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Portugal: 2001 Article IV Consultation—Staff Report and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2001 Article IV consultation with Portugal, the following documents have been released and are included in this package:

- the staff report for the 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **December 10, 2001,** with the officials of Portugal on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on March 4, 2002.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its March 25, 2002 discussion** of the staff report that concluded the Article IV consultation.

The document(s) listed below have been or will be separately released.

Selected Euro-Area Countries: The Determinants of Growth—The Experience in the Southern European Economies of Greece and Portugal

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

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PORTUGAL

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the 2001 Consultation with Portugal

Approved by Alessandro Leipold and G. Russell Kincaid

March 4, 2002

Contents | Page

I. Introduction....3

II. Background: Economic Developments and Policies....3

III. Policy Issues....10
A. Economic Prospects....11
B. Fiscal Policy: Adjustment and Structural Reform....13
Why was fiscal policy execution so poor in 2001?....13
Lessons for fiscal policy design....14
Fiscal deficits: a prudent consolidation strategy....15
Public expenditure and tax reform to support strong, equitable growth....16
C. Financial Sector Issues....18
D. Structural Policies to Support Economic Adjustment and Growth....21
E. Statistical and Other Issues....22

IV. Staff Appraisal....24

Tables
1. Selected Economic Indicators, 1996–2002....27
2. Balance of Payments, 1996–2001....28
3. General Government Accounts, 1997–2002....29
4. Indicators of External and Financial Vulnerability, 1996–2002....30
5. Stability and Growth Program and Staff's Medium-Term Scenario, 2001–07....31

Figures
1. Comparison of Selected Economic Indicators, 1992–2000....4
2. Financial Sector Indicators, 1998:01–2001:12....6
3. Asset Market Indicators, 1994:1–2002:01....7
4. External Sector Developments and Exchange Rates, 1994–2001....8

5. Labor Market Conditions and Price Developments, 1994–2001 9
6. Monetary Conditions Index and Real Interest Rates, 1994:1–2001:12 12
7. International Comparisons of Fiscal Trends, 1994–2001 17

Boxes

1. Portugal's Financial Sector 20
2. Low Labor Mobility: A Hindrance to Stronger Growth in Portugal? 23

Appendices

I. Fund Relations 32
II. Statistical Issues 33

I. Introduction

1. A staff team held 2001 Article IV consultation discussions with Portugal in Lisbon during November 29–December 10, 2001.[1] At the conclusion of the last consultation on October 20, 2000 (http://www.imf.org/external/np/sec/pn/2000/pn0099.htm), Directors commended the authorities on achieving rapid output growth and low unemployment, but urged addressing expanding macroeconomic imbalances: the rapid rise in private sector credit and the widening external current account deficit were becoming serious concerns. Moreover, they noted that labor cost increases were well above the euro-area average. Concerns about macroeconomic imbalances would have called for more ambitious fiscal targets in 2001 as well as accelerating fiscal adjustment in following years, with a focus on containing expenditures. On the latter, Portugal's *Stability Program* was viewed as less ambitious than those in most other euro-area countries.

2. Prime Minister Guterres, in power since 1995, resigned in mid-December 2001, after local election losses of his socialist party. General elections are scheduled for March 17, 2002.

3. The historic introduction of euro bank notes and coins was successfully implemented in early 2002 and the euro became the sole legal tender after end-February.

II. Background: Economic Developments and Policies

4. **An extended period of strong growth in Portugal came to an end in 2001—amid sizable macroeconomic imbalances** (Table 1; and Figure 1). Since the mid-1990s, Portugal's real growth rate has exceeded the euro-area average by about 1 percent per annum, broadly in line with most of the less wealthy countries in the euro area. Income catch-up and disinflation benefited from policies geared toward euro entry. Entry-related declines in interest rates contributed to fast credit growth, including for construction—pushing the ratio of private sector bank credit to GDP to well above the euro-area average. Banks financed the credit expansion to an important extent through foreign borrowing, the counterpart to one of the largest current account deficits (relative

Selected Indicators, 1996-2001

	Euro area		Portugal	
	1996-2000	2001	1996-2000	2001
	(Annual percentage change)			
Real GDP	2.6	1.6	3.7	1.6
CPI	1.8	2.7	2.6	4.4
Unemployment rate	10.5	8.3	5.5	4.1
	(In percent of GDP)			
External current account	n.a.	-0.1	-5.0 1/	-8.7 1/
Private sector credit 2/	n.a.	107	99	140
Structural fiscal balance	-1.5	-0.9	-2.6	-2.7

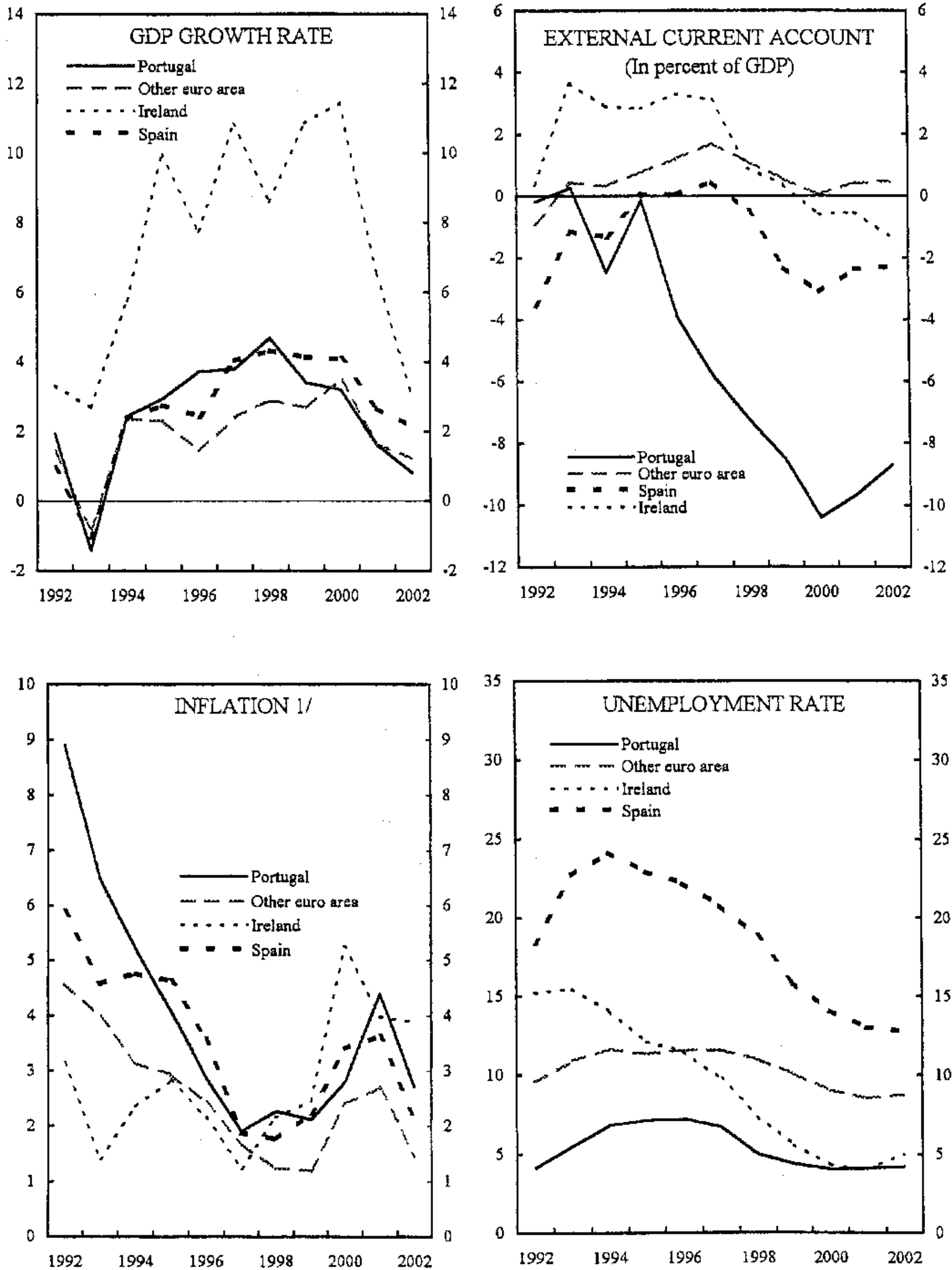
Sources: IMF, *International Financial Statistics* and WEO database.

1/ Including capital transfers.

2/ Data in the 2001 column refer to 2000.

[1] The mission—comprising Messrs. Krueger, Takizawa, Ms. Zanforlin (all EU1), and Mr. Kupiec (MAE)—met with the Governor of the Bank of Portugal, the Ministers of Finance and Planning, and other senior government officials, representatives of regulatory agencies and the financial sector, and labor and business leaders. Mr. Santos, advisor in the Executive Director's office, participated in the meetings. Portugal has accepted the obligations of Article VIII, Sections 2, 3, and 4 (Appendix I).

Figure 1. Portugal: Comparison of Selected Economic Indicators, 1992–2002
(In percent)



Source: Eurostat; and IMF, *World Economic Outlook*.

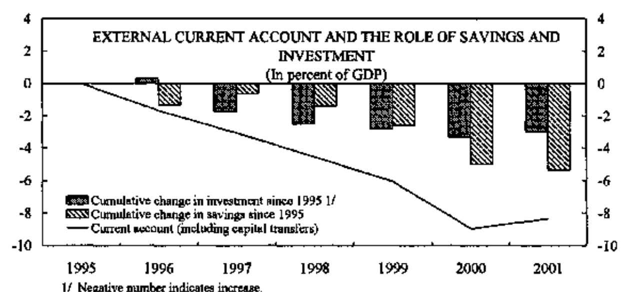
1/ Based on the harmonized index of consumer prices.

to GDP) among advanced economies. Amid these imbalances—and an unfinished fiscal consolidation agenda—economic growth weakened sharply by early 2001.

5. **Domestic demand growth began to slow in the second half of 2000, and sluggish economic growth characterized 2001**. This reflected to some extent the waning effect of the euro-entry-related decline in interest rates (Figure 2), and the completion of related stock adjustments in consumer durables and housing. Export growth remained relatively robust in the first half of 2001, as some sales were redirected from weakening domestic to external markets. As external demand also slowed, however, exports weakened and business investment stalled in the third quarter of 2001.

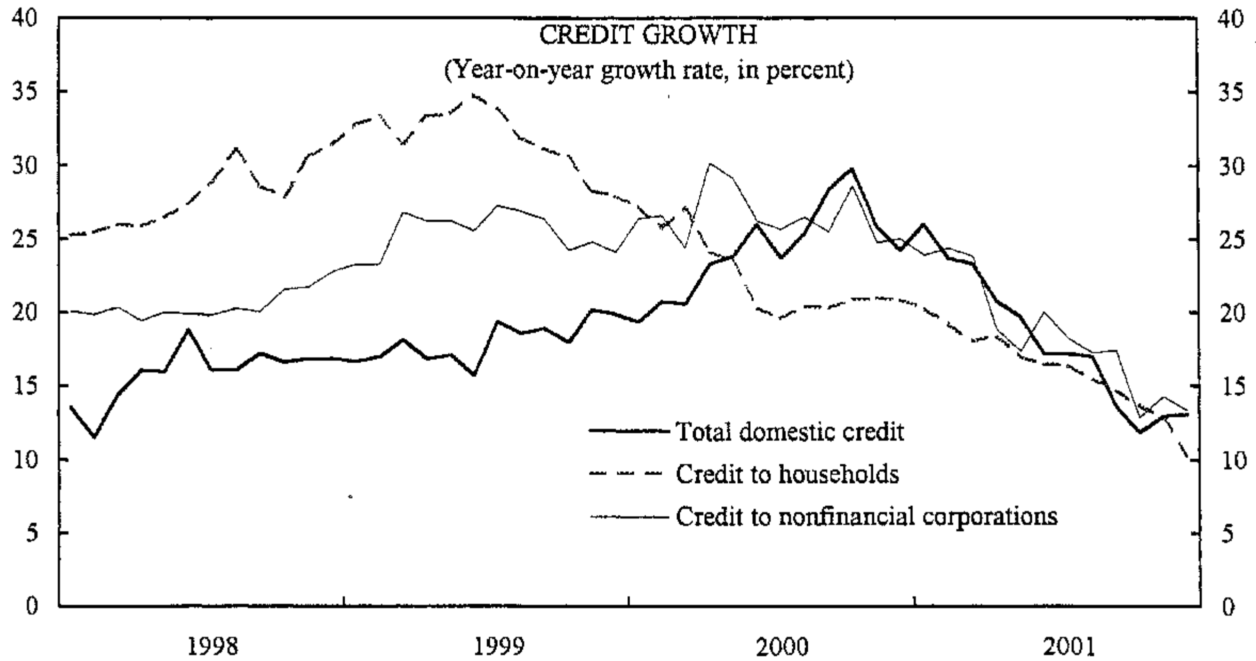
6. **Notwithstanding some deceleration, credit continued to expand considerably faster than incomes—further raising high levels of private sector indebtedness**. After posting growth rates in excess of 20 percent for four consecutive years, private sector credit growth decelerated to around 11½ percent at the end of 2001. Still, credit expanded about twice as fast as disposable income, and household debt now exceeds 90 percent of disposable income. Enterprise borrowing also remained high, buoyed in part by privately funded infrastructure projects. The credit boom has by far outstripped the growth in core deposits, and banks have tapped international capital and interbank markets extensively. Robust credit growth does not appear to have led to high asset price inflation: real estate price increases have been quite moderate (Figure 3)—below rates seen in several other euro-area countries—and a softening real estate market resulted in some real price declines during 2001.

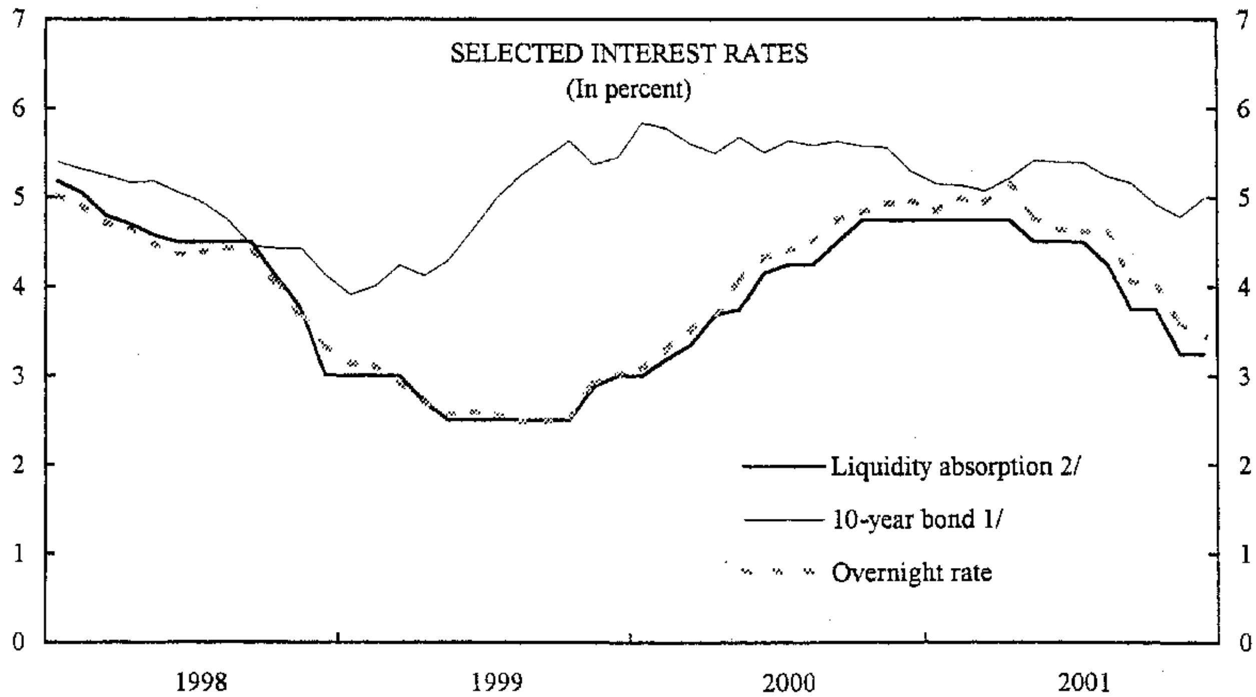
7. **The external current account deficit (relative to GDP) remained very high, and was financed predominantly by bank borrowing**. Improvements in the trade balance in 2001, reflecting weaker import demand (Table 2; and Figure 4), were partly offset by a deterioration in the income account, as the net international investment position continued to worsen and associated income obligations rose. As a result, the external current account deficit (including capital transfers) is expected to decline only moderately in 2001, to some 8¾ percent of GDP—the largest deficit among advanced economies. In terms of the saving-investment balance, well above half of the current account swing from broad balance in 1995 has been due to a fall in the domestic saving rate (in relation to GDP); moreover, the concurrent rise in investment was partly for housing, with limited implications for future export capacity. Cost competitiveness has deteriorated in recent years by about 2 percent per annum vis-à-vis euro-area countries, although its impact was cushioned (on a multilateral basis) by the depreciation of the euro. The current account deficits were largely financed by bank borrowing on the euro market (see below).



8. **With low unemployment and high public sector wage increases, cost pressures have kept inflation well above the euro-area average** (Figure 5). Notwithstanding the weakening of activity, the unemployment rate increased only gradually in the second half of 2001 (to

Figure 2. Portugal: Financial Sector Indicators, 1998:01-2002:1



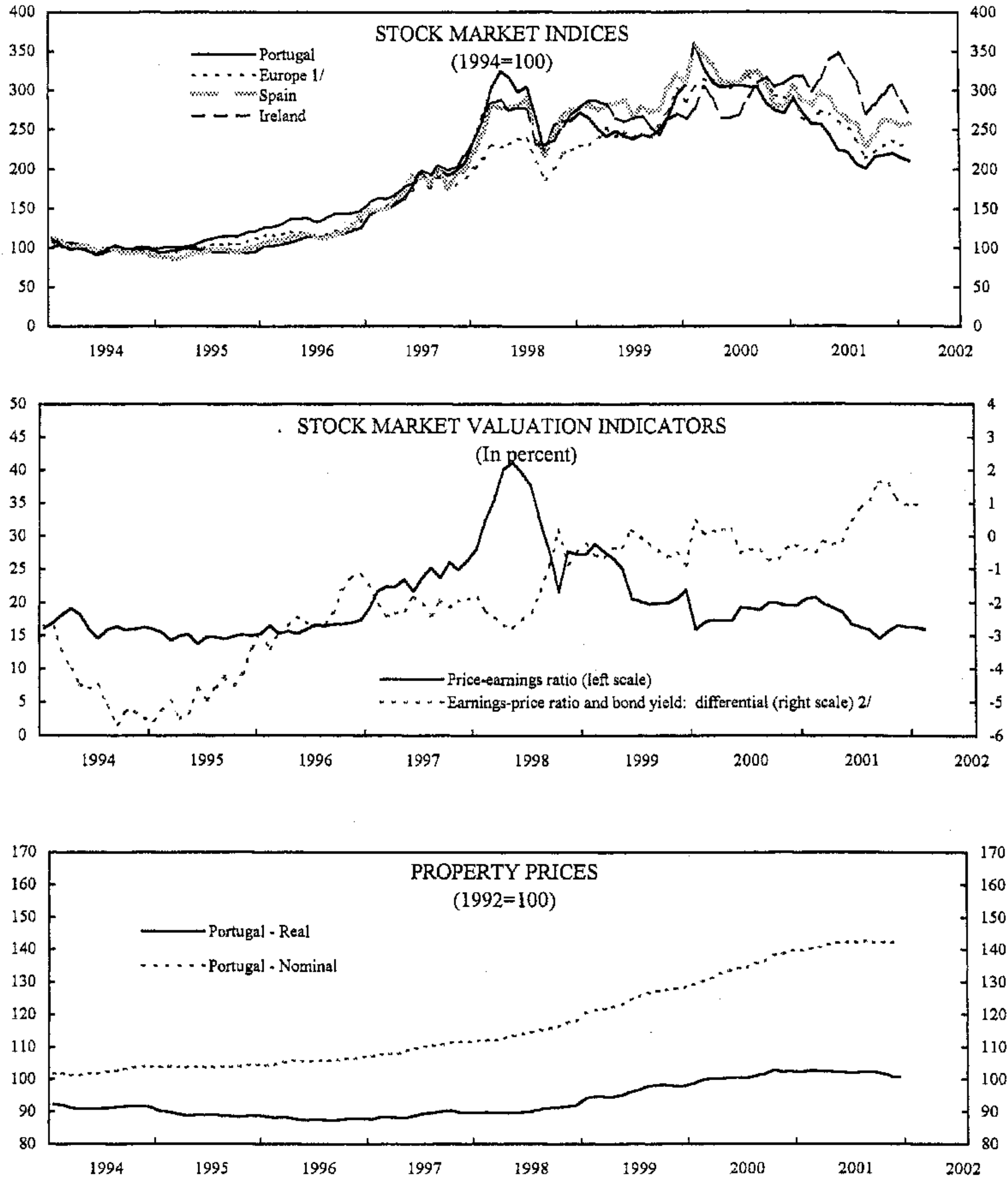


Sources: European Central Bank; and Bank of Portugal.

1/ Secondary market rate.

2/ Since January 1, 1999, figures refer to official rates of the European Central Bank.

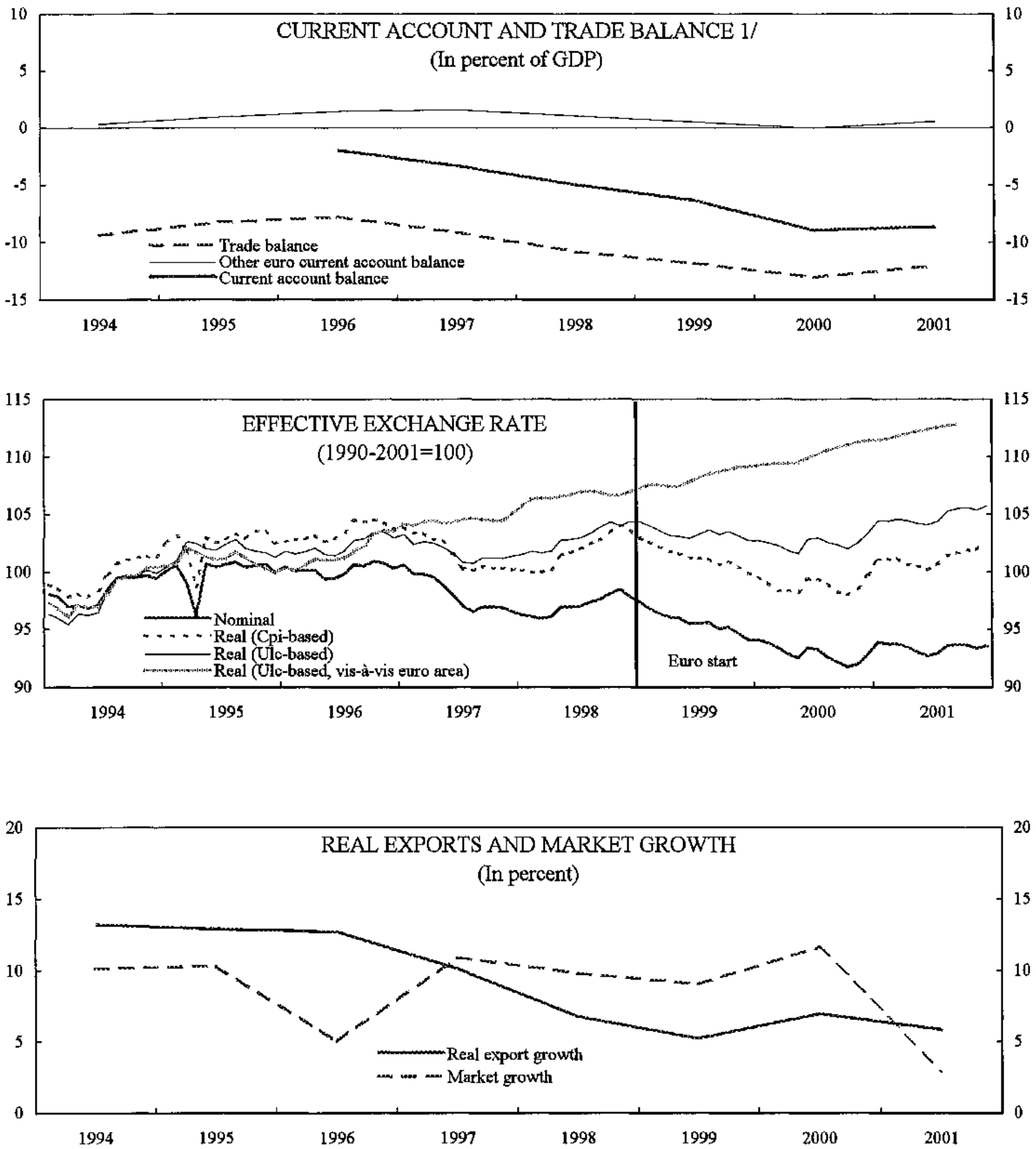
Figure 3. Portugal: Asset Market Indicators, 1994:1-2002:02



Sources: Bank of Portugal; Datastream; and Fund staff calculations.

1/ FTSE Eurotop 100 (in euros).
2/ Differential calculated using 10-year bond rates.

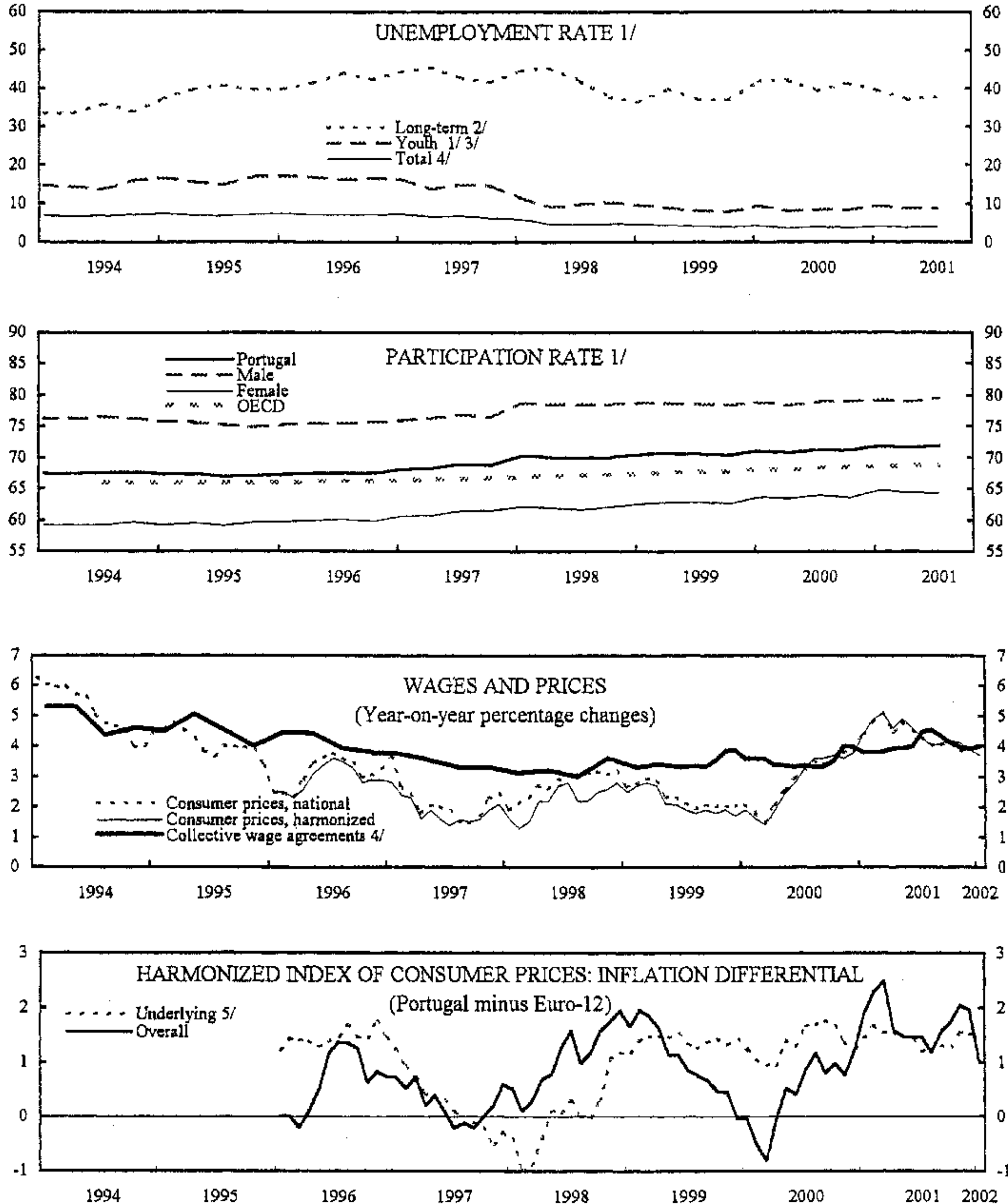
Figure 4. Portugal: External Sector Developments and Exchange Rates, 1994-2001



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

1/ Capital transfers are included in the current account.

Figure 5. Portugal: Labor Market Conditions and Price Developments, 1994-2002
(In percent)



Sources: Bank of Portugal; National Statistics Office (INE); and EUROSTAT.
1/ Change in methodology starting in 1998.
2/ Proportion of total unemployed who have been unemployed for a year or more.
3/ Proportion of those 15-24 years of age who are unemployed.
4/ Three-month moving average weighted by the number of workers covered in each month.
5/ Excluding energy and unprocessed food.

4.1 percent in the fourth quarter). Starting from a tight labor market and with high firing costs, firms seemed reluctant to lay off workers in the initial stages of the demand slowdown. Wage increases in industry were well above increases in the euro area, with the differential not compensated for by higher productivity growth in Portugal. This contributed to a continued core inflation differential vis-à-vis the euro-area average of around 1½ percentage points, above the staff's estimate of the likely Balassa-Samuelson effect (close to 1 percent). For headline inflation, the differential vis-à-vis the euro area has also been influenced by Portugal's petroleum tax scheme—designed to insulate domestic retail prices from world market developments.[2]

9. **The 2001 fiscal stance was expansionary and budget objectives were missed by a wide margin; the 2002 budget implies a tightening of the fiscal stance.** For 2001, the authorities estimate a fiscal deficit of 2.2 percent of GDP, twice the level originally targeted. Several uncertainties still surround these preliminary fiscal estimates, however, and the staff. sees additional risks (discussed below) that would leave the deficit almost ½ percentage point above the authorities' figure. Under the authorities' estimate (and even more so under the staff's) the fiscal stance weakened considerably in 2001—with staff estimating a structural fiscal deficit of around 2¾ percent of GDP, the largest such deficit in the euro area. The updated *Stability Program* targets a reduction in the deficit from the officially estimated 2.2 percent of GDP in 2001 to 1.8 percent in 2002 (versus targets of 1.1 percent and 0.7 percent, respectively, in the previous *Program*).

III. Policy Issues

10. The policy discussions in Lisbon took place amid difficult macroeconomic circumstances: weak global and domestic demand; high and rising private sector indebtedness; a large external current account deficit; sizable wage and price inflation differentials vis-à-vis the euro area; and, by area standards, large fiscal deficits and deficit overruns. Overall, the authorities were, compared with the staff, relatively optimistic that these economic imbalances could be unwound without a further—or prolonged—weakening of economic growth. They suggested that while domestic demand was decelerating, this could in part be compensated by increased export market penetration; credit growth would slow further, reflecting market-based adjustment mechanisms; and wage and price differentials should narrow in the period ahead, as labor market tightness eased. Staff was concerned that inadequate adjustment of the large imbalances could precipitate an extended period of slow growth—reducing indebtedness and saving-investment imbalances through domestic demand compression rather than an export-led expansion, with possibly adverse effects on the financial sector. Agreement existed on the pivotal role of fiscal policy—proceeding with fiscal consolidation, but also improving budget planning, monitoring, and control. Decisive actions in some areas were hampered, however, by

[2] Petroleum tax rates can be adjusted within a band. In 2000, large adjustments stabilized domestic prices when world market prices increased. Small increases in tax rates and retail prices took place in early 2001, followed by tax rate cuts in January 2002.

political constraints—and the government resigned shortly after the mission, following the governing party's defeat in local elections.

A. Economic Prospects

11. **Views differed considerably on the likely extent and duration of the economic slowdown, and thus on growth prospects for 2002.** The *Stability Program* envisaged real GDP growth of 1¾ percent in 2002, the Bank of Portugal some 1½ percent and the staff ¾ percent (latest Consensus Forecasts: 1¼ percent). The authorities thought that several factors would support activity in the period ahead. The easing of monetary conditions (Figure 6) should cushion interest-sensitive demand components—with conditions agreed to be accommodative in light of Portugal's relatively advanced cyclical position (estimates indicated a roughly zero output gap in 2001). In addition, external markets were expected to recover later in 2002, with positive spillover effects for Portugal, and public investment was to accelerate, supported by EU funds. The difference in growth projections reflected divergent views on principally two issues:

- First, on the starting point: while the authorities saw a moderate slowdown during the second half of 2001, staff thought that the deceleration was more pronounced, lowering also prospects for 2002.[3] The staff's more pessimistic view concerned in part external developments—more recent data confirm a sharp weakening of Portuguese export growth, from a relatively brisk pace in the first half of 2001.

- Second, the effects of macroeconomic imbalances on near-term growth: the authorities expected a relatively smooth unwinding of the imbalances, which they generally judged as less severe. The slowdown in domestic demand was not entirely unwelcome in rebalancing growth, and they pointed to relatively robust export growth in the early part of 2001 as an example of the economy's flexibility, shifting resources from weakening domestic to external demand. The staff cautioned, however, that the likely unwinding of the construction boom and large external current account imbalance may prove difficult to achieve without a significant impact on growth. And while relative cost adjustments vis-à-vis partner countries or more flexible labor market arrangements could facilitate the necessary resource reallocations, these were unlikely to be achieved without further reforms (Section III.D).

12. **All interlocutors agreed that an unusual degree of uncertainty surrounded the macroeconomic outlook.** A different weighing of domestic risks was to some extent behind the divergent macroeconomic projections. On the external side, important risks related to the timing and strength of the anticipated recovery in partner countries. The authorities also concurred that the euro had considerable potential to appreciate, which would further aggravate external current account imbalances. They considered competitiveness as broadly adequate, while staff saw risks

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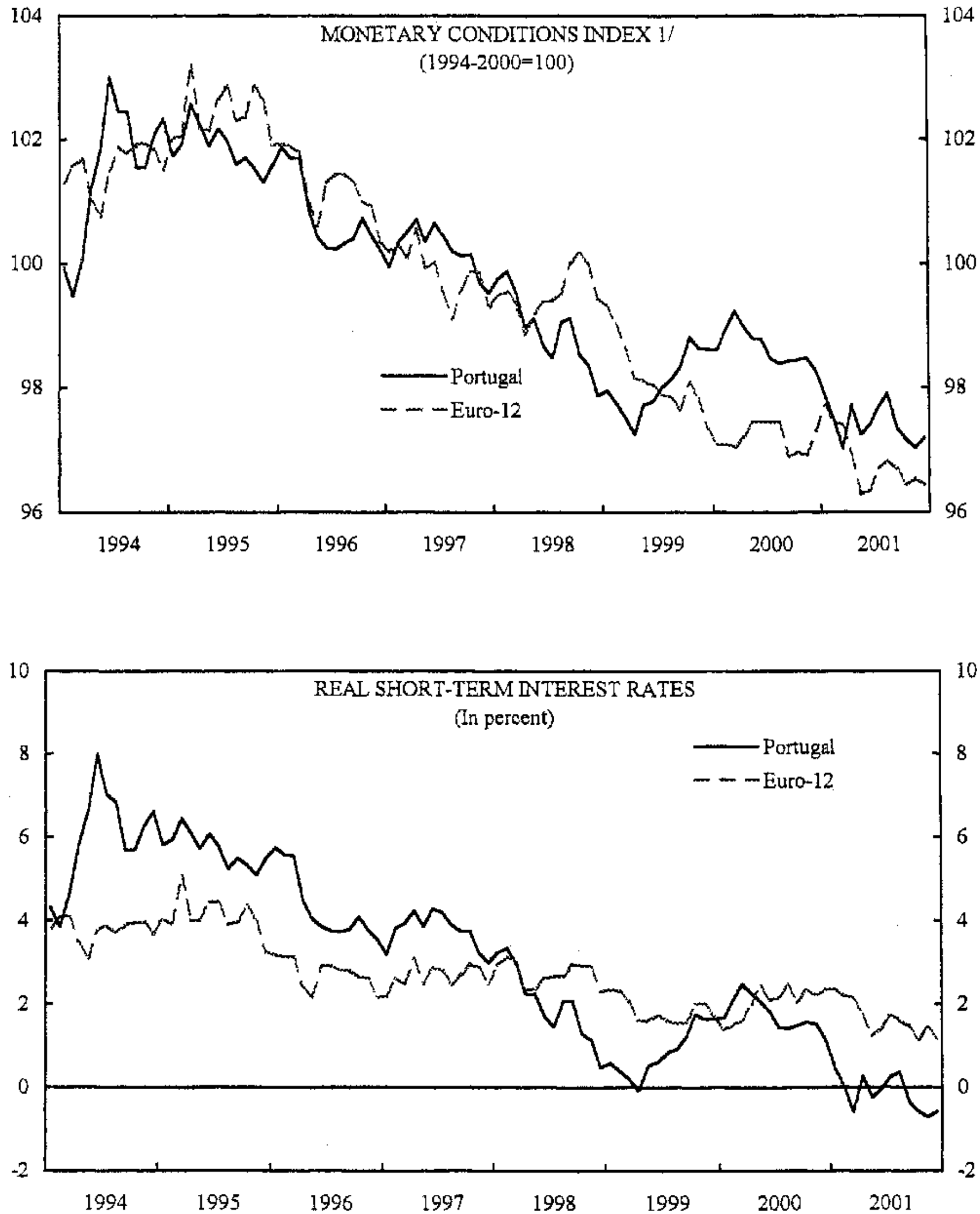
[3] Assessment of the starting point was hampered by quality weaknesses in the quarterly national accounts data (Appendix II). Data released after the mission showed a 1¼ percent (annualized) decline in GDP in the third quarter of 2001, including a marked fall in exports.

Figure 6. Portugal: Monetary Conditions Index and Real Interest Rates, 1994:1-2001:12



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

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

to growth in this regard, with the current account deficit likely to remain well above Portugal's "normal" level over the medium term.[4] It was agreed that, within a monetary union, the current account remained a useful, albeit less proximate, indicator of macroeconomic imbalances, but that financing risks had been sharply reduced with euro entry. Staff noted that a sizable, even if in 2001 declining, portion of the deficit was financed short term (see also Table 2).[5] While typically denominated in euros and thus not entailing a currency risk, such financing was agreed to leave the economy vulnerable to a liquidity squeeze in the euro market—although market participants and the authorities considered the likelihood of such a squeeze as remote. On inflation, the consensus was for a decline broadly in step with partner countries—provided that wage settlements responded to the weakening economy.

B. Fiscal Policy: Adjustment and Structural Reform

13. The fiscal policy discussions focused on four issues: (i) reasons behind the poor budget execution in 2001; (ii) lessons for the future conduct of fiscal policy; (iii) the appropriate pace for fiscal consolidation; and (iv) public expenditure and tax reform to support strong, equitable growth.

Why was fiscal policy execution so poor in 2001?

14. **The authorities saw revenue shortfalls, largely unrelated to the economic slowdown, as the root cause of fiscal deficit overruns in 2001**. They noted that, from the beginning, the 2001 budget was based on overly optimistic revenue assumptions: cuts in corporate income tax rates and a widening of personal income tax brackets were considerably more costly than the authorities had anticipated; relatively small adjustments in domestic petrol prices resulted in a considerable petrol tax shortfall; plummeting car sales lowered associated tax revenues; and for nontax revenues, revised estimates indicated a considerably lower 2000 outturn than anticipated in the budget. Weaker-than-anticipated growth—the budget assumed GDP growth of 3.3 percent, about twice the current staff estimate—also affected revenues (although staff noted that the effect was largely offset by higher-than-budgeted inflation). The authorities noted that weaknesses in tax administration had contributed to a considerably lower revenue-to-GDP elasticity than in previous years.

15. **The staff also pointed to sizable slippages in current expenditures, notwithstanding one-time tightening measures in the latter part of 2001**. Current expenditures were some € 0.9 billion (0.8 percent of GDP) higher-than-budgeted (Table 3). This reflected in particular overruns on personnel costs (rising by almost 9 percent), as well as higher expenditures on

[4] For further analysis, see last year's report (IMF Staff Country Report No. 00/152).

[5] Table 2 overstates the short-term funding of monetary financial institutions to the extent that these reflect interbank deposits by subsidiaries who in turn finance themselves longer term; see also Box 1.

subsidies and on goods and services. Larger overruns were avoided by a June supplementary budget, which tightened cash limits in the second half of the year. Moreover, capital outlays were curtailed sharply, especially in the last part of the year, to limit deficit slippages.

16. **Shortcomings in monitoring and control of fiscal developments outside the central government result in continuing uncertainty concerning the 2001 fiscal outturn.** Differences between the authorities' and the staff's 2001 fiscal deficit estimates (2.2 percent of GDP versus 2.6 percent) relate—aside from small deviations for nontax revenues—principally to the finances of local governments, which had increased spending considerably ahead of municipal elections. The authorities agreed that this risked additional deficit overruns, although available data were limited. The staff's estimated shortfall on this account (0.3 percentage points of GDP) is based on financial sector information as well as fiscal performance during previous election cycles.[6] The authorities indicated that firmer estimates will have to await additional information, and noted plans for more timely data reporting by major municipalities. They agreed that a lack of monitoring and control of government payments and their timely settlement had also contributed to overdue payments, notably for health care and investment. No information was available on the overall amount of overdue payments; it had become common practice for overdue health care payments to be discounted in the banking sector.

Lessons for fiscal policy design

17. **Improving budgetary procedures and tightening expenditure growth were agreed to be key to achieving a stronger fiscal performance, with staff arguing for steps that would go beyond planned initiatives:**

- *Strengthening public expenditure monitoring and control.* At the time of the mission in late 2001, views differed considerably among the staff's interlocutors on fiscal developments. This reflected in part a lack of information—timely data were available only for cash expenditures by the central government, covering little more than half of general government outlays. The authorities noted that steps had been taken to produce more timely cash data for other sectors, including health care. Little progress was envisaged, however, on monitoring not only cash outlays but also expenditure commitments.

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[6] Revisions to estimates for local government balances and nontax revenues have often been sizable. For example, at end-February 2002 the 2000 deficit for local governments was estimated by the authorities at 0.3 percent of GDP, compared with a zero balance estimate a year earlier. The authorities' estimate for 2001 changed only marginally (from zero to a deficit of 0.1 percent of GDP). Estimates for nontax revenues, which accrue to an important extent outside the central government, have also been subject to frequent, and at times sizable, revisions; for example, nontax revenues in 2000 are now 1½ percentage points of GDP lower than envisaged in the January 2001 *Stability Program.*

- *Limiting the growth in current primary expenditures.* The updated *Stability Program* limits the nominal growth of current primary expenditure to 4 percent per annum during 2002–04, an estimated 2 percentage points below the growth of nominal GDP. While staff agreed that this would present a clear break from the past, few of the requisite measures seemed to be in place (see discussion below), including to address the implications of one-time cuts in expenditures in the latter part of 2001 for spending pressures in future years. Moreover, after large increases in recent years, more ambitious expenditure restraint—limiting primary expenditure growth to roughly the inflation rate—seemed advisable in the near term in view of macroeconomic policy challenges. Staff also proposed introducing an explicit commitment to nominal expenditure ceilings; this could help not only in reining in annual expenditure increases, but also in providing market participants with a clear expectation of future government policies, including ultimately the tax burden.[7] The authorities would review these proposals; in the meantime, they were preparing targets for the budget balances of each level of general government: while not set for expenditures, these targets were intended to secure the overall deficit objective.

- *Strengthening tax administration and more realistic budgeting of revenues.* On tax administration, the authorities intended to utilize recent changes in bank secrecy legislation, and were taking steps to strengthen tax auditing and compliance. Even so, staff saw considerable risks to the 2002 revenue projections, which envisaged a ½ percentage point rise in the revenue-to-GDP ratio, including from social security contributions and nontax revenues. In view of the likely weakness of revenue-intensive demand components (consumption, construction, and labor income) and absent specific revenue-raising measures, staff argued for budgeting a broadly stable revenue-to-GDP ratio.

Fiscal deficits: a prudent consolidation strategy

18. **The authorities reiterated their commitment to the Stability and Growth Pact, and in particular to a medium-term balanced budget objective**. With the public debt-to-GDP ratio already below 60 percent of GDP, they considered budget balance an appropriate medium-term target for Portugal. This view was shared by the staff, and also that achieving budget balance by 2004 remained appropriate, provided that growth unfolded broadly along the lines of current staff projections. The 2004 budget balance target was reconfirmed in the December 2001 update of the *Stability Program* (Table 5), notwithstanding the deficit slippage in 2001.

19. **For 2002, the need for progress on fiscal consolidation was not in dispute**. Two considerations favored tightening the fiscal stance, despite weak growth prospects: (i) it would allow fiscal policy to play a part in addressing the large macroeconomic imbalances—an improvement in the government savings balance would strengthen the current account and contain credit growth; and (ii) after the large deficit slippage in 2001, it would provide a signal of the continued commitment to the Stability and Growth Pact (SGP).

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[7] See also *Rules-Based Fiscal Policy and Job-Rich Growth in France, Germany, Italy, and Spain*, IMF Staff Country Report No. 01/203, Chapter II.

20. **The staff saw a case for cautious budget implementation in the early part of 2002, leaving open the possibility of accelerating the pace of fiscal consolidation beyond the budget's objectives.** The case reflected in part staff's deeper concerns about macroeconomic imbalances, but also its view that ad hoc expenditure cuts in 2001 could result in additional expenditure pressures in 2002, and that prudence required not underestimating the risk that the 2001 deficit may have been closer to the 3 percent of GDP ceiling of the SGP than the authorities estimated. This argued for relatively slow expenditure implementation in the first part of 2002, at least until a firmer view emerged on the 2001 fiscal deficit and, thus, on this year's starting point. To eliminate the deficit by 2004, as targeted by the authorities, it was agreed that a roughly equally spaced fiscal consolidation path (in terms of the structural fiscal balance) seemed warranted over the three years 2002–04. Should a larger deficit overrun in 2001 ultimately be confirmed, this would (under the authorities' growth scenario) call for greater expenditure control in order to reduce the overall fiscal deficit in 2002 somewhat beyond the 0.4 percentage points of GDP implied by the budget target. Indeed, the authorities considered a ¾ percentage points of GDP deficit reduction at the time of the mission, but it was not adopted in the updated *Stability Program.* The Economic and Financial Affairs Council (ECOFIN) reviewed Portugal's *Program* in February 2002, against the background of the EU Commission's recommendation to issue an early warning to Portugal in order to prevent an excessive deficit. ECOFIN welcomed the authorities' commitments to ensure that the 3 percent deficit ceiling would not be breached, to close budget monitoring and careful budget implementation in 2002, and to reach a balanced budget by 2004. ECOFIN viewed these commitments as effectively responding to the EU Commission's recommendation and closed the early warning procedure.

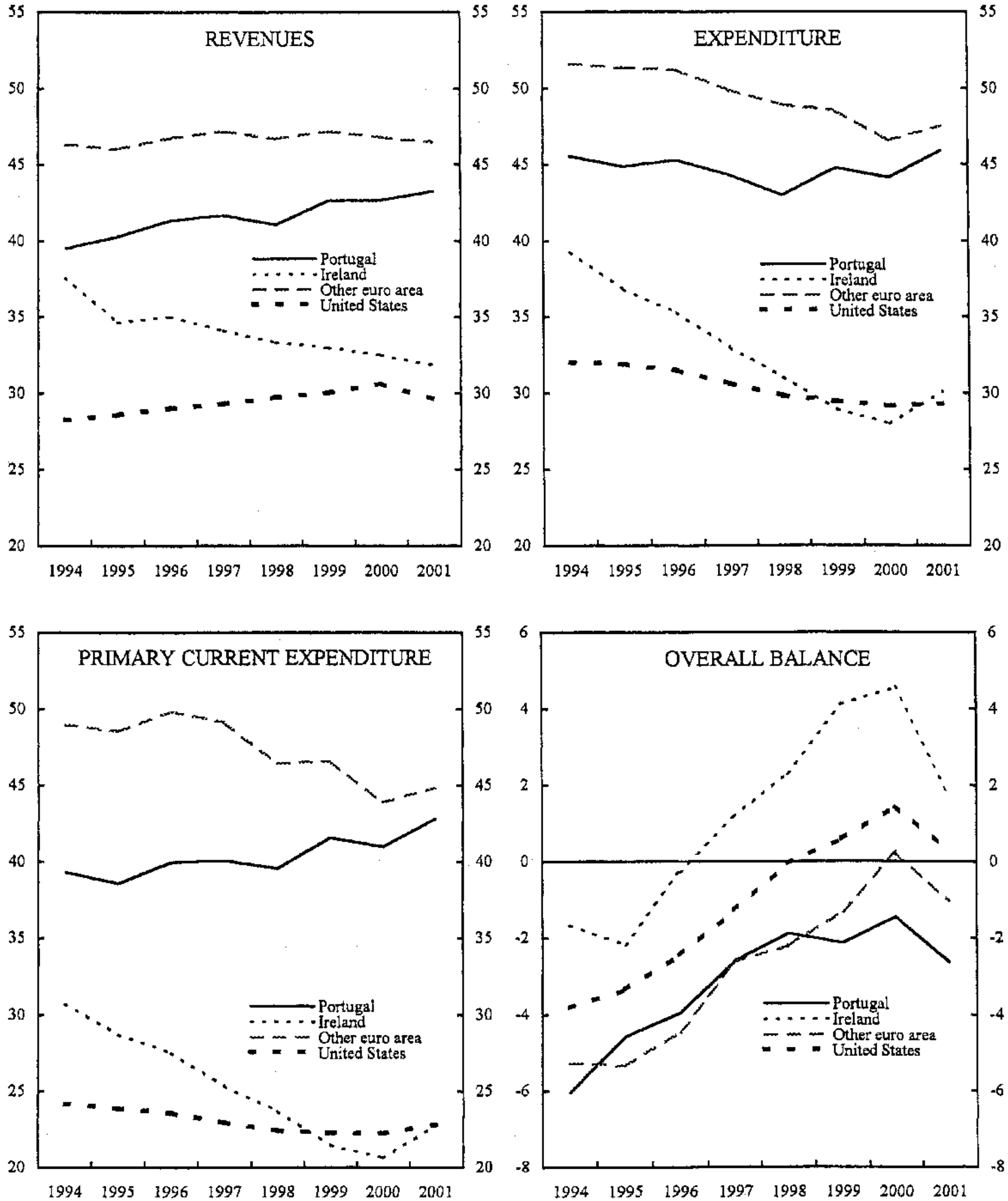
21. **It was agreed that automatic fiscal stabilizers should be allowed to play—around sufficiently ambitious fiscal targets and subject to the constraints of the SGP and to progress in reducing macroeconomic imbalances.** The symmetric play of fiscal stabilizers was incorporated into alternative scenarios of the *Stability Program.* The authorities noted, however, that countervailing steps would be taken if the play of stabilizers jeopardized the 3 percent SGP ceiling—a scenario they considered as very unlikely. They also agreed that insufficient progress in reducing macroeconomic imbalances would call for limiting the play of fiscal stabilizers during the downturn.

Public expenditure and tax reform to support strong, equitable growth

22. **After rapid increases in recent years, the updated *Stability Program* aimed at reducing primary expenditure (in relation to GDP) during 2002–04.** Portugal is the only euro-area country (aside from Greece) where the primary current expenditure ratio has increased since the mid-1990s (Figure 7). The authorities aimed at reversing this trend, lowering the ratio by 2 percentage points of GDP during 2002–04. While some steps had been initiated, reform measures remained to be identified in several key areas:

- **Public sector employment and wages**: driven in part by structural wage adjustments, including structural pay scale increases in the education sector, the wage bill (and related compensation) has risen sharply in recent years, including by close to 9 percent in 2001. In view of the fiscal adjustment needs and with public-private sector wage differentials larger

Figure 7. Portugal: International Comparisons of Fiscal Trends, 1994-2001
(In percent of GDP)



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

than in any euro-area country,[8] staff saw a case for a temporary wage freeze in 2002, together with strict hiring limits. The authorities agreed with the latter, and planned to hire only one person for each four departing the public sector. The base wage was to rise, however, by 2.8 percent in 2002; while this was only marginally lower than in 2001, they expected that the new hiring rule, together with a blocking of all structural wage adjustments, would sharply lower the wage bill expansion.

- **Pension and health care expenditure**: The authorities and social partners explained that recent pension reform steps had improved the system's fairness, notably by basing pension benefits on life-time contributions. It was agreed, however, that these reforms would not achieve major expenditure savings, and expenditures were projected to rise somewhat faster over the coming decades than for the EU average, and by 1 percentage point of GDP during 2002–05. In the staff's view, this jeopardized the authorities' objectives for medium-term expenditure restraint; additional reform steps—along the lines taken in several partner countries—were needed to put the system on a sound footing. Aging-related expenditures would also place pressures on health care. The authorities planned to limit chronic budget overruns in this area by introducing annual ceilings for subsidized pharmaceuticals (where expenditures, in relation to GDP, are among the highest in the OECD); increasing accountability of health care units and hospital managers; and enhancing the role of the private sector.

- **Subsidies and future expenditure liabilities**: after the targeted subsidy reduction was not realized in 2001, it was agreed that this area needed urgent reform (including improving the underlying performance of some public enterprises, for example, in public transportation). The authorities acknowledged also the expansive role of privately funded infrastructure projects, which had contributed to the domestic credit boom. Some of these projects entailed explicit or contingent state liabilities for future years. Staff urged to reflect these explicitly within multi-year budgets, and review the case for curtailing some of these projects.

23. **Placing priority on fiscal consolidation, the authorities saw no room for lowering the revenue burden in coming years**. The *Stability Program* envisaged a 1 percentage point of GDP increase in taxes and social security contributions during 2002–05, stemming from administrative efforts and matching a projected decline in nontax revenues (including EU transfers). While staff agreed that tax reductions should not jeopardize fiscal consolidation, it argued for deeper expenditure cuts—creating room for tax cuts that could cut spur economic growth, especially at a time when many partner countries were lowering their tax burden.

C. Financial Sector Issues

24. **The continuing rapid expansion of bank credit—financed to an important extent on international capital markets—was a shared concern, but all available indicators**

[8] See P. Portugal and M. Centeno, "Wages of Civil Servants," Banco de Portugal, Economic Bulletin (September 2001).

suggested that banks were adequately provisioned and reasonably profitable (see Box 1 for details). With domestic credit outstripping core deposit growth, banks financed themselves in international capital markets—a counterpart to the large external current account deficit. Earlier concerns about liquidity mismatches were attenuated, however, as banks have tapped extensively international capital markets using foreign subsidiaries in offshore financial centers to avoid domestic interest withholding taxes, transferring longer-term euro-denominated funds to a domestic parent using interbank deposits. The authorities underscored that private sector debt burdens have been cushioned by falling interest rates, and while the favorable position regarding nonperforming loans owed to a strong cyclical position, these loans were well covered by provisions. Moreover, the banking system's average risk-weighted capital ratio was almost 11 percent and all systemically important banking groups exceeded regulatory minima.

25. **Financial sector supervision has responded to evolving challenges with new regulatory initiatives and strengthened supervisory coordination.**[9] More recently, in addition to refining data collection to allow proper consolidation, banking supervisors have increased reporting frequency and instituted regular liquidity condition reporting requirements. New capital regulations and supervisory guidance will, in conjunction with recent tax law changes regarding treatment of special purpose vehicles, facilitate asset securitization—a step that market participants expected to improve liquidity and risk management. The National Council of Supervisors—formed in 2000 and comprising all financial sector supervisors—coordinated Portugal's contribution regarding the EU directive on financial conglomerate capital guidelines, and developed regulations and guidelines that allowed banks to issue structured products that include characteristics of traditional securities offerings.

26. **The discussions focused on potential vulnerabilities—and on steps to forestall associated risks.** The authorities agreed to review these and broader financial sector issues in the context of a Financial Sector Assessment Program (FSAP), probably in late 2002. In the meantime, risks were seen as mainly related to macroeconomic imbalances, which could create financial sector stress should economic conditions suffer a prolonged deterioration. Concentrations of banking group investments in mortgages, loans and equity in construction, and large equity interests in infrastructure companies are unlikely to provide diversification benefits in a downturn. Direct exposures to emerging market risks (1.5 percent of total bank assets, net of interbank assets, in mid-2001) were much lower than in many euro-area countries. Of these direct exposures, about 60 percent were to Brazil, which also accounted for important indirect exposures via domestic industrial enterprises. Against this background, the discussions covered several macro-prudential initiatives that could further enhance financial sector resilience:

- *Financial institutions' capital*: Financial institutions recognized that continued access to international capital markets depended on maintaining investors' confidence, and several planned to strengthen their equity capital position. In view of risk exposures, supervisors supported these efforts.

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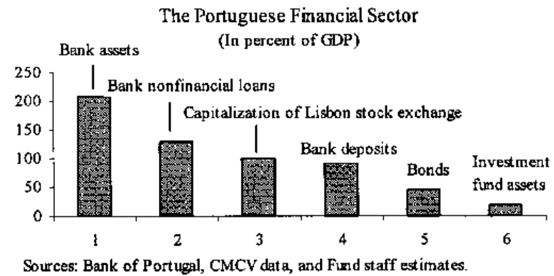
[9] See also last year's report (IMF Staff Country Report No. 00/152).

Box 1. Portugal's Financial Sector

Portugal's financial services sector includes asset management companies, banks, insurance companies, investment (mutual) funds, and pension funds. The financial sector is dominated by five large banking groups that offer a large spectrum of financial services—with Caixa Geral de Depositos owned by the state. Portugal's bond and stock markets are small by European Union standards, and the capitalization of the Lisbon stock exchange is heavily weighted toward banking, telecom, and infrastructure related companies.



Sources: Bank of Portugal, CMCV data, and Fund staff estimates.

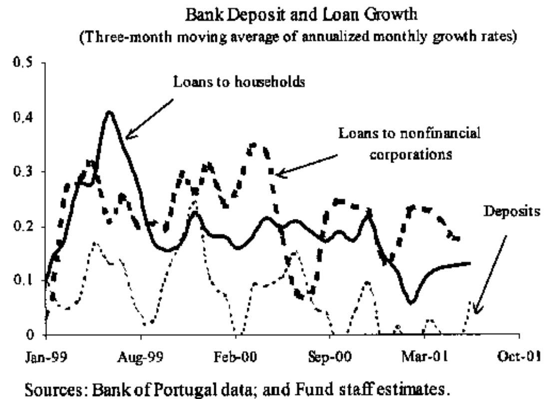
Portugal's entry into the euro area brought significant declines in interest rates that contributed to a credit boom. By the end of 2000, total credit to the private sector had risen to 140 percent of GDP—40 percentage points higher than the euro-area average. Household debt outstanding exceeds 90 percent of disposable income. By the end of 2001, credit growth slowed to 13 percent—still twice the rate of nominal GDP growth.

Market Shares 1/
(In percent)

Bank	Assets	Deposits	Loans
Caixa Geral de Depositos	22	27	28
Banco Comercial Português	22	35	30
Banco Espirito Santo	12	19	17
BSCH/Banco Totta Açores	8	11	12
BPI	8	7	10

Sources: Bank of Portugal; and Fund staff calculations.
1/ Shares are approximate.

The credit boom has not been associated with asset price "bubbles" in either real estate or equity markets. Bank of Portugal indices indicate that housing prices posted moderate real price gains in 1999 and 2000, and small declines in 2001. The value of Portuguese equities, as measured by the PSI 20 index, evolved in concert with share values in other European countries (see Figure 3).



Sources: Bank of Portugal data; and Fund staff estimates.

In recent years, the growth in domestic deposits fell far short of bank funding needs. This shortfall raised concerns in part as official data suggested that banks were funding themselves using short-term interbank deposits. In reality, as far back as 1999, banks began using international capital markets to fund operations. Foreign subsidiaries in offshore financial centers issued euro-denominated bonds, preferred stock, notes, and commercial paper to fund bank operations. Offshore issuance benefited banks by reducing withholding tax liabilities. Funds were transferred to the home office using an interbank deposit. Until recently, official data did not consolidate foreign subsidiaries' accounts and, as a consequence, long-term bank funds raised off shore appeared as short-term interbank loans in regulatory data. For example, when reported on a consolidated basis, foreign interbank liabilities fell from € 54 billion to € 27 billion—although detailed information on the maturity structure of the subsidiaries' liabilities was not available.

Notwithstanding concerns associated with private debt burdens, available information suggests that the credit quality of bank loan portfolios is good, and that banks are adequately provisioned, profitable, and capitalized at levels consistent with Basel regulatory minima. Present conditions aside, bank investments are concentrated in domestic real estate and construction lending and investments in domestic infrastructure companies. If growth falters, the credit quality of bank loan portfolios will deteriorate and other bank investments are unlikely to provide significant diversification. Given the substantial increase in private sector debt burdens and the growth in available housing, business, and retail space, there is the potential for loan losses to exceed historical experience.

Banking Statistics

NPLs as a percentage of total loans 1/	1.8
Provisions for loan losses as a percentage of total loans 1/	2.5
Interest income as a percentage of assets 2/	6.7
Interest expense as a percentage of assets 2/	4.5
Net commissions as a percentage of assets 2/	0.6
Return on assets (net income to assets in percent) 2/	0.8
Return on equity (percent) 3/	16
Regulatory capital ratio (BIS, percent) 1/	10.9
Interbank deposits (unconsolidated global reporting, in billions of euro) 4/	54
Interbank deposits (consolidated reporting, in billions of euro) 4/	27

Sources: Bank of Portugal; and Fund staff calculations.
1/ Third quarter 2001 regulatory reports.
2/ BOP estimate based upon June 2001 data annualized.
3/ Bank of Portugal estimate.
4/ Short-term liabilities vis-à-vis foreign banks, as of June 2001.

- *Nonperforming loan (NPL) classifications*: Under present regulations, only overdue interest and principal payments are recorded as delinquent, not the entire balance on the delinquent account. As a result, NPL data reflect credit market conditions with a considerable lag. NPL data are widely used as a measure of the credit quality of loan portfolios, and the authorities agreed that the current definition of NPL reduced its value as an indicator of bank asset quality. They were reviewing the staff's suggestions to classify the full amount of delinquent loans as nonperforming, and require public disclosure of this data.

- *Taxonomy for bank lending*: At present, private sector credit statistics are reported under fairly aggregated categories that may hinder the timely assessment of credit developments and sectoral exposures, including to the public sector. The authorities were studying the staff's suggestion for refining the taxonomy of credit statistics—for example, to identify all infrastructure-related lending and discounted claims on overdue payments of the public sector. Along with the revised regulatory NPL definition, this would enhance macro-prudential monitoring capabilities.

D. Structural Policies to Support Economic Adjustment and Growth

27. **The authorities agreed that structural reforms could facilitate a successful unwinding of the macroeconomic imbalances and would be indispensable for strong medium-term growth**. The discussions were framed against two major policy challenges. One, Portugal's relatively high growth vis-à-vis the euro-area average had owed much to increases in factor inputs. With participation and investment rates already high, future growth could not depend to the same extent on factor-intensive growth, necessitating rapid factor productivity increases—an area where Portugal has lagged behind partner countries in previous years.[10] Two, the unwinding of macroeconomic imbalances was likely to require a redirection of resources from domestic uses toward exports. In particular, with the waning of the construction boom and, over time, declining EU structural funds, sustaining high growth while also narrowing the large external current account deficit would require substantial gains in export markets.

The Factor Intensity of Growth in Portugal, 1990–2000
(In percent)

GDP growth	2.7
Contribution of:	
Capital	2.1
Labor	0.5
Total factor productivity	0.1
Memorandum items:	
Participation rate (2000)	
Portugal	75.2
Euro area	68.1
Investment-to-GDP ratio (2001)	
Portugal	25.7
Euro area	21.1

Sources: Bank of Portugal; OECD; and Fund staff calculations.

28. **The authorities were more confident than staff that present labor market institutions were compatible with robust medium-term growth**. They pointed to real wage flexibility and the successful integration of a growing labor force, securing one of the lowest unemployment rates in Europe. Staff agreed that labor market outcomes had been among the

[10] See selected issues paper (SM/02/41, 2/8/02). Slow productivity growth is likely to have reflected in part shortcomings in the education system; see B. Clements, "The Efficiency of Education Expenditure in Portugal," IMF Working Paper (WP/99/179).

more impressive features of Portugal's economic performance. It cautioned, however, that the market's future performance was jeopardized by one of the lowest labor mobility rates among industrial countries (Box 2). While low mobility may hamper efficient resource allocation and growth generally, concerns were heightened for Portugal at the present juncture, since the unwinding of macroeconomic imbalances could require sizable sectoral resource shifts. The authorities accepted that relatively high firing costs may at times hinder economic efficiency, but were not convinced enough of the potential economic benefits to initiate reforms, which would be politically difficult. They noted that output (rather than employment) could oftentimes be redirected, with the relatively good export performance in 2001 (in the face of weakening domestic demand) but one example. In other areas, all interlocutors agreed on the need for improving vocational training and general education, where Portugal still ranks poorly in international comparisons.

29. **Deregulation and privatization have advanced considerably in recent years, and discussions focused on ways to ensure competitive market outcomes**. In telecommunications, prices are broadly in line with the EU average, but increasing competition remains an issue, especially for local fixed-line traffic. In the electricity sector, the vertically integrated incumbent maintains a dominant position, although the authorities expected efficiency gains from creating a single market with Spain, planned for 2003. The staff noted that enforcing effective competition in other sectors was hampered by the limited mandate and resources of the Competition Council. While the Council was itself independent, it had no mandate to decide the cases that would be investigated—investigations are generally initiated and conducted by an agency within the ministry of economy—or to formally assess merger activities. The authorities were reviewing the staff's suggestion of expanding the mandate and resources of a fully independent competition agency, giving it a status similar to agencies in many partner countries.

E. Statistical and Other Issues

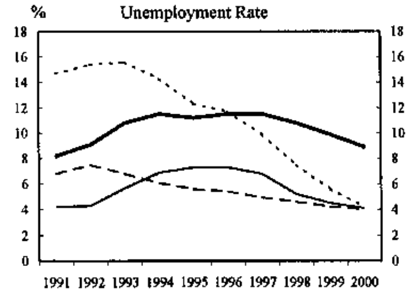
30. Portugal subscribes to the SDDS and its core **economic data** are provided in a comprehensive manner to the Fund. The authorities agreed, however, on the need to improve the statistical database, including for the real and fiscal sectors (Appendix II).

31. The authorities expressed a preference for **external trade liberalization** within a multilateral framework. On a case-by-case basis, consideration may be given to accelerating external trade liberalization for specific country groups or initiating new trade agreements.

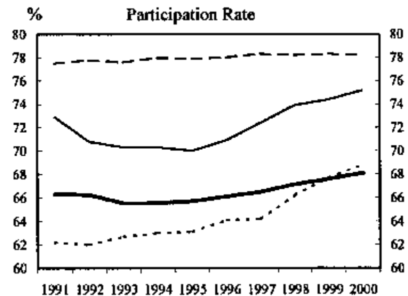
32. The authorities strongly supported the strengthening of **anti-money laundering** measures, prepared under the aegis of the EU. In the financial sector, the National Council of Supervisors has coordinated anti-money laundering efforts—including in conjunction with the launch of the euro currency—and is charged with implementing the Financial Action Task Force (FATF) recommendations concerning noncooperative countries and jurisdictions. The OECD's **antibribery** convention was adopted in January 2001.

Box 2. Low Labor Mobility: A Hindrance to Stronger Growth in Portugal?

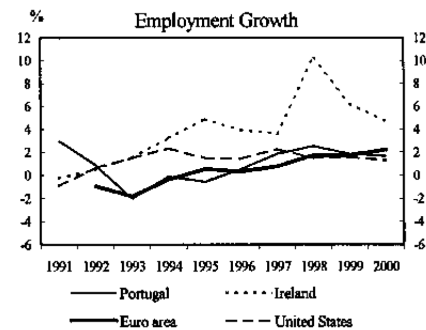
Low labor mobility—reflecting in part strong employment protection—may have hindered more efficient resource allocation in Portugal and contributed to relatively slow productivity growth. This box discusses labor mobility within the broader context of the Portuguese labor market's performance. As noted in the main text, these issues are taking on added urgency as the smooth unwinding of present imbalances is likely to require accelerating productivity growth and reallocating resources, including for labor.



Notwithstanding low labor mobility, Portugal's labor market has functioned well in many respects. The unemployment rate has been low and relatively stable; the participation rate has reached levels close to those in Scandinavian countries and the United States; and employment growth has exceeded, albeit modestly, the euro-area average over the past decade. At the same time, Portugal's labor mobility has been low compared with other industrialized countries (see tabulation below), as indicated by the share of workers separating from establishments (worker separation rate) and by the mobility rate—a measure of worker separations, normalized by the size of the reallocation of employment opportunities. Moreover, the flow of workers into unemployment is one of the smallest among the euro-area countries.



Strict employment protection, including for dismissals, is likely to have contributed to low labor mobility. Dismissal restrictions include various notification requirements, mandatory severance pay, and reinstallation with full back-pay or compensation for unjustified dismissals. Additional requirements apply to collective dismissals. In all, employment protection in Portugal is ranked as the most restrictive among OECD countries (OECD, 1999).



Sources: EUROSTAT, NewCronos database; OECD, Annual Labor Force Statistics; and OECD, Analytical database.

Dismissal costs may affect an economy's productivity in three important ways. First, continued unproductive employer-worker matches, which would be dissolved under lower dismissal costs. Second, diminished job creation, reflecting the low value of future profits which employers expect from new higher-productivity jobs. Blanchard and Portugal (2001) argue that these two implications of dismissal restrictions could lead to significant aggregate output losses.[1] Third, reduced total factor productivity growth, to the extent that technical progress can be embodied at lower costs in new rather than existing jobs. While lower worker separation rates may encourage some job-specific human capital investments, the very low mobility observed in Portugal is, overall, likely to have hindered productivity growth.

Worker Separation and Mobility Rates 1/
(In percent of employment, except where indicated otherwise)

	Worker Separation	Mobility Rate 2/	Sectors
1. **Portugal**	16.4	1.1	All sectors
2. Denmark	28.0	2.4	Manufacturing
3. Finland	24.8	2.7	Manufacturing
4. Germany	30.4	4.1	All sectors
5. Italy	33.6	3.4	All sectors (firms)
6. Netherlands	15.7	1.9	Manufacturing
7. Norway	23.0	1.8	Manufacturing
8. United States	50.4	1.7	All sectors

Sources: Albæk and Sørensen (1998); Blanchard and Portugal (2001); Davis and Haltiwanger (1999); Hohti (2000); Lane, Stevens, and Burgess (1996); OECD (1996); and Fund staff calculations.

1/ Sample period varies across countries.
2/ Ratio of worker separation rate to job destruction rate.

[1] O. Blanchard and P. Portugal, "What Hides Behind an Unemployment Rate: Comparing Portuguese and U.S. Labor Markets," *The American Economic Review* 91 No. 1 (2001): 187–207.

IV. Staff Appraisal

33. **After an extended period of real convergence in living standards, the Portuguese economy has weakened markedly—amid sizable macroeconomic imbalances.** Since the mid-1990s, economic growth in Portugal has exceeded the euro-area average, contributing to one of the lowest unemployment rates in the area. At the same time, inflation and interest rates declined to historically low levels. By mid-2001, however, economic growth weakened sharply, with domestic factors exacerbating spillovers from the global slowdown. With policy adjustments not fully commensurate to the demands of monetary union, sizable macroeconomic imbalances emerged: domestic demand outpaced production growth, and the external current account deficit widened sharply; household and enterprise indebtedness rose at unsustainable rates; and the fiscal deficit increased sharply in 2001 and remains large compared with other euro-area countries.

34. **Against this background, the new government will have to undertake decisive actions to facilitate an orderly unwinding of macroeconomic imbalances—laying the foundation for rapid, equitable real income convergence.** Absent policy adjustments, there is a risk of prolonged slow growth, with imbalances narrowed by demand compression. The financing of the large external current account deficit also underscores the importance of sound macroeconomic policies, in order to maintain investor confidence. Relative cost and price adjustments could facilitate the needed sectoral resource shifts by strengthening competitiveness. Within monetary union, this calls principally for nominal wage moderation—and, for the public sector to lead by example, wage increases and wage drift will have to be curtailed sharply from levels of recent years.

35. **Improving fiscal policy design and implementation will be critical to strengthening the economy's performance.** The lessons from the sizable fiscal slippages in 2001 argue for steps in three areas in particular: improving public expenditure monitoring and control—covering also sectors outside the central government as well as expenditure commitments; limiting the growth in nominal primary expenditure—a policy whose benefits could be leveraged by introducing binding expenditure ceilings; and strengthening tax administration and adhering to realistic revenue budgeting.

36. **The *Stability Program's* objective—structural budget balance by 2004—is appropriate, but sufficient progress is needed already in 2002.** After the deficit slippage in 2001, it is all the more important that the next government will reconfirm Portugal's commitment to the medium-term *Stability Program* target—a balanced budget by 2004 in structural terms (excluding the temporary effects of the business cycle). Equally phased structural consolidation during the years 2002–04 should broadly balance the different demands on fiscal policy, with rising public saving strengthening the external current account and containing credit growth. For 2002, this may call for accelerating fiscal consolidation beyond the pace envisaged in the budget, should the 2001 fiscal deficit ultimately be higher than presently estimated by the authorities. Until uncertainties about the durability of expenditure cuts in the latter part of 2001 and about the 2001 fiscal outturn have been resolved, prudence argues for cautious expenditure execution. At present, however, doubts remain whether all the elements are

in place to meet even the budgeted fiscal adjustment. Were growth in 2002 ultimately to fall short (as expected by staff) or be stronger than anticipated in the budget, fiscal revenue stabilizers should be allowed to play, provided that this would not jeopardize the containment of macroeconomic imbalances or risk a breach of the Stability and Growth Pact's ceiling.

37. **Reining in the growth of nominal expenditures will be indispensable for achieving fiscal consolidation, and a signal could be provided by complementing the fiscal balance targets with an explicit commitment to nominal expenditure ceilings.** The *Stability Program's* objective of limiting primary expenditure increases to 4 percent per annum would present a break from the past, when expenditure increases have far outstripped income growth. To secure early progress on fiscal consolidation, however, consideration should be given to initially tighter limits—constraining expenditure increases to inflation.

38. **Achieving public expenditure restraint will require measures in several areas.** Most immediate is a need to curtail the public sector wage bill, where several years of rapid increases in compensation and employment have undermined fiscal consolidation. Potential savings from the intended hiring of only one new worker for every four who leave the public sector have to be evaluated carefully, notably as retirees would draw civil service pensions. Moreover, the rule should cover the whole public sector—with redeployment within the sector supporting areas of greatest need. With public-private sector wage differentials being well above the euro-area average, consideration should be given to limit *actual* wage increases (i.e., the rise in the wage bill per employee, including the effects of promotions and any structural pay-scale adjustments) to at most the targeted inflation rate in 2002, and broadly similar targets for coming years. On pensions, the recent legislation establishes a closer link between contributions and benefits. However, reforms are needed to limit aging-related expenditure increases to levels that are financeable and leave sufficient room for other social objectives. In the health care sector, recent steps are facilitating expenditure monitoring; but additional actions will be needed should other reform measures, notably on pharmaceuticals, not deliver their intended savings. Sustained progress on expenditure restraint should, in time, also create room for tax reductions, preferably keeping pace with the sizable reductions underway in other euro-area countries.

39. **Sizable expenditure commitments are incurred outside the annual budget and their fiscal as well as macroeconomic implications need to be reviewed carefully.** The fiscal costs of these expenditures, including for privately funded infrastructure projects, should be fully integrated into the government's medium-term expenditure program; and all relevant expenditures need to be publicly recorded in a transparent multi-year framework, including in the context of the annual budget. Moreover, in the health care and the public sector more broadly, all expenditure obligations should be settled in a timely fashion. The incoming government may find it useful to explore these and other issues in the context of undertaking a fiscal module of a Report on the Observance of Standards and Codes.

40. **In the financial sector, supervisory and regulatory changes have responded to strong credit growth and rising private sector indebtedness.** Credit growth, while decelerating, continues to outpace income growth by a wide margin and measures of private sector indebtedness are high both historically and in comparison with many other countries. In

response, supervision has rightly been intensified—including with increased reporting requirements and strengthened supervisory coordination. At the same time, banks remain profitable and have adequate provisions and capital relative to regulatory standards. A more definitive assessment of the sector will have to await a Financial Sector Assessment Program; the authorities' intention to undertake this in late 2002 is most welcome.

41. **Looking ahead, the policy challenge is to adjust to evolving financial market conditions and forestall potential risks.** In view of macroeconomic imbalances with possibly adverse effects on the banking sector, supervisory guidance on increasing equity capital positions, where warranted by potential risks, is well placed. Consideration should also be given to introducing a new nonperforming loan category that classifies the full amount of delinquent loans as nonperforming, and to requiring public disclosure of this data.

42. **Portugal's growth prospects will ultimately depend on raising productivity growth.** In this regard, fiscal and financial sector policies, along the lines envisaged above, can play an important role, but structural reforms in other areas are also needed. To strengthen competition and raise efficiency, the resources and mandate of the Competition Council should be expanded, empowering the Council to have the independent power to direct, or to undertake itself, all investigations concerning competition issues. In the labor market, performance has in many respects been remarkable, recording low unemployment and high employment growth. Portugal stands out, however, in terms of low labor market mobility, possibly resulting in inefficient labor market allocations. This could hamper productivity growth as well as the resource reallocations needed to unwind present imbalances. To facilitate labor mobility, consideration should be given to reduce the relatively high dismissal costs and to further strengthen job training (and education more generally).

43. **Statistical data weaknesses in some areas hamper the assessment of economic conditions and some aspects of Fund surveillance.** Notably, enhanced efforts are needed to improve real and fiscal sector statistics in several areas.

44. The authorities are encouraged to support the full **liberalization of imports** from the least developed countries; and to raise **official development assistance** from its low level (0.3 percent of GNI in 2000) to the UN target.

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

Table 1. Portugal: Selected Economic Indicators, 1996–2002 1/
(Changes in percent, except as otherwise indicated)

	1996	1997	1998	1999	2000	Est. 2001	Proj. 2002
Domestic economy							
Real GDP	3.6	3.8	4.7	3.4	3.2	1.6	0.8
Real domestic demand	3.1	5.2	7.1	5.4	2.9	0.7	0.6
Private consumption	3.3	3.0	7.3	5.5	2.8	1.0	0.6
Gross fixed investment	4.8	14.4	9.1	5.2	4.0	-0.3	0.0
Foreign sector contribution	-6.6	-1.4	-2.8	-2.4	-0.1	0.8	0.2
Employment	0.6	1.9	9.4	1.8	1.7	1.5	0.3
Unemployment rate	7.3	6.7	5.0	4.4	4.0	4.1	4.2
Output gap	-1.6	-0.5	1.0	1.3	1.4	0.2	-1.4
Compensation per worker (manufacturing)	4.9	4.8	4.8	4.5	5.1	5.4	4.8
Unit labor costs (manufacturing)	-5.9	2.1	2.8	3.9	2.6	4.2	4.2
Consumer prices (national index)	3.1	2.2	2.8	2.3	2.9	4.4	2.7
Consumer prices (harmonized index)	2.9	1.9	2.2	2.2	2.8	4.4	2.7
GDP deflator	3.6	3.1	4.3	3.4	2.8	4.4	3.0
External accounts							
Export volume	12.7	10.1	6.7	5.2	6.0	5.6	4.0
Import volume	8.4	13.2	15.2	10.3	5.1	3.6	2.2
Export unit value	-1.9	2.1	0.4	-0.9	5.2	0.7	4.3
Import unit value	1.3	2.3	-1.6	-1.0	8.2	-0.9	3.4
Trade balance (in percent of GDP)	-7.8	-9.2	-10.8	-11.9	-13.1	-12.0	-11.5
Capital transfers (net, US$ billions)	2.2	2.8	2.5	2.5	1.5	1.1	2.0
Current account including capital transfers (US$ billions)	-1.9	-3.3	-5.3	-7.4	-9.6	-9.5	-8.3
(in percent of GDP)	-1.7	-3.1	-4.7	-6.4	-9.0	-8.7	-7.5
Nominal effective exchange rate	-8.6	-2.1	-1.0	-1.4	-2.9	...	...
Real effective exchange rate (CPI based)	-4.5	-1.8	0.2	-0.5	-2.5	...	...
General government finances (in percent of GDP) 2/							
Revenues	41.3	41.7	41.1	42.6	42.8	43.2	44.4
Expenditures	45.3	44.3	43.0	44.8	44.3	45.9	47.0
Of which: capital expenditures	5.8	6.0	5.6	5.8	4.9	5.9	6.8
Overall balance	-3.8	-2.6	-1.9	-2.1	-1.5	-2.6	-2.6
Structural balance	-3.5	-2.4	-2.3	-2.7	-2.4	-2.7	-2.0
Primary balance	1.4	1.6	1.5	1.0	1.5	0.4	0.5
Privatization receipts	2.7	4.7	3.8	1.4	2.2	0.4	...
Government debt, Maastricht definition	62.4	59.1	54.6	54.0	53.3	55.7	56.0
Financial variables 3/							
National contribution to euro area M3	6.1	6.3	7.8	9.8	6.6	4.5	...
Domestic credit	12.6	11.6	16.8	19.9	24.5	13.1	...
Credit to the private sector 4/	16.8	20.7	25.0	26.2	24.2	11.6	...
Interest rates (percent)							
Overnight rate	6.7	5.1	3.3	3.0	5.0	3.5	...
Deposit rate, 91–180 days	5.5	4.6	3.3	2.8	4.5	3.5	...
Lending rate, 91–180 days	11.0	8.4	6.0	5.1	6.4	5.5	...
Government benchmark bond	7.0	5.7	4.1	5.5	5.3	5.1	...

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

1/ Unless otherwise noted, 2001 and 2002 data are staff estimates or projections.
2/ For 2000, including UMTS receipts of 0.3 percent of GDP as a negative entry under capital expenditure; however, these receipts are removed for the purpose of calculating the structural balance.
3/ End-of-period data.
4/ Comprises all domestic credit except that to the central government.

Table 2. Portugal: Balance of Payments, 1996–2001

	1996	1997	1998	1999	2000	2001
			(In millions of U.S. dollars)			
Current account	-4,090	-6,057	-7,888	-9,866	-11,070	-10,571
Trade balance	-8,806	-9,773	-12,273	-13,750	-13,926	-13,172
Exports fob	24,837	24,441	25,751	25,434	25,198	25,946
Imports fob	33,643	34,214	38,024	39,184	39,125	39,117
Services, net	1,380	1,420	1,929	1,731	1,763	2,478
Of which						
Tourism	2,435	2,520	3,153	3,001	3,026	3,382
Exports	4,670	4,572	5,492	5,262	5,257	5,487
Imports	2,235	2,052	2,339	2,261	2,231	2,105
Income	-979	-1,455	-1,649	-1,766	-2,313	-3,120
Current transfers, net	4,314	3,751	4,105	3,919	3,406	3,242
Private remittances, net	3,337	3,268	3,345	3,334	3,241	3,297
Official transfers, net	977	482	760	585	166	-55
Capital account	2,178	2,806	2,550	2,485	1,512	1,061
Current account (including capital transfers)	-1,912	-3,251	-5,338	-7,381	-9,558	-9,511
Financial account	3,908	4,670	5,509	8,794	11,194	10,331
Direct investment	693	559	-741	-1,826	-586	-1,881
Portuguese investment abroad	-764	-1,900	-3,875	-3,094	-7,174	-5,129
Foreign investment in Portugal	1,457	2,459	3,134	1,268	6,588	3,248
Portfolio investment, net	-1,558	631	-693	3,340	-1,763	581
Equity securities	914	1,808	1,176	-1,389	-561	-1,195
Long-term debt securities	-2,100	-3,682	-591	3,463	-2,024	-615
Money market instruments	-372	2,505	-1,278	1,265	821	2,392
Financial derivatives	-29	-23	132	199	313	255
Other investment, net	5,498	4,822	7,313	7,357	13,612	12,227
Of which						
Monetary financial institutions	5,787	3,559	8,579	7,829	10,899	13,137
Of which						
Short-term	5,562	4,903	7,125	3,842	8,166	5,444
Long-term	289	-1,370	1,379	3,989	2,733	7,694
Reserve assets	-696	-1,320	-501	-276	-381	-852
Errors and omissions	1,996	1,419	171	1,413	1,636	820
			(In percent of GDP)			
Memorandum items:						
Current account	-3.6	-5.7	-7.0	-8.5	-10.4	-9.6
Current account (including capital transfers)	-1.7	-3.1	-4.7	-6.4	-9.0	-8.7
Net international investment position 1/	-9.2	-15.8	-23.2	-30.4	-39.4	-41.7

Sources: Bank of Portugal; and Fund staff calculations.

1/ End-of-period data.

Table 3. Portugal: General Government Accounts, 1997–2002

	1997	1998	1999	2000	2001			2002		
				Est.	Budget	Auth. Est. 1/	Staff Est.	Budget	Auth. Est. 1/	Staff Proj. 2/
					(In millions of euros)					
Total revenues	38,774	41,748	46,317	49,284	54,627	53,168	52,981	57,462	57,097	56,686
Current receipts	36,554	39,861	44,334	47,358	51,487	50,305	50,118	53,455	53,032	52,679
Taxes on goods and services	13,193	14,542	16,119	16,729	18,481	17,894	17,894	19,052	18,957	18,645
Direct taxes and social security	19,719	21,322	23,626	25,858	27,384	27,462	27,276	28,788	28,332	28,420
Other	3,641	3,997	4,589	4,771	5,622	4,948	4,948	5,614	5,614	5,613
Capital revenue	2,220	1,887	1,984	1,925	3,139	2,863	2,863	4,007	4,065	4,007
Total expenditures	41,201	43,666	48,630	51,058	56,006	55,923	56,223	59,769	59,360	60,000
Current expenditures	35,639	37,930	42,378	45,460	48,068	49,000	49,000	51,123	50,996	51,353
Of which: Interest payments	3,898	3,463	3,452	3,550	3,781	3,764	3,764	4,001	3,940	3,940
Capital expenditures	5,562	5,736	6,251	5,598	7,937	6,923	7,223	8,647	8,364	8,647
Overall balance	-2,427	-1,917	-2,313	-1,775	-1,379	-2,755	-3,242	-2,307	-2,263	-3,314
					(In percent of GDP, except as otherwise indicated)					
Total revenues	41.7	41.1	42.6	42.8	45.7	43.3	43.2	44.6	44.3	44.4
Current receipts	39.3	39.2	40.8	41.1	43.1	41.0	40.9	41.5	41.1	41.2
Capital revenue	2.4	1.9	1.8	1.7	2.6	2.3	2.3	3.1	3.2	3.1
Total expenditures	44.3	43.0	44.8	44.3	46.8	45.5	45.9	46.4	46.0	47.0
Primary current expenditure	34.1	33.9	35.8	36.4	37.0	36.8	36.9	36.6	36.5	37.1
Of which: Interest payments	4.2	3.4	3.2	3.1	3.2	3.1	3.1	3.1	3.1	3.1
Capital expenditures	6.0	5.6	5.8	4.9	6.6	5.6	5.9	6.7	6.5	6.8
Capital balance	-3.6	-3.8	-3.9	-3.2	-4.0	-3.3	-3.6	-3.6	-3.3	-3.6
Overall balance 3/	-2.6	-1.9	-2.1	-1.5	-1.2	-2.2	-2.6	-1.8	-1.8	-2.6
Memorandum items:										
Structural balance 3/	-2.4	-2.3	-2.7	-2.4	-1.0	-2.2	-2.7	-1.8	-1.8	-2.0
Primary balance	1.6	1.5	1.0	1.5	2.0	0.8	0.4	1.3	1.3	0.5
Primary structural balance 3/	1.8	1.1	0.5	0.7	1.9	0.8	0.3	1.4	1.3	1.0
Nominal GDP (in millions of euros)	93,037	101,639	108,666	115,282	119,562	122,789	122,589	128,792	129,004	127,733
Change in nominal GDP (in percent)	7.0	9.2	6.9	6.1	6.1	6.5	6.3	5.1	5.1	4.2
Real GDP growth (in percent)	3.8	4.7	3.4	3.2	3.3	2.0	1.6	2.0	2.0	0.8

Sources: Ministry of Finance; and Fund staff estimates.

1/ Authorities estimates as submitted to EUROSTAT at end-February 2002.
2/ The fiscal projections for 2002 assume that fiscal measures have the effects estimated in the 2002 budget, adjusted for differences between the authorities' and the staff's 2002 macroeconomic framework and 2001 budget estimates.
3/ For 2000, including UMTS receipts of 0.3 percent of GDP as a negative entry under capital expenditure; however, these receipts are removed for the purpose of calculating the structural balance.

Table 4. Portugal: Indicators of External and Financial Vulnerability, 1996-2002 1/
(In percent of GDP, unless otherwise indicated)

	1996	1997	1998	1999	2000	2001	2002	
							Proj.	Date
External indicators								
Exports (annual percent change, in U.S. dollars)	3.4	-1.6	5.4	-1.2	-0.9	3.0	5.9	
Imports (annual percent change, in U.S. dollars)	2.2	1.7	11.1	3.1	-0.2	0.0	3.1	
Terms of trade (annual percent change)	-3.2	-0.2	2.0	0.1	-2.7	1.9	0.9	
Current account balance	-3.6	-5.7	-7.0	-8.5	-10.4	-9.6	-8.8	
Current account balance (including capital transfers)	-1.6	-2.9	-4.7	-6.4	-9.0	-8.7	-7.1	
Capital and financial account balance	3.6	7.0	7.1	9.7	11.9	10.4	8.8	
Of which: Inward portfolio investment (debt securities, etc.)	3.6	7.6	4.8	8.6	2.7	6.0	5.9	
Inward foreign direct investment	1.3	2.3	2.8	1.1	6.2	3.0	2.9	
Other investment liabilities (net)	4.9	4.5	6.5	6.3	12.8	11.1	8.0	
Official reserves (in U.S. dollars, billions, end-of-period) 2/	21.3	20.5	21.6	14.1	14.6	14.5	...	
Broad money to reserves 3/	3.7	3.6	3.9	1.6	1.5	1.5	...	
Central Bank foreign liabilities (in U.S. dollars, billions) 2/	0.4	2.1	2.9	10.7	7.7	8.8	...	
Foreign assets of the financial sector (in U.S. dollars, billions) 4/	7.3	8.1	56.2	57.1	54.3	47.1	...	
Foreign liabilities of the financial sector (in U.S. dollars, billions) 4/	38.6	42.7	56.8	57.9	75.1	72.3	...	
Official reserves in months of imports 2/	7.7	7.2	6.8	4.3	4.5	4.5	...	
General government non-euro denominated debt 5/	...	7.7	5.3	7.4	5.9	...	...	
Exchange rate (per U.S. dollars, period average)	154.2	175.3	180.1	187.9	217.0	223.9	...	
Financial market indicators								
Public sector debt (Maastricht definition)	62.4	59.1	54.6	58.0	57.4	56.8	...	
Money market rate (in percent)	7.4	5.8	4.3	2.8	4.0	3.5	3.3	Jan.
Money market rate (real, in percent)	3.1	2.6	2.1	0.0	1.7	-0.8	-1.0	Jan.
Stock market index (1995=100)	132.6	219.0	253.5	259.9	317.1	222.0	217.5	Jan.
Share prices of financial institutions	116.0	168.3	297.2	266.9	341.8	213.5	201.3	Jan.
Spread of 10-year benchmark bond with German rate (percentage points)	2.0	0.6	0.3	0.3	0.4	0.3	...	
Financial sector risk indicators								
Foreign exchange loans (in billions of U.S. dollars) 6/	...	3.3	4.1	3.4	2.9	2.8	...	
Share of foreign exchange loans in total lending (percent) 6/	...	3.7	3.4	2.6	1.9	1.8	...	
Deposits in foreign exchange (in billions of U.S. dollars) 7/	...	14.7	19.2	17.6	20.3	20.1	...	
Share of foreign deposits in total deposits (percent) 7/	...	13.9	16.0	15.3	17.7	19.9	...	
Share of real estate sector in private credit	33.2	35.6	38.0	40.1	39.8	...	...	
Share of nonperforming loans in total loans 4/	0.0	4.5	3.4	2.4	2.0	2.1	...	
Share of nonperforming loans in total assets 4/	0.0	1.7	1.5	1.2	1.1	1.1	...	
Risk-based capital asset ratio 8/	8.4	9.1	9.3	8.9	8.4	...	...	

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

1/ The interpretation of some indicators is affected by the introduction of monetary union in 1999.
2/ Reserves and foreign liabilities refer to the Bank of Portugal, both before and after EMU. Statistical break in 1999.
3/ Ratio of reserves to M2 until 1998, and harmonized M3 in 1999 and 2000.
4/ Banks only, data for 2001 refer to November 2001.
5/ External debt concept for euro-area members.
6/ Share of loans in non-euro currencies.
7/ Financial sector liabilities in non-euro currencies to nonresidents.
8/ Capital over risk-weighted liabilities according to BIS methodology; lowest value among the six largest banking groups (which account for 90 percent of the banking system).

Table 5. Portugal: Stability and Growth Program and Staff's Medium-Term Scenario, 2001–07 1/
(In percent of GDP, unless otherwise indicated)

	Est.	Projections					
	2001	2002	2003	2004	2005	2006	2007
Stability and Growth Program							
GDP (percent change)	2.0	1.8	2.5	3.0	3.0	...	...
Consumer prices (HICP, period average, percent change)	4.4	2.8	2.3	2.1	2.0	...	...
Gross domestic investment	2.0	3.3	6.1	6.7	7.0	...	...
General government balance 2/	-2.2	-1.8	-1.0	0.0	0.4	...	...
Revenues	44.0	44.5	44.2	44.1	44.0	...	...
Expenditures	46.2	46.3	45.2	44.1	43.6	...	...
General government primary balance	0.9	1.3	1.9	2.7	3.1	...	...
General government debt	55.9	55.7	55.5	54.0	53.2	...	...
Staff projections (unchanged policy scenario)							
GDP (percent change)	1.6	0.8	2.0	3.0	3.2	3.4	3.4
Output gap (percent of potential output)	0.2	-1.4	-1.9	-1.4	-0.9	-0.5	0.0
Consumer prices (HICP, period average, percent change)	4.4	2.7	2.2	2.2	2.2	2.2	2.2
Gross fixed investment	-0.3	0.0	1.6	2.4	2.7	3.2	3.1
Current account balance (including capital account)	-8.7	-7.5	-7.3	-7.3	-7.2	-7.0	-6.8
General government balance 1/	-2.6	-2.6	-2.5	-2.3	-2.1	-1.9	-1.7
General government primary balance 1/	0.4	0.5	0.6	0.8	1.0	1.2	1.4
General government debt 1/	55.7	56.0	56.5	55.9	55.1	54.0	52.8

Sources: Ministry of Economy and Finance, " Stability and Growth Programme: Update for the period 2002–05" (December 2001); and Fund staff estimates and projections.

1/ The fiscal projections for 2002 assume that fiscal measures have the effects estimated in the 2002 budget, adjusted for differences between the authorities' and the staff's 2002 macroeconomic framework and 2001 budget estimates. Fiscal projections for 2003 are based on the staff's estimate of the effects of the Stability and Growth Program presented December 2001. For 2004–06, a constant structural primary balance is assumed.

2/ Not consistent with authorities' estimates as submitted to EUROSTAT at end-February 2002.

Portugal: Fund Relations

(As of January 31, 2002)

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

II. **General Resources Account**:	SDR Million	Percent Quota
Quota	867.40	100.0
Fund holdings of currency	567.98	65.48
Reserve position in Fund	299.42	34.52
Operational budget transfers (net)	65.00	

III. **SDR Department**:	SDR Million	Percent Allocation
Net cumulative allocation	53.32	100.0
Holdings	49.42	92.69

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

V. **Financial Arrangements**:

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

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

VII. **Exchange Rate Arrangements**:

• Portugal entered the final stage of European Economic and Monetary Union on January 1, 1999, at a rate of 200.482 Portuguese escudos per 1 euro. The official currency was changed to the euro on January 1, 2002.

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

VIII. **Article IV Consultation**: Portugal is on a standard 12-month consultation cycle. The last Article IV consultation discussions were concluded at EBM/00/113, 10/8/00

IX. **Technical Assistance**

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

X. **Resident Representative**: None.

Portugal: Statistical Issues

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

In the fall of 2000, **real sector** statistics were improved, as INE published a full set of national accounts based on ESA95, including on a quarterly basis and has began timely publication of quarterly GDP estimates. However, statistical weaknesses still hamper assessments of the quarterly outturn and the Bank of Portugal continues to produce separate and considerably different estimates of the national accounts, though only on an annual basis. Thus, the analysis of current output trends is done using a range of quantitative and opinion surveys, including the Bank of Portugal's and INE's coincident economic indicators. The lack of consistent and timely monthly or quarterly data on output, employment, and total wage compensation hampers the monitoring of within-year developments in the labor market. Unemployment data also suffer from statistical problems caused, inter alia, by frequent revisions to the measurement of unemployment and sampling rotations.

Fiscal sector data have undergone a number of revisions during the transition to ESA95, sizably altering revenues and expenditures and hampering comparisons across years and on a cross country basis. However, some progress was made as the 2001 and the 2002 budgets were presented fully consistent with recent changes in national and fiscal accounting methodology. However, fiscal outturn figures on a cash basis are only available with considerable time lags—except for the central administration, which covers some 50 percent of expenditures and 70 percent of revenues. No estimates of the accrual outturn are available on a monthly or quarterly basis and accrual accounts—including for autonomous funds such as the National Health Service—are only published on an annual basis. Forecasts for the yearly outturn for the general government (including autonomous funds) are disseminated semiannually.

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

Portugal: Core Statistical Indicators
as of January 31, 2002

	Exchange Rates	Interna-tional Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Central Government Balance 1/	GDP/GNP 2/	External Debt
Date of Latest Observation	1/31/02	11/30/01	11/30/01	11/30/01	11/30/01	1/31/02	Dec. 2001	Nov. 2001	Nov. 2001	Dec. 2001	2001 Q3	Nov. 2001
Date Received	10/31/01	3rd week of October	3rd week of October	3rd week of October	3rd week of October	10/31/01	3rd week of October	3rd week of October	3rd week of October	3rd week of October	Mid-July	3rd week of October
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly
Source of Update 3/	Reuters, Bloomberg	BoP	BoP	BoP	BoP	Reuters, Bloomberg	INE	BoP	BoP	MoF	INE	BoP
Mode of Reporting	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic
Confidentiality	None	None	None	None	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly

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

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 02/48
FOR IMMEDIATE RELEASE
[April 26, 2002]

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

IMF Concludes 2001 Article IV Consultation with Portugal

On March 25, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Portugal.[1]

Background

After an extended period of real convergence in living standards toward the euro-area average, the Portuguese economy weakened markedly in 2001. GDP growth in 2001 is estimated at around 1.6 percent, about half the rate recorded over the previous two years. The growth slowdown reflected to some extent the waning effect of euro-entry-related declines in interest rates and private sector responses to rising indebtedness levels. With external demand also weakening, exports stalled in the third quarter of 2001. The external current deficit narrowed moderately, but it remained (in relation to GDP) among the highest for advanced economies.

Inflation has continued to exceed the euro-area average, reflecting to an important extent relatively strong cost pressures in Portugal. With low unemployment, wage increases (including in the public sector) have remained well above increases in the euro area, and the differential has not been compensated by higher productivity growth. This has left core consumer price inflation (that is, headline inflation, excluding energy and unprocessed food) some 1½ percentage points above the area average.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the March 25, 2002 Executive Board discussion based on the staff report.

In the financial sector, credit growth has moderated, but continues to exceed nominal income growth by a wide margin. As a result, private sector indebtedness levels have risen further, and bank credit (in relation to GDP) is well above the euro-area average. The credit boom has outstripped the growth in core deposits, and banks have financed themselves extensively on international capital markets.

Considerable uncertainty surrounds the fiscal outturn for 2001. All estimates indicate, however, that the fiscal deficit widened appreciably and the original target was missed by a substantial margin, reflecting higher-than-budgeted expenditures as well as lower revenues. Overall, the authorities expect a fiscal deficit of 2.2 percent of GDP (twice the original target), while staff sees additional risks that would further increase the deficit. For 2002, the budget aims at lowering the deficit by 0.4 percentage points to 1.8 percent of GDP. Notwithstanding the fiscal slippage in 2001, the updated *Stability Program* reconfirms Portugal's commitment to achieve a balanced budget (in structural terms, that is, net of the impact of the business cycle) by 2004.

The near-term economic outlook is subject to unusual risks. In part, these relate to external market prospects, particularly as concerns the timing and strength of the recovery in partner countries. In addition, economic growth will depend on the domestic economy's response to sizable macroeconomic imbalances, which are likely to require a redirection of resources from domestic uses toward exports. In all, staff expects GDP growth of somewhat below 1 percent in 2002 (versus 1.75 percent growth envisaged in the *Stability Program*).

Executive Board Assessment

Executive Directors noted that economic activity had slowed markedly in Portugal, after an extended period of growth above the euro-area average that had contributed to one of the area's lowest unemployment rates. The growth slowdown reflected the global weakening of activity but also domestic factors, and has taken place against the background of sizable macroeconomic imbalances, including a large external current account deficit, rapidly increasing household and enterprise indebtedness, and a marked widening of the fiscal deficit in 2001.

Directors called on the incoming government to take decisive, early steps to unwind the macroeconomic imbalances and recommence the convergence in Portugal's living standards toward the euro-area average. Wage moderation could facilitate the needed shift in resources, improving cost competitiveness and raising export growth.

Directors considered the strengthening of fiscal policy as central to improved macroeconomic performance. In light of the large fiscal deficit slippage in 2001, which reflected in part current expenditure overruns, improvements are needed in expenditure monitoring and control, so that ad hoc expenditure cuts during the course of a fiscal year could be avoided. Directors cautioned against reducing taxes until sufficient expenditure cuts have been implemented to secure the required reduction in the fiscal deficit. Noting the lower-than-budgeted revenue outturn in 2001, Directors called for strengthening tax administration and also for more realistic revenue projections.

Directors considered the *Stability Program's* objective of achieving structural budget balance by 2004 as appropriate. They also noted that a rise in public saving would facilitate a reduction of the external current account deficit and contain credit growth. For 2002, Directors called for cautious budget implementation, especially in the early part of the year, given the uncertainty surrounding the sustainability of expenditure cuts implemented in the latter part of 2001, and the larger-than-expected projected 2001 deficit, which, if confirmed, would call for fiscal consolidation to be accelerated in 2002.

Directors considered public expenditure restraint as critical for securing durable fiscal consolidation. They welcomed the fact that the *Stability Program* targets nominal expenditure growth well below projected GDP growth. Nevertheless, Directors argued for more decisive expenditure containment in 2002, especially for the public sector wage bill. Directors also urged consideration of measures to stem future increases in payments for pensions and health costs, a review of public expenditure commitments incurred outside the annual budget, and an examination of the impact on the fiscal position of local government spending. They advised the authorities to undertake a fiscal module of a Report on the Observance of Standards and Codes.

With respect to the financial sector, Directors noted that the banking sector appears to be adequately provisioned and profitable. At the same time, private sector credit growth continues to exceed nominal income growth by a wide margin. Directors cautioned that, in the event of a prolonged economic downturn, credit concentration in housing and infrastructure could entail larger risks than observed historically. Directors also observed that credit growth has far outstripped the growth in core bank deposits, with banks securing additional financing needs on international capital markets, which could expose the financial sector to potential liquidity risks.

Directors noted that supervisory coordination has been strengthened considerably. In view of potential financial sector risks related to Portugal's macroeconomic imbalances, Directors considered that supervisory guidance on increasing equity capital, where warranted by potential risks, was well placed. They welcomed the authorities' intention to review financial sector issues in the context of a Financial Sector Assessment Program in late 2002. They also welcomed Portugal's adoption of the OECD anti-bribery convention, and its commitment to strengthen measures against money laundering and the financing of terrorism.

Directors considered that Portugal's medium-term growth prospects depend on raising productivity growth. This would require further progress on structural reform, which would also facilitate the unwinding of present macroeconomic imbalances. Directors called for policy initiatives to strengthen competition, and to reduce the relatively high dismissal costs in the labor market. While the latter may have contributed to a low unemployment rate, they may hinder labor market efficiency and flexibility, with adverse implications for productivity.

Directors encouraged the authorities to fully liberalize imports from the least developed countries and to raise the level of Portugal's official development assistance to the UN target.

Directors encouraged the authorities to strengthen the statistical weaknesses, notably in the fiscal and real sectors, that complicate the assessment of economic conditions and policymaking.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2001 Article IV Consultation with Portugal is also available.

Portugal: Selected Economic Indicators

	1998	1999	2000	2001	2002 1/
Real economy (change in percent)					
Real GDP	4.7	3.4	3.2	1.6	0.8
Domestic demand	7.1	5.4	2.9	0.8	0.5
CPI (year average, harmonized index)	2.2	2.2	2.8	4.4	2.7
Unemployment rate (in percent)	5.0	4.4	4.0	4.1	4.2
Gross national saving (percent of GDP)	19.7	18.5	17.1	16.6	17.0
Gross domestic investment (percent of GDP)	26.7	27.0	27.5	26.2 2	25.8
Public finance (percent of GDP)					
General government balance 2/	-1.9	-2.1	-1.5	-2.6	-2.6
Primary balance 2/	1.5	1.0	1.7	0.4	0.5
Public debt	54.6	54.0	53.3	55.7	56.0
Money and credit (end-period, percent change)					
Total domestic credit	16.8	19.9	24.5	13.1	...
National contribution to euro area M3	7.8	9.8	6.6	4.5	...
Interest rate (end-period)					
Deposit rate, 91–180 days	3.3	2.8	4.5	3.5	...
Ten-year government bond yield	4.1	5.5	5.3	5.1	...
Balance of payments (percent of GDP)					
Trade balance	-10.8	-11.9	-13.1	-12.0	-11.2
Current account (including capital transfers)	-4.7	-6.4	-9.0	-8.7	-7.1
Net official reserves (in US$ billions, end of period)	21.6	14.1	14.6	14.5	...
Exchange rate regime		Euro area member			
Present rate (February 28, 2002)		US$0.87 per euro			
Nominal effective rate (1995 = 100)	97.1	95.7	92.9	93.4	...
Real effective rate (1995 = 100)	99.3	98.9	96.4	98.7	...

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

1/ Staff projections.

2/ Fiscal balance figures are based on data that reflect Portugal's derogation on recording taxes and social security contributions under ESA 95 rules. EUROSTAT reports that the changeover to these rules, to take place in mid-2002, would add, for example, an estimated 0.4 percent of GDP to the 2001 general government deficit.