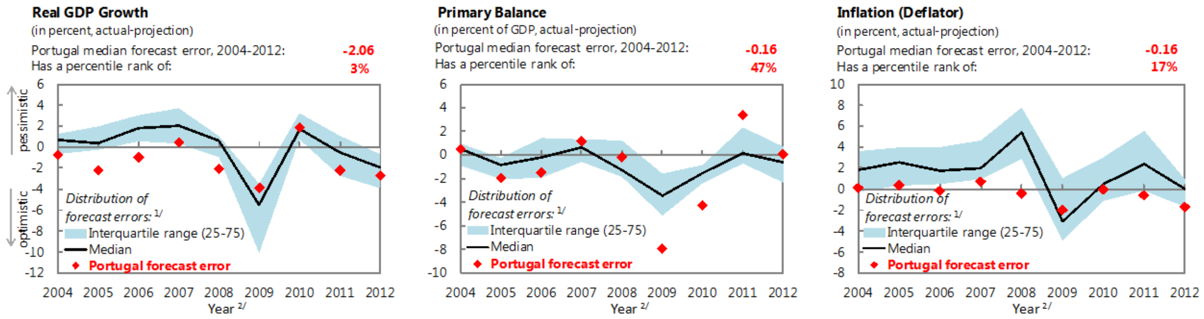
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, 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, 05-Dec-13 through 05-Mar-14.

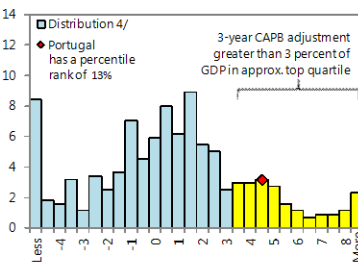
## Figure AI.2. Portugal: Public DSA – Realism of Baseline Assumptions

**Forecast Track Record, versus program countries**

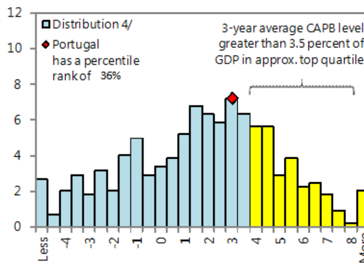



**Assessing the Realism of Projected Fiscal Adjustment**

**3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)**
(Percent of GDP)




**3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)**
(Percent of GDP)




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 AI.3. Portugal: Public DSA – Baseline Scenario, 2003-19

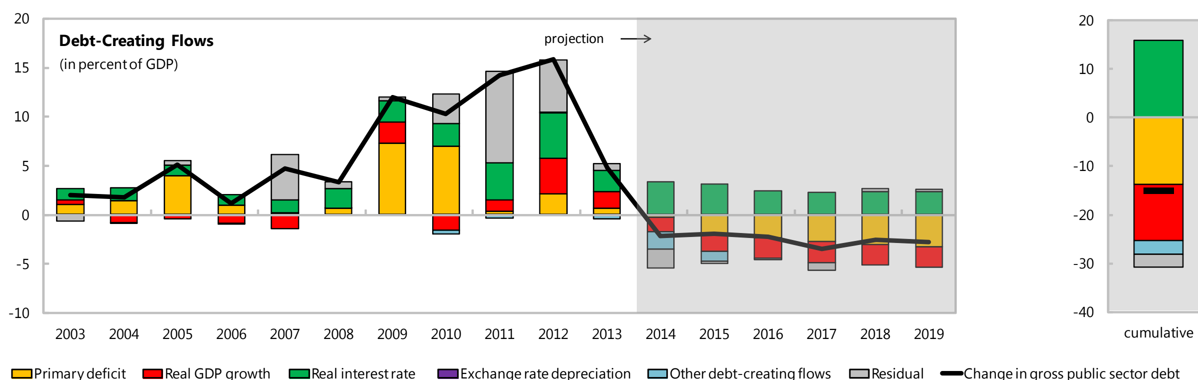
(Percent of GDP, unless otherwise indicated)

### Debt, Economic and Market Indicators [1]

| | Actual | | Prel. | Projections | | | | | | As of March 05, 2014 | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2003-2011 [2] | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | Sovereign Spreads | | |
| Nominal gross public debt | 73.9 | 124.1 | 128.8 | 126.7 | 124.8 | 122.6 | 119.1 | 116.6 | 113.8 | Spread (bp) 3/ | | 316 |
| Public gross financing needs | ... | 29.1 | 24.1 | 19.4 | 21.5 | 20.4 | 20.9 | 20.7 | 19.4 | CDS (bp) | | 217 |
| | | | | | | | | | | Ratings | Foreign | Local |
| Real GDP growth (in percent) | 0.3 | -3.2 | -1.4 | 1.2 | 1.5 | 1.7 | 1.8 | 1.8 | 1.8 | Moody's | Ba3 | Ba3 |
| Inflation (GDP deflator, in percent) | 1.9 | -0.3 | 1.7 | 0.8 | 1.0 | 1.7 | 1.8 | 1.8 | 1.8 | S&Ps | BB | BB |
| Nominal GDP growth (in percent) | 2.2 | -3.5 | 0.3 | 2.0 | 2.5 | 3.4 | 3.6 | 3.7 | 3.7 | Fitch | BB+ | BB+ |
| Effective interest rate (in percent) [4] | 4.5 | 3.9 | 3.4 | 3.4 | 3.6 | 3.7 | 3.7 | 3.9 | 3.9 | | | |

### Contribution to Changes in Public Debt

| | Actual | | Prel. | Projections | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2003-2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | cumulative | debt-stabilizing primary balance [9] |
| Change in gross public sector debt | 6.1 | 15.8 | 4.8 | -2.1 | -1.9 | -2.2 | -3.4 | -2.5 | -2.8 | -15.0 | |
| Identified debt-creating flows | 4.1 | 10.4 | 4.1 | -0.2 | -1.7 | -2.0 | -2.7 | -2.8 | -3.0 | -12.4 | |
| Primary deficit | 2.5 | 2.1 | 0.7 | -0.3 | -1.9 | -2.4 | -2.8 | -3.1 | -3.3 | -13.8 | 0.3 |
| Primary (noninterest) revenue and grants | 41.3 | 40.9 | 43.3 | 42.8 | 42.8 | 42.6 | 42.2 | 41.7 | 41.2 | 253.4 | |
| Primary (noninterest) expenditure | 43.8 | 43.1 | 44.0 | 42.5 | 40.9 | 40.2 | 39.4 | 38.6 | 37.9 | 239.6 | |
| Automatic debt dynamics [5] | 1.6 | 8.3 | 3.8 | 1.8 | 1.3 | 0.4 | 0.1 | 0.3 | 0.3 | 4.2 | |
| Interest rate/growth differential [6] | 1.6 | 8.3 | 3.8 | 1.8 | 1.3 | 0.4 | 0.1 | 0.3 | 0.3 | 4.2 | |
| Of which: real interest rate | 1.8 | 4.7 | 2.2 | 3.3 | 3.1 | 2.4 | 2.2 | 2.4 | 2.4 | 15.8 | |
| Of which: real GDP growth | -0.1 | 3.6 | 1.7 | -1.5 | -1.8 | -2.0 | -2.1 | -2.1 | -2.1 | -11.6 | |
| Exchange rate depreciation [7] | 0.0 | 0.0 | 0.0 | ... | ... | ... | ... | ... | ... | ... | |
| Other identified debt-creating flows | -0.1 | 0.0 | -0.4 | -1.7 | -1.0 | 0.0 | 0.0 | 0.0 | 0.0 | -2.8 | |
| Privatization Revenue (negative) | -0.1 | -1.3 | -0.8 | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | -0.1 | |
| Increase in deposits and other (- means drawn down of deposits) | 0.0 | 1.4 | 0.4 | -1.7 | -1.0 | 0.0 | 0.0 | 0.0 | 0.0 | -2.7 | |
| Residual, including asset changes [8] | 2.0 | 5.4 | 0.7 | -1.9 | -0.2 | -0.2 | -0.8 | 0.3 | 0.3 | -2.6 | |




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 $r - \pi (1+g)$ and the real growth contribution as -g.

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

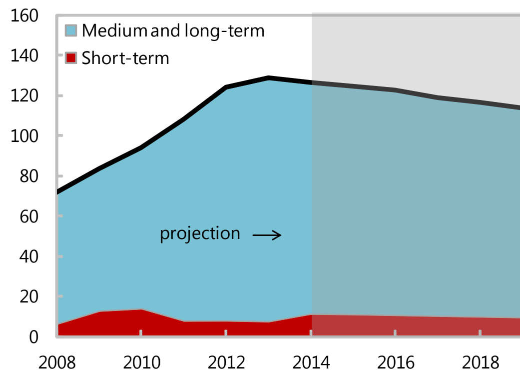
8/ For projections, this line includes exchange rate changes during the projection period.

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.

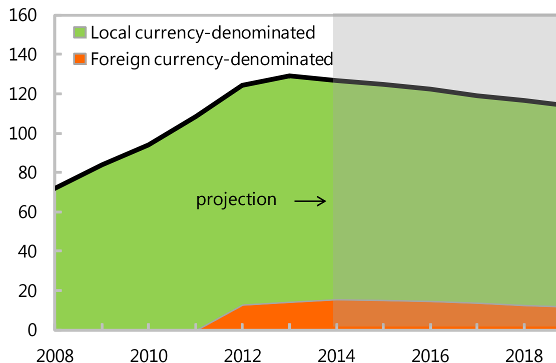
## Figure AI.4. Portugal: Public DSA – Composition of Public Debt and Alternative Scenarios, 2008-19

### Composition of Public Debt

**By Maturity**
(in percent of GDP)



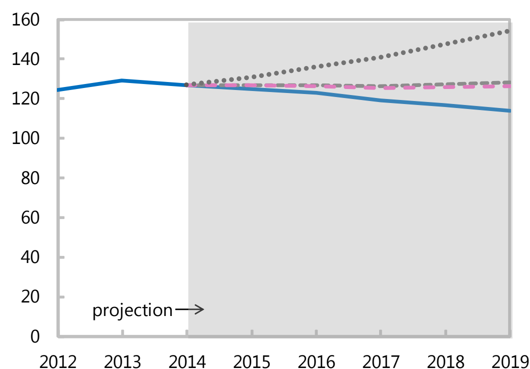

**By Currency**
(in percent of GDP)



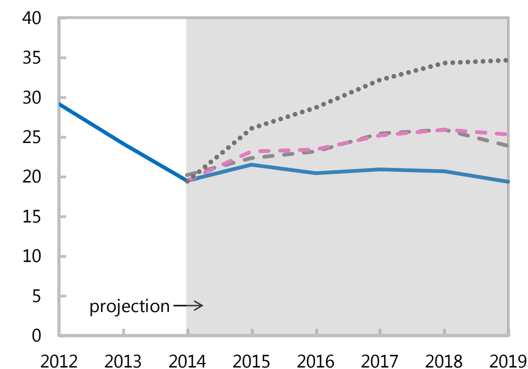

### Alternative Scenarios

Baseline — Historical, 2004-2013 — Historical, 2000-2007 — Constant Primary Balance

**Gross Nominal Public Debt**
(in percent of GDP)




**Public Gross Financing Needs**
(in percent of GDP)




### Underlying Assumptions
(in percent)

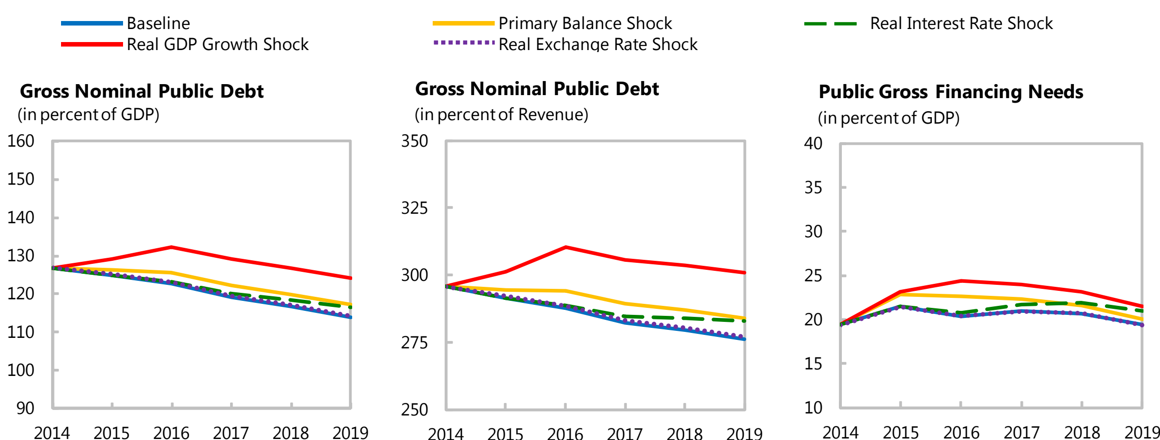
| Baseline Scenario | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|
| Real GDP growth | 1.2 | 1.5 | 1.7 | 1.8 | 1.8 | 1.8 |
| Inflation | 0.8 | 1.0 | 1.7 | 1.8 | 1.8 | 1.8 |
| Primary Balance | 0.3 | 1.9 | 2.4 | 2.8 | 3.1 | 3.3 |
| Effective interest rate | 3.4 | 3.6 | 3.7 | 3.7 | 3.9 | 3.9 |
| **Constant Primary Balance Scenario** | | | | | | |
| Real GDP growth | 1.2 | 1.5 | 1.7 | 1.8 | 1.8 | 1.8 |
| Inflation | 0.8 | 1.0 | 1.7 | 1.8 | 1.8 | 1.8 |
| Primary Balance | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 |
| Effective interest rate | 3.4 | 3.6 | 3.7 | 3.8 | 4.0 | 4.0 |

| Historical, 2004-13 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|
| Real GDP growth | 1.2 | -0.1 | -0.1 | -0.1 | -0.1 | -0.1 |
| Inflation | 0.8 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 |
| Primary Balance | 0.3 | -2.5 | -2.5 | -2.5 | -2.5 | -2.5 |
| Effective interest rate | 3.4 | 3.6 | 3.8 | 3.9 | 4.2 | 4.4 |
| **Historical, 2000-07** | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
| Real GDP growth | 0.8 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 |
| Inflation | 0.9 | 3.0 | 3.0 | 3.0 | 3.0 | 3.0 |
| Primary Balance | 0.3 | -1.3 | -1.3 | -1.3 | -1.3 | -1.3 |
| Effective interest rate | 3.4 | 3.5 | 3.6 | 3.8 | 3.9 | 4.1 |

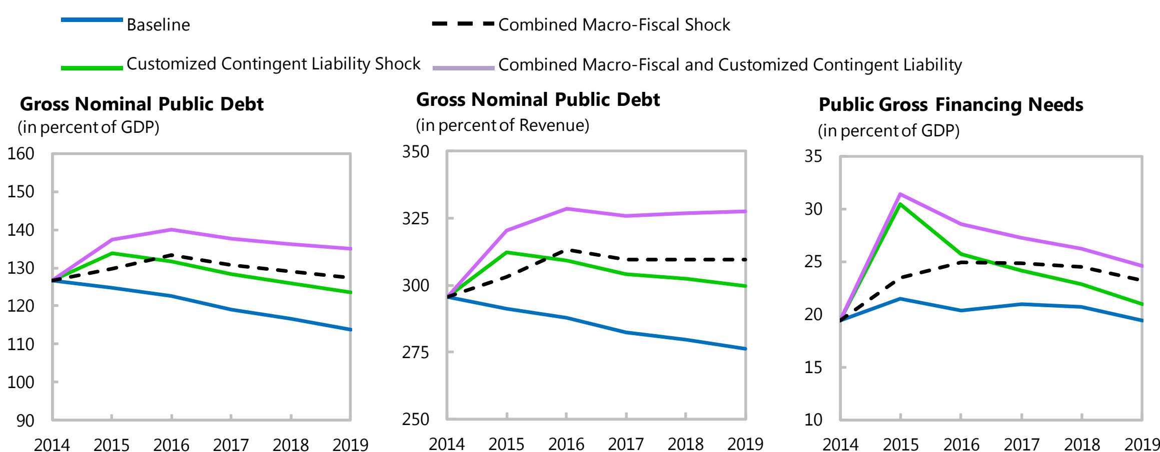
Source: IMF staff.

## Figure AI.5. Portugal: Public DSA – Stress Tests, 2014-19

### Macro-Fiscal Stress Tests




### Additional Stress Tests




### Underlying Assumptions
(in percent)

| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|
| **Primary Balance Shock** | | | | | | |
| Real GDP growth | 1.2 | 1.5 | 1.7 | 1.8 | 1.8 | 1.8 |
| Inflation | 0.8 | 1.0 | 1.7 | 1.8 | 1.8 | 1.8 |
| Primary balance | 0.3 | 0.6 | 1.0 | 2.8 | 3.1 | 3.3 |
| Effective interest rate | 3.4 | 3.6 | 3.7 | 3.8 | 4.0 | 4.0 |
| **Real Interest Rate Shock** | | | | | | |
| Real GDP growth | 1.2 | 1.5 | 1.7 | 1.8 | 1.8 | 1.8 |
| Inflation | 0.8 | 1.0 | 1.7 | 1.8 | 1.8 | 1.8 |
| Primary balance | 0.3 | 1.9 | 2.4 | 2.8 | 3.1 | 3.3 |
| Effective interest rate | 3.4 | 3.6 | 4.0 | 4.2 | 4.5 | 4.8 |
| **Combined Shock** | | | | | | |
| Real GDP growth | 1.2 | -0.6 | -0.3 | 1.8 | 1.8 | 1.8 |
| Inflation | 0.8 | 0.5 | 1.2 | 1.8 | 1.8 | 1.8 |
| Primary balance | 0.3 | 0.6 | 0.3 | 2.8 | 3.1 | 3.3 |
| Effective interest rate | 3.4 | 3.6 | 4.0 | 4.3 | 4.6 | 4.8 |
| **Customized Contingent Liability Shock** | | | | | | |
| Real GDP growth | 1.2 | 1.5 | 1.7 | 1.8 | 1.8 | 1.8 |
| Inflation | 0.8 | 1.0 | 1.7 | 1.8 | 1.8 | 1.8 |
| Primary balance | 0.3 | -7.1 | 2.4 | 2.8 | 3.1 | 3.3 |
| Effective interest rate | 3.4 | 3.6 | 3.7 | 3.8 | 4.0 | 4.1 |

| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|
| **Real GDP Growth Shock** | | | | | | |
| Real GDP growth | 1.2 | -0.6 | -0.3 | 1.8 | 1.8 | 1.8 |
| Inflation | 0.8 | 0.5 | 1.2 | 1.8 | 1.8 | 1.8 |
| Primary balance | 0.3 | 0.9 | 0.3 | 2.8 | 3.1 | 3.3 |
| Effective interest rate | 3.4 | 3.6 | 3.7 | 3.9 | 4.0 | 4.0 |
| **Real Exchange Rate Shock** | | | | | | |
| Real GDP growth | 1.2 | 1.5 | 1.7 | 1.8 | 1.8 | 1.8 |
| Inflation | 0.8 | 1.1 | 1.7 | 1.8 | 1.8 | 1.8 |
| Primary balance | 0.3 | 1.9 | 2.4 | 2.8 | 3.1 | 3.3 |
| Effective interest rate | 3.4 | 3.6 | 3.7 | 3.7 | 3.9 | 3.9 |
| **Combined Macro-Fiscal and Customized Contingent Liability Shock** | | | | | | |
| Real GDP growth | 1.2 | -0.6 | -0.3 | 1.8 | 1.8 | 1.8 |
| Inflation | 0.8 | 0.5 | 1.2 | 1.8 | 1.8 | 1.8 |
| Primary balance | 0.3 | -7.4 | 1.7 | 2.8 | 3.1 | 3.3 |
| Effective interest rate | 3.4 | 3.6 | 4.2 | 4.4 | 4.8 | 5.0 |

Source: IMF staff.

# Portugal—Letter of Intent

Lisbon, March 28, 2014

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. The end-December 2013 deficit and debt performance criteria were met by a sizeable margin, reflecting *inter alia* strong tax collection, prudent expenditure control in the second half of 2013, and one-off revenues from the (tax and social security) debt recovery scheme. Preliminary information suggests that we are also on track to meet the end-March targets. We have continued to work on boosting the competitiveness of the Portuguese economy, most recently by eliminating the port user fee and easing licensing requirements for the tourism and industrial sectors. We have also made important progress with several initiatives aimed to facilitate access to finance, including enhancements to the existing government-guaranteed credit instruments.

3. Market prospects have improved, and we were able to issue long-term bonds and conduct a bond swap at favorable rates. Nevertheless, further efforts are needed to secure durable market access, generate higher sustained growth, reduce unemployment, complete our ambitious fiscal consolidation plan in line with our European commitments, and vigilantly monitor the resilience of the financial system in the context of the ongoing deleveraging and rebalancing of the economy. In particular,

- In the course of the program, significant reforms of labor and product markets were implemented in order to alleviate nominal rigidities, facilitate adjustment, and foster a reallocation of resources toward the tradable sector. To assess the impact of these reforms and ensure that the initial objectives are being achieved, we are preparing an outcome-based accountability framework to draw more concrete links between notional reforms and actual outcomes. In addition, we are working toward identifying the remaining policy distortions and other potential priority areas (notably, energy and labor markets) which will be tackled in the next phase of reforms.

- We remain committed to achieving our 2014 fiscal deficit target of 4 percent of GDP. To this end, we are carefully assessing progress towards the attainment of the defined budget objectives by line ministries; we are also finalizing supporting legislation necessary to implement the compensating measures adopted in January. Furthermore, should any risks to budget execution materialize, we stand ready to implement compensatory measures of equivalent size and quality. As part of our strategy to arrest any accumulation of new domestic arrears, we have identified specific public entities with structural financial imbalances and developed targeted programs to underpin their financial sustainability.

- We will advance our fiscal consolidation efforts in 2015, with a targeted deficit of 2.5 percent of GDP. The 2014 Fiscal Strategy Document will provide detailed spending ceilings by line ministries and underlying adjustment measures on, *inter alia*, supplements and wage scale reform and pension reform. Measures deemed to be consistent with achieving the budget deficit target of 2.5 percent of GDP in 2015 will be specified as a *prior action* for completion of this review.

- We are committed to preserving financial stability and supporting an orderly deleveraging of balance sheets. Banco de Portugal (BdP) continues to scrutinize the resilience of the banking system amidst a challenging operating environment and to ensure compliance with new capital requirements. We are also reviewing our strategies to facilitate corporate debt restructuring and to support the necessary capital reallocation towards the productive sectors of the economy. The BSSF resources—which amount to €6.4 billion—have been set aside for banking sector support and deposited in a dedicated account at the BdP.

4. 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 eleventh review under the Extended Arrangement, as well as a waiver of applicability for the end-March deficit and debt performance criteria. In view of the expiration of the arrangement on May 19, 2014, we request an extension for technical purposes until June 30, 2014. This extension is needed to provide sufficient time to assess the end-March performance criteria, complete the final review, and enable the final purchase under the arrangement in accordance with Fund policies.

5. 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.

6. 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

March 28, 2014

## Macroeconomic Outlook

1. **Recent macroeconomic developments.** The economic recovery is gaining traction. Exceeding expectations, output grew by 0.5 percent in the last quarter of 2013. Compared with the last quarter of 2012, output grew by 1.6 percent, the first positive yearly growth in three years. This, together with the upward revisions of the historical quarterly data, resulted in a 1.4-percent contraction in output in 2013, compared with the 1.6-percent decline projected at the time of the last review. The recovery is underpinned by improved domestic demand (in particular investment) and strong exports, which are estimated to have increased by close to 6 percent in 2013 in real terms. Employment growth has exceeded expectations, while the labor force has remained stable. Consequently, the unemployment rate has declined from 15.6 percent in the third quarter to 15.3 percent in the last quarter of 2013, resulting in an unemployment rate of 16.3 percent for 2013 as a whole, compared with 16.5 percent projected at the time of the last review. Inflation, at 0.4 percent in 2013, has remained below the euro area average.

2. **Outlook.** High-frequency indicators point to a continued expansion in activity, and economic sentiment is now close to its long-term average. Buoyed by a stronger-than-expected carry-over from the last quarter of 2013, growth in 2014 is expected to reach 1.2 percent, compared with 0.8 percent projected at the time of the last review. This growth will be supported by the continued recovery in investment and the strong export performance. The unemployment rate is expected to average 15.7 percent in 2014 vis-à-vis 16.8 percent envisaged in the 10th review. Inflation will increase slowly to 0.7 percent, in line with a still-large slack in the economy. Risks surrounding this baseline are related to the negative effects of private sector deleveraging and of the envisaged fiscal consolidation on growth; these effects may turn out to be stronger than expected.

3. **External adjustment.** The adjustment in the current account is expected to moderate, as the recovery in domestic demand gathers momentum. Having reached an estimated surplus of about ½ percent of GDP in 2013—an improvement of 2½ percentage points relative to 2012—the current account is expected to register a surplus of about 1 percent this year, in line with what was projected at the time of the 10th review. Export growth is expected to be supported by continued gains in market share amid the recovery in demand from other EU economies—notably Spain that alone contributed to a half of merchandise export growth in 2013—as well as continued robust demand from non-EU trading partners . Nevertheless, weaker external demand remains the main downside risk to external adjustment. More importantly, notwithstanding reforms already implemented, continued competitiveness gains will be needed to sustain robust export growth over the medium term.

**Fiscal Policy**

4. **2013 Outcome.** In 2013, we made significant progress towards our fiscal consolidation objectives. The end-December quantitative performance criteria on the general government cash balance and debt were met by a sizable margin (Table 1). The ESA95 general government deficit was successfully reduced to around 4.5 percent of GDP (excluding the BANIF recapitalization costs of 0.4 percent of GDP), compared to a 5.5 percent of GDP target. This over-performance reflects strong tax collection, on the back of positive macroeconomic developments and continued efforts to strengthen tax compliance, as well as prudent expenditure control and one-off revenues from the (tax and social security) debt recovery scheme. The underlying structural primary adjustment in 2013 is estimated at about 0.8 percent of GDP. Nevertheless, the continuous indicative target on arrears was missed, with 0.2 billion in new arrears accumulated in 2013, notably due to structural imbalances in state-owned hospitals.

5. **2014 Budget.** We remain committed to achieving our 2014 deficit target of 4 percent of GDP—consistent with a structural primary adjustment of about 0.7 percent of GDP. New additional pressures arising from lower social security revenues as well as higher transfers to state-owned hospitals—as part of the targeted programs to halt arrears (see ¶9)—are expected to be offset by the positive 2013 carryover (0.2 percent of GDP) and improved macroeconomic outlook (0.5 percent of GDP). We are monitoring closely budget implementation. Specifically,

- **Public Expenditure Review (PER)**. We are carefully assessing progress towards the attainment of the defined budget objectives by line ministries, through monthly reporting to the Council of Ministers, with a special focus on the Public Expenditure Review measures in the budget. In order to achieve the targeted reduction in the size of the public sector workforce, another scheme for low-skilled employees will be launched during the second quarter of 2014. We have extended the term of the ongoing schemes for teachers, with effects from March 2014. In the design of any new programs aimed at reducing over-employment in specific sub-sectors, we will continue to aim at a change in the composition of the public sector workforce towards high-skilled and better-trained civil servants.

- **Additional Measures.** Supporting legislation necessary to implement some of the additional measures in the budget is also being finalized. In particular, we have approved the ministerial order defining the levy on financial institutions. The framework law for online gambling has been sent to the Council of Ministers, for approval by end-April 2014. The port concession tender and real estate sale is expected by end-September 2014, while the Silopor concession, the transfer from the CTT health fund, and the sales of excess oil reserves are expected to be finalized by end-year.

Should any risks to the execution of the budget materialize, we remain committed to implement, following discussion with EC/ECB/IMF staff, compensatory measures of equivalent size and quality to meet the agreed deficit target.

6. **Medium-term fiscal consolidation.** We will advance our fiscal consolidation efforts in 2015, with a targeted deficit of 2.5 percent of GDP, consistent with a structural primary adjustment of around 1 percent of GDP, securing a successful exit from the EU Excessive Deficit Procedure. Moreover, further fiscal effort of about ½ percent of GDP will be needed in the outer years to keep public debt on a downward trajectory, in compliance with the medium-term fiscal sustainability requirements in the European Treaty on Stability, Coordination, and Governance. The 2014 Fiscal Strategy Document, that we are about to submit to the EC by end-April, will provide detailed spending ceilings by line ministries and underlying adjustment measures consistent with our EU budgetary commitments. Specifically, the following measures will underpin our medium-term plans in the 2014 Fiscal strategy document, largely building on the Public Administration law which is expected to be approved by end-March:

- **Supplements and Wage Scale Reforms**. Building on the principles identified in the Public Administration law, we have recently conducted a comprehensive review of wage supplements, aimed at standardizing and rationalizing existing supplements by key categories. Draft proposals will be presented by the time of the twelfth review mission, with the draft law expected to be submitted to Parliament by end-June. In parallel, we are advancing our comprehensive review of public sector remunerations and careers towards a new single wage scale for public employees. We expect to finalize the reform in the second half of 2014, in line with the budgetary plans to be presented in the 2014 Fiscal Strategy document.

- **Pension reform**. New comprehensive measures as part of the ongoing pension reform shall be undertaken, aimed at improving the long-term sustainability of the pension system. The recently appointed Pension Reform Committee is tasked to develop the specific details of the reform. The reform shall include short-term measures further linking pension entitlements to demographic and economic criteria while also respecting progressivity principles, in line with the recent Constitutional Court ruling on the convergence of the public workers' pension regime (CGA) to the general system. The final design of these short-term measures shall be presented by the time of the twelfth review and a draft law will be submitted to Parliament in the first half of the year. Further measures ensuring the long-term sustainability of the pension systems shall be also specified by the time of the twelfth review. In addition, the Government shall ensure that the recently increased retirement age effectively applies to the pension requests made to CGA as of 2014.

- Additional areas that are being considered include, amongst others, a further reduction in the number of management positions and administrative units in central administration, the use of European funds for vocational and professional training, concessions in the transport sector, further reorganization of SOEs (including mergers and additional privatizations), as well as green taxes.

Measures deemed to be consistent with achieving the budget deficit target of 2.5 percent of GDP in 2015 will be specified as a *prior action* for completion of this review.

7. **Reform of the State.** The above-mentioned steps to reform the Public Administration are part of our far-reaching **Proposal for the Reform of the State**, whose general principles were approved by the Council of Ministers last October. The reform will aim at achieving efficient and sustainable public sector policies, underpinning the balanced budget objectives and fiscal sustainability rules in the recently-ratified European Treaty on Stability, Coordination, and Governance—which now ranks higher than ordinary legislation. In recent months, we have conducted consultations with social partners and proposed the setting up of a Parliamentary committee to reach broad-based consensus on these reforms. Building on the first round of consultations with social partners, a new document will be approved by the Council of Ministers by end-March 2014 with draft proposals on different reform areas, which should ideally include social security sustainability, flexibilization and requalification of the public sector workforce, rationalization of general government entities, as well as greater efficiency in health and education. Further progress with this process will be discussed at the time of the next review.

8. **Debt Path.** Preliminary data indicate that gross debt reached 128.8 percent of GDP in 2013, against an initial projection at the time of the 10$^{th}$ review of 129.4 percent of GDP, supported by the improved fiscal cash balance and upward revision in nominal GDP. Looking forward, under the programmed fiscal path, debt is expected to start gradually declining, with a projected debt ratio of 126¾ percent of GDP in 2014, supported by recent buyback operations, further use of cash deposits as well as the ongoing reallocation of the Social Security portfolio from foreign assets to government securities. Given the buildup of Central Government cash balances, net debt is projected below 120 percent of GDP by end-2014.

**Containing Fiscal Risks**

9. **Public Financial Management.** We are advancing Public Financial Management reforms, including through new efforts to improve our accounting and reporting framework, but stricter compliance with the commitment control law (CCL) is needed to prevent any new accumulation of domestic arrears, particularly in the health sector.

- We remain committed to complete the transposition of the EU Fiscal Compact provisions in our Budget Framework Law (BFL) by end-March 2014. In parallel, on the basis of the report of the technical group charged with revising the BFL, we are working, in close consultation with IMF staff, on developing the key principles and elements that will be reflected at a later stage in an amended BFL to crystallize the reforms undertaken so far while underpinning an effective public financial management system. As the next step, we will consult in the coming months with key stakeholders to discuss the key elements of the legislation, notably streamlining the budget appropriation structure, strengthening accountability relations, and broadening the focus and analysis of fiscal risks. We will aim at developing the key aspects and structure of the new law by end-April and completing the underlying technical work, upon consultations with key stakeholders by end-September. As part of these efforts and key input into this process, we will undertake an IMF Fiscal Transparency Evaluation by the end of the program, which will be made publicly available.

- We remain committed to arrest any accumulation of new domestic arrears. As part of our strategy, we have identified specific public entities with structural financial imbalances, including twelve State Owned Enterprise (SOE) hospitals and the railroad company Comboios de Portugal (CP), and are finalizing by end-April the targeted programs to underpin their financial sustainability. Specifically, the programs targeted to SOE hospitals, envisage for 2014 the use of additional budgetary funds (up to €300 million) to close the operational imbalances and fully fund the investment needs of these hospitals. To this end, should any new arrears emerge, they will be fully offset by transfers from the general government. As regards CP, a new debt management strategy is currently being developed, which will aim at improving the company's funding model and halt any further accumulation of arrears, expected to be discussed at the time of the 12th review. Beyond these specific programs, the CCL will be enforced in full to all public entities in line with the continuous indicative target under the program. In this context, the dedicated unit within the Ministry of Finance, reporting directly to the State Secretary of the Budget in charge of the expenditure arrears for the public sector, was also established last February and is currently operational.

- We will take immediate steps to improve the public sector accounting and reporting framework, building on recent technical assistance recommendations by the IMF. In particular, we are committed to ensure adequate accounting for revenues, expenses, assets, and liabilities related to government bank accounts, debt, investments, tax revenue, and public private partnerships. To this purpose, we will have a central government accounting function in the Ministry of Finance by end-June, responsible for accounting for these and any other balance-sheet items that may not currently be accounted for in the government accounting system. It will also be responsible for preparing consolidated financial statements of general government and other public sector entities, including all SOEs and other controlled entities.

10. **Revenue Administration.** 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 include hiring approximately 1000 new tax auditors and developing successfully the e-invoicing reform. The Compliance Risk Management Unit, created last November, is fully operational since last February. This unit is focused on strengthening tax compliance by (i) phasing in of a modern compliance risk model; (ii) improving PIT compliance management, through the pilot projects on the High Net Wealth Individuals and Self-employed Professionals; and (iii) enhancing control of the monthly PIT withholding information. Moreover, we are planning to establish by end-2014 a dedicated Taxpayer Services Department, unifying most services related to taxpayers and improving their relationship with the tax administration. As part of its reorganization 50 percent of local tax offices will be closed by end-May 2014.

11. **Anti-money laundering (AML).** We are committed to strengthen our AML legal and regulatory framework to tackle more effectively money laundering (as we did with the publication of Notice nº 5/2013 of Bank of Portugal that regulates the conditions, mechanisms and procedures needed for effective compliance of the financial institutions subject to the supervision of Banco de Portugal with the anti-money laundering and terrorist financing obligations) and its predicate

crimes, including tax crimes. To this end, we have set up a multidisciplinary working group that will carry out a national AML/CFT risk assessment. It will also propose any necessary amendment to bring our AML/CFT regime in line with the revised AML/CFT standard adopted by the Financial Action Task Force (FATF/GAFI). In this context, on the basis of recommendations made by IMF technical assistance, we have identified key areas of reforms to strengthen the exchange of information system between the AML authorities and other competent authorities, such as the Tax and Customs Authority, and we are committed to implementing these reforms by end-2014.

12. **Public-Private Partnerships (PPPs).** We continue taking steps to achieve a fiscally responsible PPP model. We are finalizing a major renegotiation of road contract PPPs with all concessionaires, generating additional structural savings of more than €2.5 billion over the life cycle of these concessions. The revision of the regulatory framework for the road and rail sectors, reducing operation, maintenance, and major repair requirements, in line with EU standards and with the objective of minimizing fiscal risks is also nearly finalized. Moreover, with a negotiation team appointed last February, the renegotiation of the Security Integrated System (SIRESP) PPP contract is proceeding as envisaged, with the objective of generating further permanent savings in 2014 via a reduction on its internal rate of return and full network scope improvement and optimization. Furthermore, the Ministry of Finance PPP unit continues working towards enhancing fiscal transparency, improving reporting on PPPs, expanding its field of action to other sectors, namely health and security, and advising the autonomous region of Madeira.

13. **State-Owned Enterprises.** Despite the reinstatement of the 13th and 14th month salaries, cost-cutting efforts and voluntary separation programs ensured that the consolidated operational balance of transport SOEs remained in surplus in 2013. Nonetheless, legacy debt burdens continue to weigh on the financial results of most firms. We will retain formal cost-reduction objectives for these firms, while requiring other firms to continue improving operating balances. In addition, we launched a new comprehensive debt management strategy as part of the efforts to restore the financial sustainability of transport SOEs and stop the accumulation of arrears (see ¶9). A plan is expected to be discussed at the time of the $12^{th}$ review. We have started the selection process to staff the dedicated Technical Unit that was created under the new framework law for SOEs, and are on track to make it operational by end-April 2014.

14. **Privatization.** The privatization program is ahead of target. Agreement was reached with an investor on the sale of the insurance arm of state-owned CGD in February, with the proceeds contributing towards CGD's CET1 capital. The sale of the airline, TAP, however, remains on hold. We continue to actively seek buyers for the group as a whole and expect to re-launch the process in the course of this year. The privatization of the rail cargo firm, CP Carga, has been postponed pending the unbundling of its terminals and the approval of the rail investment plan, expected to take place by June 2014. We have prepared a strategic plan for the water, sanitation, and waste sectors (PENSAAR 2020 and PERSU 2020), with a view to improving their efficiency, including by introducing private capital and management in the public waste company. Binding offers for the sale of the waste management company, EGF, are expected by end-June 2014. Opening water concessions to private capital and management is expected to take longer. The restructuring of transport SOEs in

Lisbon and Porto is ongoing. We have launched the consultation process for four concessions in February. The concessions are now expected to be launched by end-April 2014. The government will further consider expanding the privatization program to include additional assets for sale or concessions.

15. **Regional and Local Governments.** We remain committed to fiscal discipline in local and regional governments. Under the program for local governments' arrears settlement (PAEL), nine municipalities remain to be cleared by the Court of Auditors. The coordination council between the central and subnational governments, envisaged in the Regional Finance Law and Local Finance Law (LFL) approved by Parliament last year is expected to become operative by end-April 2014. The council is expected to enhance exchange of information in order to support budgetary planning. The LFL also introduced a Municipality Resolution Fund, for which rules and procedures are being proposed by a group of specialists. On this basis, we expect to submit to Parliament a draft law by end-April 2014. In terms of regional governments, we will continue to closely monitor Madeira's program with the State (PAEF).

**Safeguarding Financial Stability**

16. **Bank Supervision.** Banco de Portugal (BdP) continues to scrutinize the resilience of the banking system amidst a challenging operating environment.

- *Credit Impairments*. In line with past credit impairment reviews, and also in anticipation of the ECB's Comprehensive Assessment, the BdP continues to monitor the adequacy of banks' impairment levels, including via targeted audits of provisioning levels for exposures that relate to a selected number of large non-financial groups—where necessary resulting in further reinforcements. Guidelines on measuring credit portfolio impairment and disclosure of asset quality and risk management practices have been published incorporating best practices identified during the impairment reviews that have been conducted since May 2011.

- *Stress Testing*. The BdP continues its quarterly stress tests, which have been strengthened via the enhanced top-down stress testing framework, and uses their results to improve the banks' resilience, also in the light of the forthcoming EU-wide stress test. As usual, and where necessary, the stress test will be used as the basis to require measures that result in a strengthening of banks' capital positions.

- *Management of Distressed Loans. The BdP is review*ing action plans for enhancing operational capabilities in the area of distressed loan management (DLM), drawn up by the eight largest banks in response to the Special Assessment Program that reviewed DLM practices.

- *Recovery and Resolution Plans.* Banks have made significant progress in fine-tuning their recovery plans, based on recommendations and additional guidance from the BdP. In parallel, the BdP is continuing on-site visits to validate input received from the largest banks for resolution planning purposes. We remain committed to swiftly transposing the new EU Directive on bank recovery and resolution once it has been adopted.

17. **Transition to CRD IV.** As of January 1, 2014, banks are required to maintain a minimum common equity Tier 1 (CET1) capital ratio of 7 percent, considering all the transitional provisions related to capital definition. In the context of the ECB's asset quality review, the largest banks are expected to maintain a CET1 add-on of 1 percentage point. Additional measures are in place to conserve banks' current capital buffers, ensuring that they remain commensurate with the challenging operating environment. We continue to ensure compliance with the requirements envisaged in the EBA Recommendation on the preservation of capital and any future regulatory initiatives at European level.

18. **BSSF.** While we will continue to encourage banks to seek private solutions, we remain committed to providing further support to viable banks, with resources from the Bank Solvency Support Facility (BSSF), in the event new capital shortfalls were to arise. The BSSF resources—which currently amount to €6.4 billion, following the deposit of the remaining funds that were set aside for banking sector support as part of the program envelope—will solely be utilized to provide public support, if needed, to the banking system. Any public support will remain subject to strict conditionality, in line with 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.

19. **Funding and Liquidity Conditions.** Deposits have remained stable in an environment of gradually decreasing remuneration rates, while banks have been able to expand their access to financial markets funding. Non-standard measures by the ECB to restore the proper transmission of monetary policy continue to play a pivotal role in easing liquidity pressures and 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.

20. **Corporate Debt Restructuring.** Considering its importance to the deleveraging of the economy and potential medium- to long-term growth outlook, we are reviewing our strategy to facilitate corporate debt restructuring. In particular, we will draft, in consultation with the BdP, a strategic plan, to be discussed with the EC, ECB, and IMF staff during the 12th review, aiming at addressing the corporate sector debt overhang—with a particular focus on economically viable SMEs—and supporting the necessary capital reallocation towards the productive sectors of the economy, notably in the tradable sectors, while promoting financial stability.

21. **Initiatives to Facilitate Access to Finance.** Notwithstanding recent improvements and banks continued efforts to facilitate an orderly deleveraging of the private sector, credit conditions and access to finance remain challenging, especially for SMEs. In light of that, we have made important progress with key government supported initiatives.

- *National Guarantee System (NGS).* We concluded the implementation of several enhancements to our existing government-guaranteed credit instruments, such as the implementation of a new pricing methodology for determining interest rate caps, supported by a new rating

framework, and changes in the ownership and governance structure of the NGS. These improvements have led to lower interest rate caps than those applicable in 2013. Going forward, we will take stock of the impact of these measures on actual interest rates by May 15, 2014. We stand ready to pursue policy alternatives, if deemed necessary, in order to ensure that government guaranteed loans will be priced in a competitive and transparent manner in favor of end-users.

- *Development Financial Institution (DFI).* We continue to explore ways to promote an efficient use of EU structural funds and allocation of other government supported funding instruments. These initiatives will be streamlined and centralized through a DFI, already approved by the Council of Ministers. A task force has recently been constituted to design and operationalize the DFI, ensuring (i) that no additional burden on or risks to public finances will be incurred; (ii) that the DFI's sole purpose shall be to address market failures in the financing of private non-financial corporations, notably SMEs; and (iii) in doing so it shall not accept deposits or other repayable funds from the public, nor engage in direct lending, nor invest in Government debt or grant loans to the Government. The DFI's draft business model and by-laws will be submitted for in-depth consultations with EC, ECB and IMF staff prior of the 12th Review.

22. **Central Credit Registry.** We are on track to complete the agreed enhancements in our credit registry, including ongoing updates in the IT systems that will allow financial institutions to have access to companies' historical information as well as to the corporate balance sheet database, reducing information asymmetries. For this purpose, the Ministry of Finance is finalizing the needed changes to the Central Credit Registry legal framework, with support from BdP and in consultation with the Portuguese Data Protection Authority. We expect to be able to submit a final draft of the proposed legislation for approval by the Council of Ministers by end-April 2014, going subsequently to Parliament, and to complete the implementation of these changes before end-2014.

23. **BPN SPVs.** The gradual recovery of the assets from Banco Português de Negócios (BPN), held by three state-owned Special Purpose Vehicles (SPV), is progressing. Business plans of the two contracted service providers for the management of part of the credit portfolio of Parvalorem are expected to be finalized shortly, and the disposal of the participations and assets held by the other two state-owned SPVs is continuing. 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**

24. **Overall Reform Strategy.** The ultimate objective of our structural reform agenda is to enhance competitiveness and improve the business environment, so as to engineer a sustainable rebalancing of the economy toward the tradable sectors and boost medium-term growth and job creation prospects. Most reforms initiated at the beginning of the program are drawing to a close. Significant steps were taken on the labor and product market fronts, where reforms were designed to alleviate nominal rigidities, facilitate adjustment, and foster a reallocation of resources toward the tradable sector. Important steps were also taken to reduce red tape and raise the efficiency of the

judicial system. We are now refocusing our efforts on assessing the impact of the reforms already implemented and ensuring that the initial objectives are being achieved. In this context, an outcome-based accountability framework is being prepared to draw more concrete links between notional reforms and actual outcomes. Concurrently, we are working toward identifying the remaining policy distortions and other potential priority areas which will be tackled in the next phase of reforms. This will form the basis for our medium-term reform strategy, to be adopted by the end of the program.

25. **Competition/Regulation**. A framework law for the functioning of regulators was enacted last year. The law: (i) establishes a regulatory environment that protects the public interest and promotes market efficiency, (ii) guarantees the independence and the 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. We will redouble efforts to finalize the amendment of the corresponding bylaws of the National Regulatory Authorities, with the last revised drafts expected to be approved by end-April 2014. Once the regulators 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. We are taking the necessary steps to ensure the effective functioning of the Competition Authority's financing model. To avoid disruptions in the transitory period up to the entry into force of the corresponding provisions in the forthcoming bylaws, we have issued an executive order specifying the necessary transfers from the contributing sectoral regulators. We will also leave room to accommodate potential growing needs over the medium term, and ensure the competition authority is adequately and sustainably funded. The competition authority has a critical role to play in evaluating public policies. As a first step in this direction, a new unit was created to assess impediments to competition/market entry in selected sectors.

26. **Energy.** The Portuguese government has taken measures in excess of €3.4 billion in order to achieve an elimination of tariff debt by 2020. Having taken these steps, the focus should now be on limiting energy price increases. To this end, the government commits to present additional concrete measures to tackle remaining excess rents and to deliver cost reductions to be reflected in energy prices. These measures shall be agreed by end-April (*structural benchmark*). Following the identification by the government of the problem of distortion on the system services market and highlighted in the reports of the relevant regulators, we are implementing measures in line with these reports to prevent the risk of overcompensation in the adjustment calculations (*revisibilidade*) of the CMEC scheme. In particular, an independent audit on the risk of overcompensation and the amount of past overcompensations will be launched soon and is expected to be finalized by the second half of the year. Finally, we will ensure that the energy sector levy introduced in the context of the 2014 budget will not be passed through to end-users.

27. **Transport.** The reform agenda in the transport sector is geared toward reducing costs for exporters and making the economy more competitive.

- The bylaws of the *transport sector regulator* have been approved by the Council of Ministers. They were drafted so as to ensure its financial and operational independence.

- A stakeholder working group has prepared a *long-term strategic transport infrastructure plan*, which prioritizes infrastructure investment projects taking into account their impact on competitiveness and the budget constraint. Following public consultation, the infrastructure investment priorities will be included in the long-term strategic vision of the transport sector, to be adopted by the Council of Minister by end-April 2014 and discussed at the time of the 12th review.

- In the *rail sector*, we continue to prepare the privatization of the freight branch of the state-owned rail operator, by implementing measures to ensure operational balance by 2015, by assessing the investment plan on rail to fully enhance the economic value of the company, and by completing the company terminals' unbundling.

- In the *ports sector*, we have taken the initiative to fully eliminate the port user fee (*TUP-Carga*) as of January 2014. Following the revision of the Ports Work Law, we are monitoring its effective implementation. We are now seeking further transmission of lower labor costs to end-users of port services. We have published a detailed timetable for other measures ensuring cost reduction and enhanced performance of both port authorities and port operators. The immediate priority will be to engage with concessionaires with a view to modifying existing concession contracts so as to foster efficiency and price reduction. To this end, we have signed in March an executive order to appoint the legally required negotiation commissions and set out detailed guidelines on the scope and objectives of the negotiations. Formal negotiations will be launched on this basis (*end-April structural benchmark*). 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 by the Port Work Law is being conducted, the result of which will be discussed at the time of the 12th review.

28. **Labor Market Institutions.** Significant steps have been taken over the past couple of years to make the labor market more dynamic and efficient—including reforming the Employment Protection Legislation, streamlining unemployment benefits and reforming the wage-setting mechanism. Notwithstanding the recent decline, unemployment remains high, particularly for the youth and long-term unemployed. The labor market is also segmented, with a large proportion of new employment contracts extended on short-term basis—although flows have improved recently. In light of this we intend to further advance our reforms aimed at encouraging the creation of long-term jobs and a better job matching process. We are studying policy options in dialogue with the social partners with a view to specifying measures by the time of the 12th review. Several options are available to foster more effective wage bargaining and wage developments consistent with economic fundamentals namely: (i) foster collective agreements by adjusting the current criterion for the extension of collective agreements taking into account the representativeness of SMEs in the various sectors; (ii) after the analysis of the independent study on the desirability of shortening the survival (sobrevigência) of contracts that are expired but not renewed (art 501 of the Labour Code)

the Government will present policy options, in dialogue with social partners about expiration and survival of collective agreements—in case the latter option is not implementable, we will study and present a proposal regarding mutually agreed and temporary suspensions of collective agreements; (iii) in the area of employment protection legislation, some reduction of severance pay for unfair dismissals would help reduce the gap opened up with the large reduction in severance for fair dismissal, striking a balance between limiting incentives to challenge fair dismissals in court and adequately penalizing unfair dismissals; (iv) finally, we intend to strengthen activation policies, with significant expected pay offs when vacancies pick up.

29. **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 submission of the remaining 5 (out of 68) necessary legislations—including to the Construction Law—to parliament by mid-April2014 for adoption by end-May. The related ordinance, ensuring appropriateness of fees linked to construction activities will be in enacted by the date of adoption of the Construction Law. Following the publication last year of the new legal framework aimed at improving the functioning of the regulated professions, 18 professional bodies' statutes are being amended. We expect all bylaws to be submitted to Parliament for final approval by end-April2014. These new legislations eliminate unjustified restrictions to activity and further improve the conditions for mobility of professionals in line with the EU Directives in the area of free movement of professionals.

30. **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. We have already adopted legislation to ease licensing requirements for tourism and industrial sectors. The legislation regarding commercial activities has been submitted to Parliament. Once the Base Law of Soil and Territorial and Urbanism Planning will have been adopted by Parliament (twelfth review), the various related legal regimes will be reviewed. To prevent future growth in excessive licenses and regulations, the government will adopt—by end-March—a rule that makes it mandatory to propose eliminating an existing regulation for all new regulations generating costs for businesses. We are preparing an inventory of regulations that are likely to have higher impact in economic activity (at central, regional and local levels), selecting the most burdensome. On this basis, we will devise a cost-analysis (currently under preparation) and roadmap for a regulatory simplification by end-March. We have also taken significant steps and will continue our efforts to make fully operational the Point of Single Contact, an e-government portal which allows administrative procedures to be conducted online.

**Table 1. Portugal: Quantitative Performance Criteria**
(Billions of euros, unless otherwise specified)

| | Jun-13 | | Sep-13 | | Dec-13 | | Mar-14 |
|---|---|---|---|---|---|---|---|
| | Program | Actual | Program | Actual | Program | Actual | |
| 1. Floor on the consolidated General Government cash balance (cumulative) | -6.0 | -3.8 | -7.3 | -4.3 | -8.9 | -7.2 | -1.7 |
| 2. Ceiling on accumulation of domestic arrears by the General Government (continuous indicative target) 1/ | 0 | Not met | 0 | Not met | 0 | Not met | 0 |
| 3. Ceiling on the overall stock of General Government debt | 187.3 | 184.1 | 188.9 | 184.7 | 191.3 | 187.5 | 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 |

1/ As of end-December, domestic arrears for the purpose of the program declined by €0.2 billion since end-September (although the continuous indicative target was not met in October and November). The overall accumulation of domestic arrears since end-December 2012 was about €0.2 billion.

**Table 2. Portugal: Structural Conditionality: Eleventh Review Under the EFF**

| Measure | | Timing | Status |
|---|---|---|---|
| Prior Actions | | | |
| 1 | Specify fiscal measures consistent with achieving the general government deficit target of 2.5 percent of GDP in 2015 (MEFP ¶6). | | Expected to be met by mid-April |
| Structural Benchmarks | | | |
| 2 | Present measures to tackle remaining excess rents in the energy sector and to deliver cost reduction to be reflected in energy prices (MEFP ¶26). | End-April, 2014 | |
| 3 | Launch formal negotiations with port concessionaries with a view to modifying existing concession contracts so as to foster efficiency and price reduction (MEFP ¶27). | End-April, 2014 | |

# Attachment II. Portugal: Technical Memorandum of Understanding

March 28, 2014

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**

## C. 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

[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.

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 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.

## D. 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.

## E. 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. For 2014, 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.

## F. 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.

## G. 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.

## H. 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.

Press Release 14/173
FOR IMMEDIATE RELEASE
April 17, 2014

International Monetary Fund
Washington, D.C. 20431 USA

**IMF Completes Eleventh Review Under an EFF Arrangement with Portugal, Approves €851 Million Disbursement**

The Executive Board of the International Monetary Fund (IMF) today completed the eleventh review of Portugal's performance under an economic adjustment program supported by a 3-year, SDR 23.742 billion (about €26.58 billion) Extended Fund Facility (EFF) arrangement. The completion of the review enables the immediate disbursement of an amount equivalent to SDR 760 million (about €851 million), bringing total disbursements under the EFF arrangement to SDR 22.942 billion (about €25.68 billion).

The prior action for completion of this review was met. The Executive Board also approved a request for waivers of applicability for the end-March 2014 performance criteria (PCs). The waivers were necessary because the Executive Board meeting took place after end-March 2014 but prior to the availability of data to assess the relevant PCs.

The Executive Board also approved a request for extension of the arrangement to June 30, 2014. This extension is needed to provide sufficient time to assess the end-March performance criteria, complete the final review, and enable the final purchase under the arrangement in accordance with Fund policies.

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, Mr. David Lipton, First Deputy Managing Director and Acting Chair, said:

"The short-term macroeconomic outlook has continued to improve and the program is on track, underpinned by a sizable budgetary over-performance in 2013. The authorities remain committed to fiscal discipline and have fully specified the measures necessary to achieve the

2015 fiscal target. Efforts are ongoing to complete unfinished reforms under the program and further strengthen banks' balance sheets. Portugal, however, still needs to address important challenges, as large financing needs leave the country susceptible to market volatility, and remaining bottlenecks to growth and competitiveness risk delaying the necessary rebalancing of the economy.

"Fiscal consolidation efforts must be sustained to set debt on a downward trajectory. In view of budgetary risks ahead, the authorities' solid track record in implementing compensatory measures offers important reassurances. Nevertheless, close monitoring of budget implementation and further progress in the reform of pensions and public administration as well as in fiscal structural areas remain necessary.

"Steady commitment to advance the structural agenda is critical to raise Portugal's growth potential. In many areas, reforms have yet to translate into effective change, calling for a medium-term strategy to tackle remaining rigidities in product and labor markets, while improving the business climate. New measures to promote orderly corporate deleveraging are also important to underpin a sustainable investment-led recovery.

"Continued vigilance in the financial sector is also needed. Recent initiatives by Banco de Portugal are welcome steps in this direction, including ongoing efforts to strengthen banks' stress tests. Eurosystem's liquidity continues to play a pivotal role in easing remaining funding constraints.

"In addition to strong program implementation, crisis management policies at the euro area level, including the commitment by the European leaders to support Portugal until full market access is restored, are essential to help the country remain resilient to shocks."

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

## 1. Overview

We appreciate and welcome the IMF Staff Report on the eleventh review. In particular, we wish to highlight staff's assessment on the fiscal consolidation results of 2013 and the ongoing recovery of economic activity.

The prior action set for the completion of the eleventh review has been met. Measures that are consistent with the achievement of the 2.5% of GDP target in 2015 have been presented.

In what regards the prior actions for the tenth review, the supplementary budget enacting the changes to the existing extraordinary solidarity contribution on pensions (CES) entered into force in mid-March, in line with what was expected. The Government also reaffirmed its commitment to implement the increase in the beneficiaries' contributions to the special health insurance schemes (ADSE, SAD and ADM). After the non approval by the President of the Republic of the decree law, the measure was submitted to Parliament, under the form of a draft law. This new piece of legislation is expected to enter into force by May, pending the ongoing Parliamentary procedures.

Overall, the adjustment of the Portuguese economy continues to advance at good pace, with the year of 2013 marking an important turnaround in the key dimensions of the Program. On the fiscal front, data from the National Statistics Institute (INE) confirmed that the ESA95 deficit in 2013 was 4.9% of GDP, which represents a significant consolidation effort vis-à-vis 2012. In addition, financing conditions have significantly improved, with Treasury bond yields in the secondary markets having reached levels of late 2009. At the same time, the reform *momentum* has been maintained, with additional measures being implemented in several areas.

These are in fact important achievements, which result from the strong compliance with the Economic and Financial Assistance Program, as well as from the global adjustment effort over the past three years. Nonetheless, in order to provide enough time to assess end-March performance criteria, complete the final review and enable the final purchase under the arrangement in accordance with Fund policies, a short extension of the program for technical reasons was agreed by the Portuguese authorities.

Looking forward, it is recognized that the adjustment must continue on all fronts. In particular, fiscal consolidation and fiscal structural reforms will have to advance further, so as to ensure compliance with the enhanced European rules and, most importantly, to guarantee the soundness of public finances. In parallel, the continuous effort to safeguard financial stability will continue. Finally, the ongoing structural transformation of the Portuguese economy will be defined by two courses of action: the continuous monitoring of reforms already in place and the identification of other potential areas for reform. Notwithstanding these encouraging prospects, the authorities are mindful of the uncertainty that subsists,

namely in what regards the risks that had already been identified at the time of the tenth review.

**2. Economic Activity**

The update of macroeconomic scenario during the review mission followed several months of consistent improvement in monthly indicators and intra-annual economic performance.

Preliminary data from INE for 2013 indicate that GDP declined by 1.4% in 2013, which consists in an upward revision vis-à-vis the projected 1.6% fall at the time of the tenth review. This result, as well as recent labor market data and the generalized improvement in economic activity, led to the upward revision of GDP growth in 2014 to 1.2%, which is 0.4 p.p. higher than expected at the time of the tenth review. The projected unemployment rate for 2014 was also revised downwards, by more than 1 p.p., to 15.7% and should continue to decline in subsequent years. In addition, recently published Eurostat data for February indicates that Portugal registered the third largest year-on-year decrease in the unemployment rate in the European Union.

In what regards the economy's external adjustment and overall deleveraging process, 2013 marked very important progress. According to INE, Portugal registered a net lending position of 2.0% of GDP in 2013, which compares to the net borrowing positions of 0.1% of GDP in 2012, 5.6% in 2011 and 9.0% in 2010. Additionally, the External Balance of Goods and Services turned positive, amounting to 1.1% of GDP. Finally, all non-financial institutional sectors improved their net lending/borrowing position in 2013. Households and Non-Profit Institutions Serving Households improved their net lending position by 0.4 p.p. to 6.8% of GDP, while their savings rate increased by 0.6 p.p. to 12.6%. Non-financial corporations still registered a net borrowing position of 2.1% of GDP, which does represent an improvement of 1.8 p.p. vis-à-vis 2012.

**3. Fiscal Policy**

After the conclusion of the review mission, INE published the first Excessive Deficit Procedure (EDP) notification of 2014, which confirmed that the ESA95 General Government deficit was 4.9% of GDP in 2013. Since the Program's definition excludes from the calculation the BANIF recapitalization costs amounting to 0.4% of GDP, the deficit was in fact 4.5% of GDP, thus below the annual deficit target of 5.5%. This result not only confirms the ongoing reduction in the General Government deficit, but also contributes to the compliance with the annual target of 4.0% of GDP set for 2014 through the partial carry-over effect. The authorities remain confident that this year's target will be met. The Cumulative General Government budget deficit on a cash basis, according to the Program's definition, stood at EUR 30.8M up to February, which compares favorably with the EUR 181.7M deficit in January-February 2013 and stands well below the Program target set for 2014Q1.

The EDP notification also indicates that the estimate for General Government Gross Debt in 2013 is 129.0% of GDP. This result is broadly in line with the eleventh review projections.

By end-2014, the gross public debt ratio is expected to decline to 126.8% of GDP, while net debt is projected to remain below 120% of GDP, given the size of the accumulated cash buffer.

**4. Financial Sector Policies**

The measures adopted under the Economic and Financial Assistance Program helped avoid financial sector instability. An orderly deleveraging process has taken place and banks' capitalization was stepped up. This happened in parallel with a wide range of initiatives to increase transparency and improve the valuation accuracy of banks' books, against the background of challenging economic conditions calling for a significantly increased need to recognize losses.

In terms of solvency, the banking system's Core Tier 1 ratio virtually stabilized in the fourth quarter of 2013, reaching 12.3 per cent at year-end (11.5 per cent in December 2012, 9.6 per cent in December 2011 and 8.1 per cent in December 2010). These positive developments occurred despite negative bank profitability in domestic operations (with positive results in international activities not enough to offset domestic losses). Compressed net interest income and elevated loan impairments were the main drivers of domestic profitability in recent years. Throughout this process, Banco de Portugal remained very active in ensuring that the recessionary environment was duly reflected in banks' accounts, through several impairment reviews, either to the whole portfolio or to dedicated segments or sectors, the definition of even stricter valuation rules and procedures, and the issuance of guidelines for proper and timely recognition of impairments, as well as for improved public disclosure of information on asset quality and credit risk management.

The deleveraging process in the banking sector continued in the fourth quarter of 2013, with the credit to deposits ratio falling from 121 per cent in September 2013 to 117 per cent in December 2013 (from levels as high as 158 per cent in December 2010). The decline of this ratio in 2013 resulted from a reduction in credit granted by banks, as deposits stabilized during this period. However, the heterogeneity underlying the overall credit portfolio should not be ignored. In fact, credit decreased quite considerably in sectors most dependent on domestic demand (domestic trade, construction, real estate development), while exporting firms have been benefitting from positive flows of credit. This is a desirable feature of the adjustment process, taking into account the need for reallocating resources towards the most productive sectors of the economy, most notably the tradable sector.

Banks' collateral buffers allow for the coverage of more than one year of banks' refinancing needs. Deposits, Portuguese banks' most important funding source, have shown a remarkable resilience throughout the whole Program, despite the challenges raised by the economic environment.

Banks continued to prepare and present funding and capital plans and undertake stress tests on a quarterly basis - two instruments Banco de Portugal has continued to actively use in planning supervisory activities and setting priorities. Concerning stress tests, Banco de

Portugal has been particularly focused on the identification of vulnerabilities, prompting corrective measures when needed.

Looking forward, net interest income shows signs of having bottomed out in the latest quarters while economic activity is picking up, with a positive implication for NPLs and loan losses developments. Further, banks' operating costs should continue on a declining trend, by rationalizing distribution channels, with a resulting lower density of branch networks and reduced staff levels. Consequently, a gradual return to positive bank overall profitability is expected.

Improved profitability, in conjunction with initiatives taken by Banco de Portugal on impairment reviews, targeted audits and issuance of best practice guidelines for impairment recognition, should contribute to a strengthened position of Portuguese banks in the Comprehensive Assessment in the context of the Single Supervisory Mechanism.

## 5. Structural Reforms

The Portuguese Government reaffirmed its commitment to the ambitious reform agenda.

As recognized in the staff report, in the last three years a large number of important structural measures were implemented in the areas of the judicial system, competition and regulation, labor market and education, business environment and services and regulated professions. As the end of the program approaches, almost all measures foreseen in the memorandum are in place. The challenge now is to maintain the reform momentum as well as to enforce and to monitor the impacts of the reforms already in place, introducing changes as needed.

In the labor market, the Portuguese authorities consider that the key reforms have already been implemented. The early signs in the employment recovery might, in fact, already be related with these changes. According to Eurostat data, unemployment stabilized at 15.3% in the first months of the year (coming down from a peak of 17.5%) and employment creation by the end of 2013 was significant. It is important to recall that these reforms were performed under a broad consensus, achieved through the tripartite agreement signed by the Portuguese Government, all the employers' associations and the confederation of labor unions UGT. Despite a strong track record, the Government remains vigilant to the evolution of the market and is ready to take action as needed. In this context, some refinements are being prepared, specifically in the areas of extension and survival of collective agreements and regarding employment protection.

Overall, we continue to note some progress towards a convergence of views between the authorities and IMF staff. Nevertheless, some differences persist. The reduction in unit labor costs and in hourly labor costs experienced in Portugal during 2012 and 2013 was substantial and they clearly stand out within the Eurozone. Moreover, legislative barriers to individual dismissal have been addressed too recently and any definite conclusions drawn on this matter would be premature.

More broadly, the Portuguese Government believes more time is needed to assess the impact of recent reforms and to guarantee the expected results in terms of job creation and enhanced

competitiveness in the economy. Nonetheless, the authorities agree with the staff that this is a central issue and that unemployment is still at very high levels. Thus, authorities will continue to closely monitor developments in the labor market and fine tune reforms, as needed.

The competition framework and the regulatory environment have progressed. The full transposition of the Services Directive is near completion (only 3 out of nearly 70 diplomas still need to be adjusted), and this will have a positive effect in the productivity of services.

Progress has also been made on the removal of the bottlenecks in the Portuguese economy and in the improvement of its business environment. The new Base Law of Land and Territorial Planning was approved in Parliament in April. The Government approved the "one-in one-out rule" which mandates that whenever a service proposes a new regulation generating costs to the economy, it has the obligation to eliminate an existing regulation or regulations with equivalent cost. The Government also approved the new commercial licensing regime, which is now in Parliament. At this point in time, and in order to tackle remaining vulnerabilities, the authorities are finalizing a comprehensive review and cost-benefit analysis of all existing bureaucratic procedures with higher impact in the economy. It should also be noted that all foreseen action in the reform of the judicial system were carried out and that the chapter was therefore closed in this review. Early statistics already show improvement in both the productivity of the court system and the efficiency of enforcement cases.

In the energy sector, with the liberalization of both the electricity and gas market already in place, the goal of ensuring the sustainability of the National Electricity System (NES) is reasserted by the Portuguese authorities. Adding to the measures announced in May 2012, which resulted in reductions of various types of public subsidies in the amount of EUR 2.1Bn., a second package of measures was presented and approved totaling EUR 1.3Bn.. The Portuguese Government thus affirms that with the measures already implemented the objective of tariff debt elimination by 2020 is on track. Furthermore, recent growth in energy consumption is having a positive impact in this effort. A major new measure presented in the context of the 2014 budget was the introduction of a levy on the energy operators which will be used for fiscal consolidation purposes and for the sustainability of the NES. Furthermore, the Government has committed to study and present new measures to continue this effort to limit increases in energy prices.

The Portuguese Government considers that the privatization program was and is an important tool for opening up the Portuguese economy and attracting new investment that will increase the economy's competitiveness in the medium-term. Currently, the program has already far surpassed the initial overall financial objective (total revenues of EUR 8.1Bn. against an objective of EUR 5.5Bn.). The necessary preparatory work for privatization of *EGF* (Waste Management) is ongoing and on track. Furthermore, the restructuring of *Águas de Portugal* is underway.

Lastly, in the health sector, operational improvements geared at cost control and efficiency continues to be implemented, as exemplified by the recent publication of the clinical and prescription guidelines. Following the difficult but successful negotiations with the

pharmaceutical industry, which limited the state's drug expenditure to 1% of GDP in 2013, the authorities were able to extend this ambitious goal to 2014. The Government continues to pursue the reorganization plans for the hospital network and the improvement of the expenditure control mechanisms so as to fully eliminate arrears in the health sector (which decreased from a monthly accumulation rate of EUR 76M in 2012 to EUR 34M in 2013). Specific measures include the creation of a special unit which monitors arrears and the approval of additional budgetary funds totaling EUR 300M.

To sum up, the authorities consider that the eleventh review was an opportunity to confirm continued progress in the structural reform agenda and reaffirm their commitment to maintaining the reform momentum. These reforms should contribute to increase Portugal's potential growth and, together with the progressive design of the consolidation measures, to a better balance of the economy.