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Portugal: 2002 Article IV Consultation—Staff Report; Staff Supplement; 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 2002 Article IV consultation with Portugal, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **November 18, 2002,** 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 February 11, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of **March 24, 2003** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its March 26, 2003 discussion** of the staff report that concluded the Article IV consultation.

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 2002 Article IV Consultation

Prepared by the Staff Representatives for the 2002 Consultation with Portugal

Approved by Ajai Chopra and G. Russell Kincaid

February 11, 2003

- The Article IV discussions were held during November 7–18, 2002. The staff—Mr. Krueger, Mdms. Bal Gündüz and Zanforlin (all EU1), and Mr. Kupiec (MAE)—met with the Governor of the Bank of Portugal, the Ministers of Finance and Health, and other senior officials, representatives of regulatory agencies, financial markets, and labor and business organizations, and members of parliament. 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, and maintains an exchange system free of restrictions, apart from those related to UN resolutions (Appendix I).

- For Directors' conclusions at the last Article IV consultation on April 26, 2002, see (http://www.imf.org/external/np/sec/pn/2002/pn0248.htm).

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I. KEY ISSUES

1. **The discussions focused on three major challenges facing the new government, which took office in April 2002**:

- **Addressing sizable macroeconomic imbalances**: Portugal's external current account deficit, while declining, remained the largest (in relation to GDP) among industrial countries. Concurrent with rising external indebtedness, private sector credit ratios reached levels well above the euro-area average.

- **Advancing fiscal consolidation**: Structural fiscal deficits have exceeded those in other euro-area countries and Portugal breached the Stability and Growth Pact's 3 percent limit in 2001 by a wide margin, largely because of rising public expenditures. Further, aging-related spending pressures are projected to be sizable over the medium term.

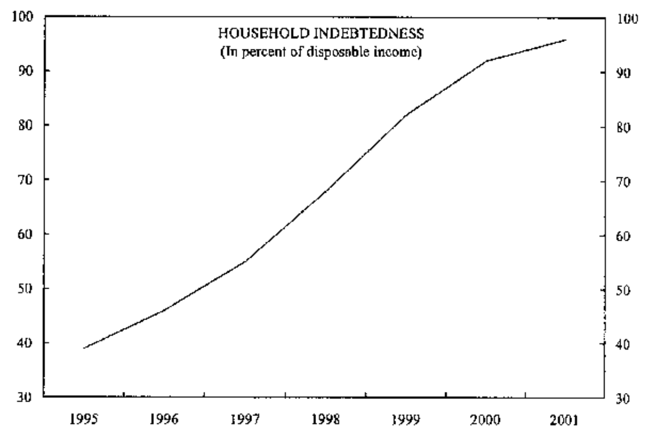
- **Safeguarding the financial sector**: Slow economic growth is adding to financial sector risks, following an extended period of rapid credit growth, and sectoral profitability and asset quality indicators have weakened.

2. **Some progress has been secured in all three areas—but formidable policy challenges remain**. The new government, elected on a market-oriented platform, has begun with fiscal consolidation—contributing to a narrowing of external imbalances—and advanced structural reforms, amid public opposition. Moreover, further steps have been taken to strengthen the financial sector. But fiscal adjustment has initially relied on increased revenues and one-off measures and here, as in several other areas, the challenge remains one of durable reforms and adjustment. Addressing these challenges has been at the center of Fund advice in recent years (Box 1).

II. BACKGROUND

3. **Economic growth stalled in 2002, as the economy began to adjust to large macroeconomic imbalances amid weak external demand** (Table 1; and Figure 1):

- At an estimated ½ percent, **GDP growth fell below the euro-area average** for the first time in almost a decade. Domestic demand declined, reflecting weakness in all major components: households adjusted to high indebtedness (reaching almost 100 percent of disposable income) and deteriorating employment prospects by curtailing consumption and housing expenditures; business investment fell sharply amid declining profits, slowing demand, and rising global and domestic



uncertainty; and the fiscal stance tightened, following large slippages in 2001 (Table 2).

Selected Indicators for Portugal and the Euro Area, 2001–03

	2001		2002		2003
	Portugal	Euro area	Portugal	Euro area	Portugal
	(Annual percentage change)				
Real GDP	1.6	1.4	0.4	0.8	0.4
CPI	4.4	2.6	3.7	2.2	2.8
Unemployment rate	4.1	8.0	4.7	8.3	5.6
	(In percent of GDP)				
External current account	-8.4 1/	0.4	-6.5 1/	1.1	-6.0 1/
Private sector credit	141.7	95.5	...	...	...
Structural fiscal balance 2/	-4.7	-1.5	-3.3	-1.5	-3.1

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

1/ Includes capital transfers.
2/ For Portugal, excludes asset sales.

- The **external current account deficit** (including capital transfers, which increased substantially) narrowed by an estimated 2 percentage points in 2002, to 6½ percent of GDP (Table 3; and Figure 2). The narrowing resulted foremost from trade developments, as the weakness in domestic demand led to a decline of imports while exports expanded slightly faster than external demand. As in previous years, the deficit was financed predominantly through the banking sector. In particular, banks resorted extensively to euro-denominated financing on international capital markets as domestic **credit growth**—despite a deceleration in 2002—continued to outpace the growth in core deposits by a wide margin.

Box 1. Policy Recommendations and Implementation

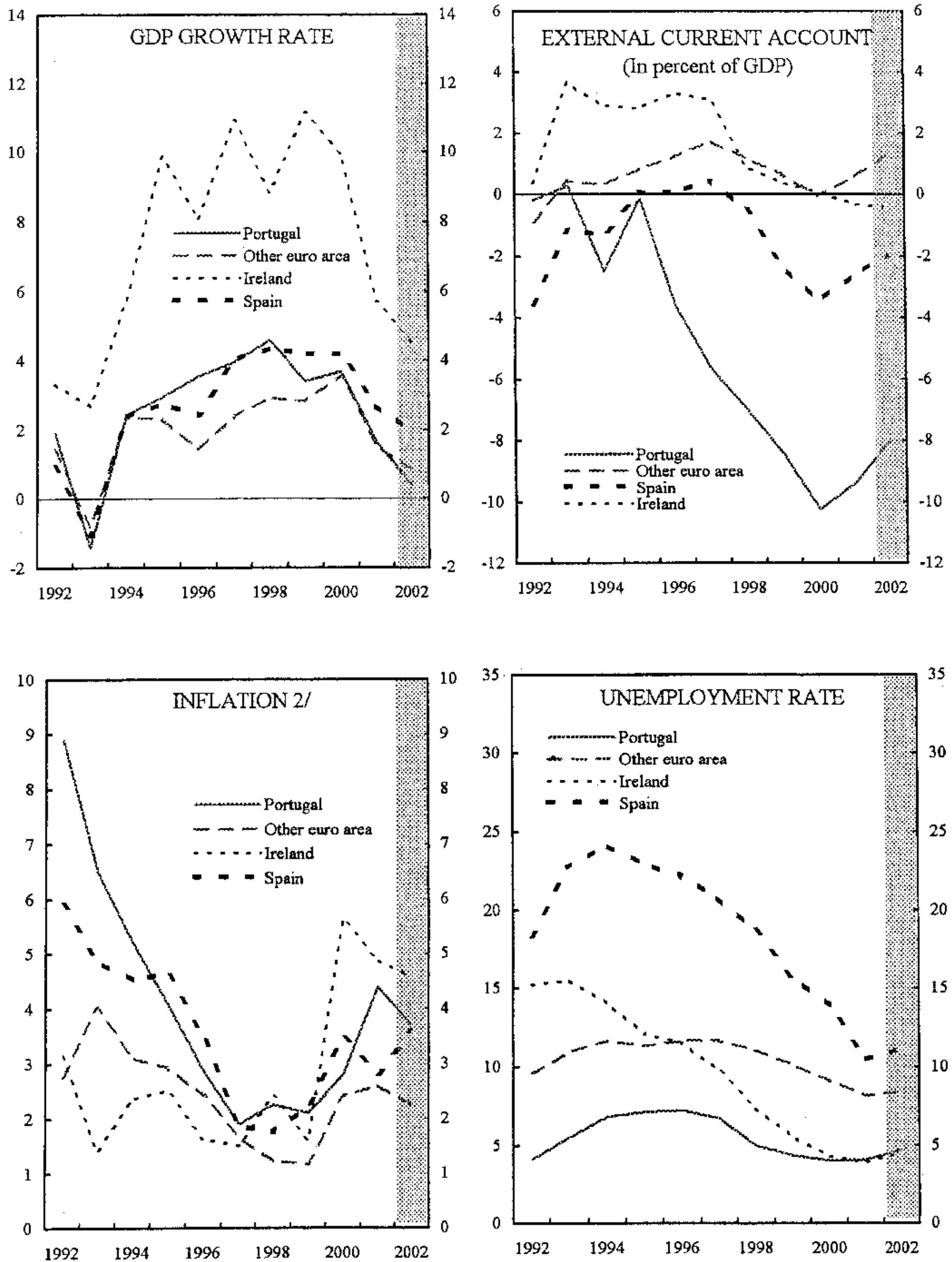
Since euro-area entry, the Fund's policy advice has focused on policies to safeguard macroeconomic stability and enhance Portugal's longer-term growth prospects: reducing the comparatively high fiscal deficit; reining in the rapid growth of current primary expenditures, especially the public sector wage bill; strengthening the financial sector; and improving education and accelerating structural reforms to boost economic growth.

Over this period, fiscal outturns fell appreciably short of Fund advice, reflecting policy priorities but also sizable expenditure slippages vis-à-vis budgeted amounts. Notwithstanding relatively strong, euro-entry-related growth, the structural fiscal deficit remained the largest in the euro area and, net of asset sales, widened markedly to above 4 percent of GDP in 2000/01. Moreover, primary current expenditures rose strongly, by a cumulative 4 percentage points of GDP during 1998–2002. This contributed to persistent, large external current account deficits. Aging-related future spending pressures remained largely unaddressed.

Some progress was secured in strengthening financial sector supervision and regulations. Among the many steps, particularly noteworthy were the establishment of a coordinating council of financial sector supervisors; and supervisory guidance and regulatory changes to strengthen banks' capital and reduce their short-term funding exposure.

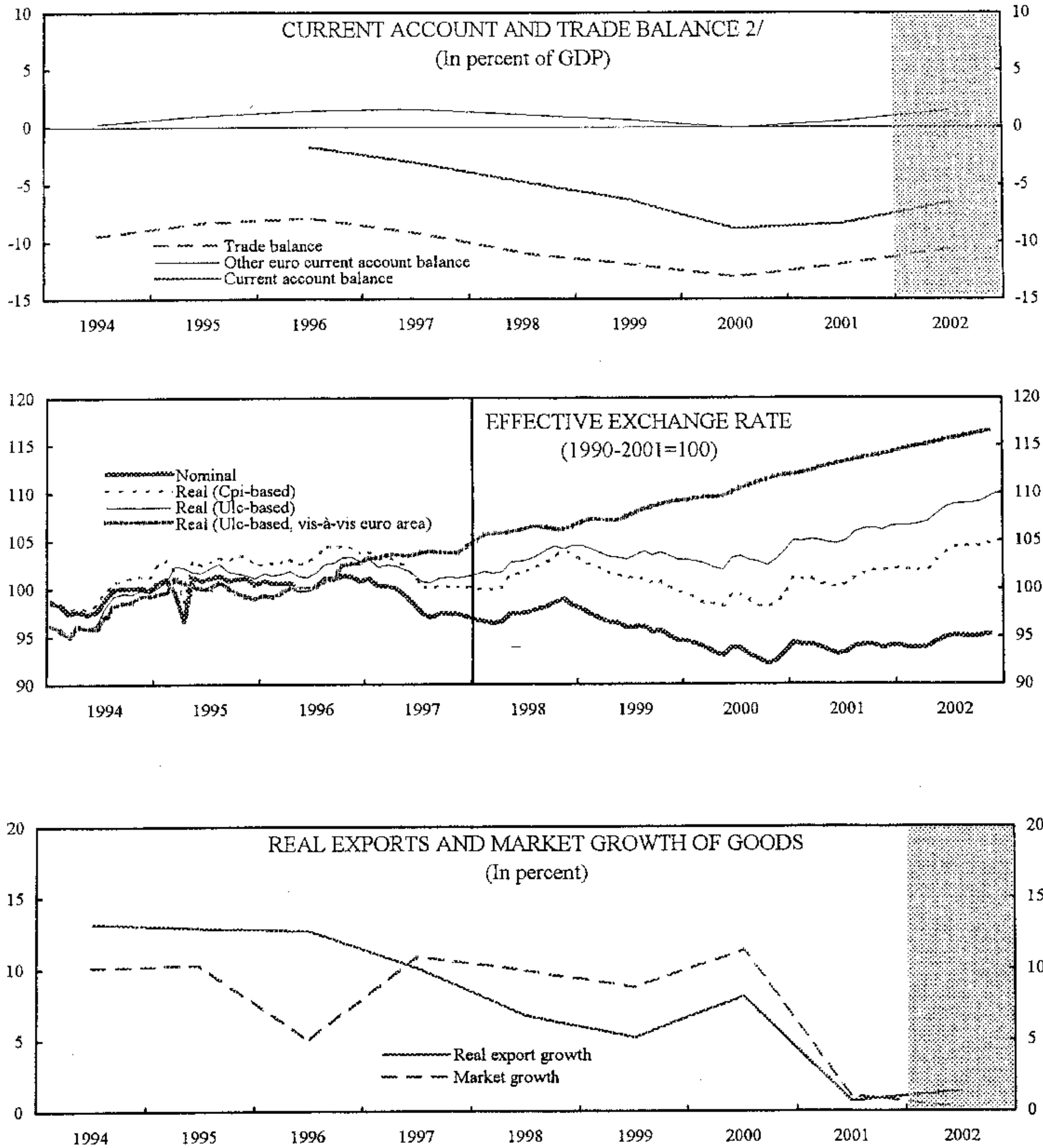
On structural policies, an extensive privatization program was implemented throughout the 1990s, and some product markets have been liberalized in line with EU directives. Educational performance was strengthened to some extent, but this remains an area where Portugal scores poorly relative to most industrial countries. Attempts to establish a fully independent competition agency were unsuccessful until end-2002. In the labor market, dismissal restrictions remain among the tightest in OECD countries, but the Fund has also noted relatively low unemployment and high labor force participation.

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



Sources: Eurostat; and IMF, *World Economic Outlook*.
1/ Shaded areas show staff projections.
2/ Based on the harmonized index of consumer prices.

Figure 2. Portugal: External Sector Developments and Exchange Rates, 1994–2002 1/

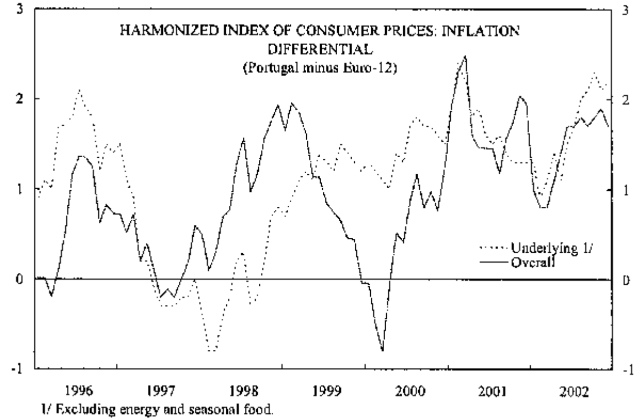


Sources: IMF, Information Notice System and *World Economic Outlook*; and Fund staff projections.

1/ Shaded areas show staff projections.

2/ Capital transfers are included in the current account.

4. **Notwithstanding weakening labor market conditions during 2002, inflation has remained well above the euro-area average.** Employment cutbacks accelerated during 2002 and the unemployment rate increased to 5.1 percent (from 3.9 percent a year earlier; Figure 3). Contractual wage increases declined only marginally, although a growing number of employees was not covered by collective contracts. Labor cost increases have contributed to a persistent inflation differential vis-à-vis the euro area and the HICP inflation differential—affected in the second half of 2002 also by a VAT rate increase in June—was about two percentage points, roughly twice the gap attributed to Balassa-Samuelson effects.



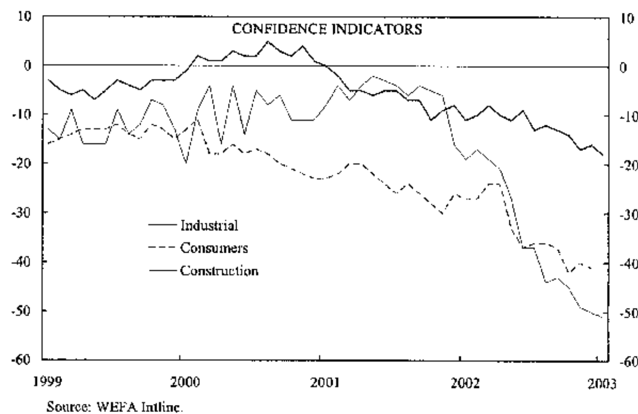
1/ Excluding energy and seasonal food.

III. Policy Issues

5. **The discussions focused on the new government's policy agenda, against the background of weak prospects for economic growth.** While some progress had been secured, durable and more far-reaching reforms were seen as critical for addressing macroeconomic risks.

A. Economic Prospects and External Imbalances

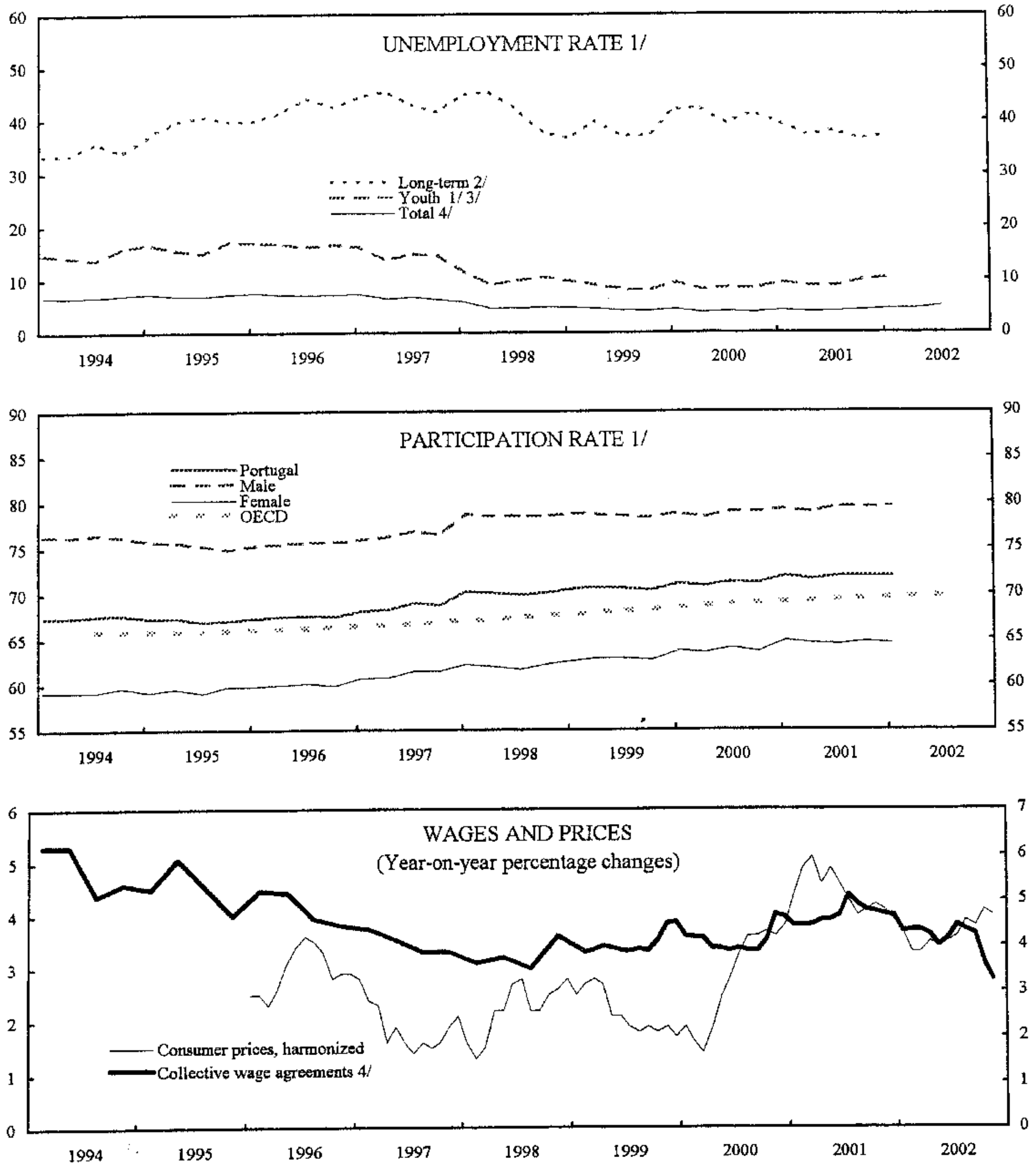
6. **The authorities and staff agree that developments since the November mission have further weakened near-term growth prospects, with staff, however continuing to expect slower growth than the ministry of finance.** Indicators of activity (including for industrial production, retail trade, and employment) deteriorated in the latter part of 2002, and business and consumer confidence reached historical lows. While the updated *Stability Program*, published in late December, lowered the 2003 GDP forecast from the budget's 1¾ percent to 1¼ percent (in line with the latest Consensus Forecasts), this remains appreciably above the staff's current projection (½ percent), which envisages more persistent weakness of domestic demand.



Source: WEFA Intline.

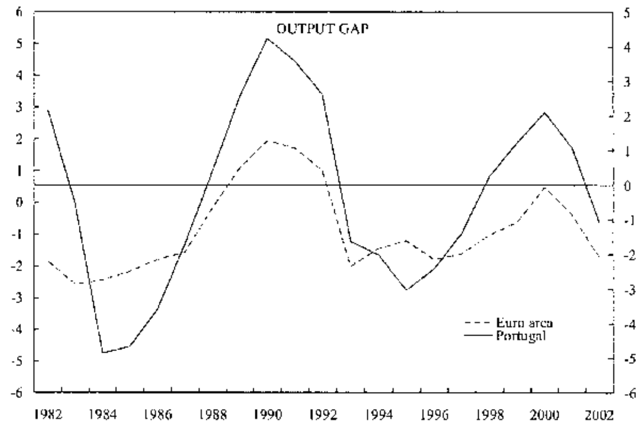
7. **All interlocutors agreed that considerable downside risks surrounded growth prospects.** The authorities noted that the anticipated recovery in partner countries seemed increasingly precarious. Moreover, a continuing euro appreciation could further undermine

Figure 3. 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.

competitiveness, albeit with Portugal less affected due to its large share of intra euro-area trade. On the domestic side the authorities concurred that risks surrounded (i) the response by households and enterprises to historically high debt levels; and (ii) the financial sector, should the economic slowdown and rising unemployment significantly weaken banks' balance sheets and their external funding access—although the authorities were confident that banks were well positioned to address these risks. On the upside, the economy has typically been more synchronized with European recoveries (see text chart) than envisaged in current staff projections. Staff and the authorities agreed that monetary conditions remained relatively supportive for economic growth (Figure 4) and that historically low real and nominal rates had contributed to the credit expansion. The interest rate cut by the ECB in December did not fundamentally alter monetary conditions, taken into account also the appreciation of the euro in late 2002 and early 2003.

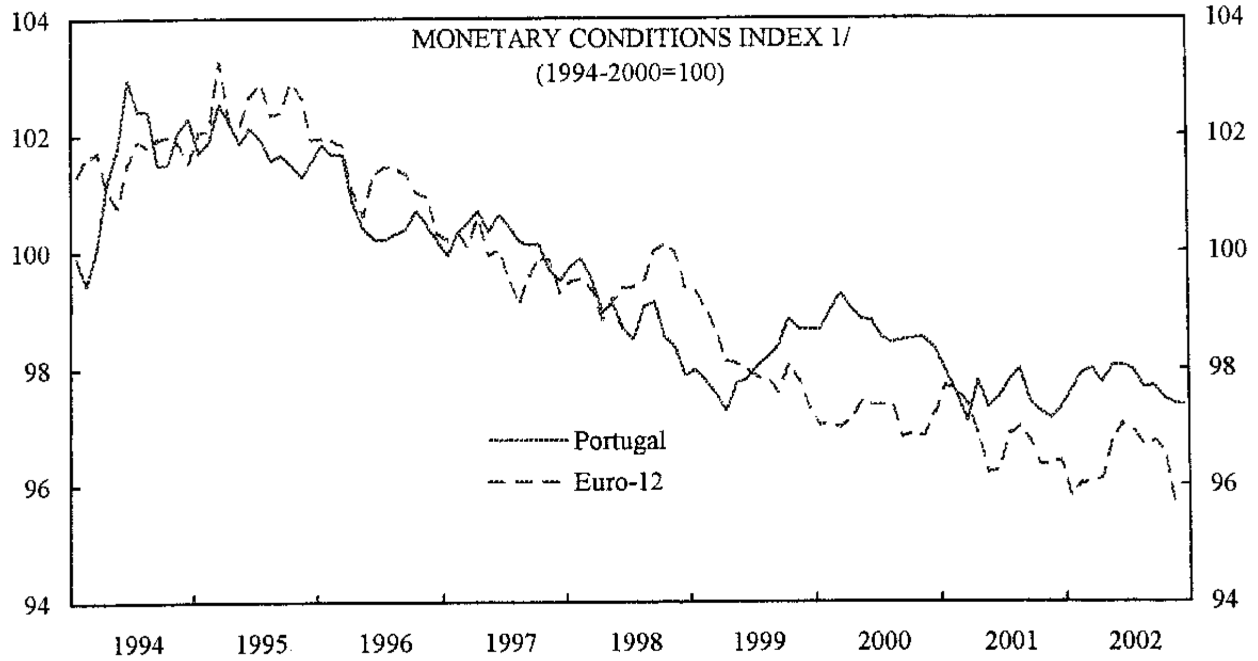


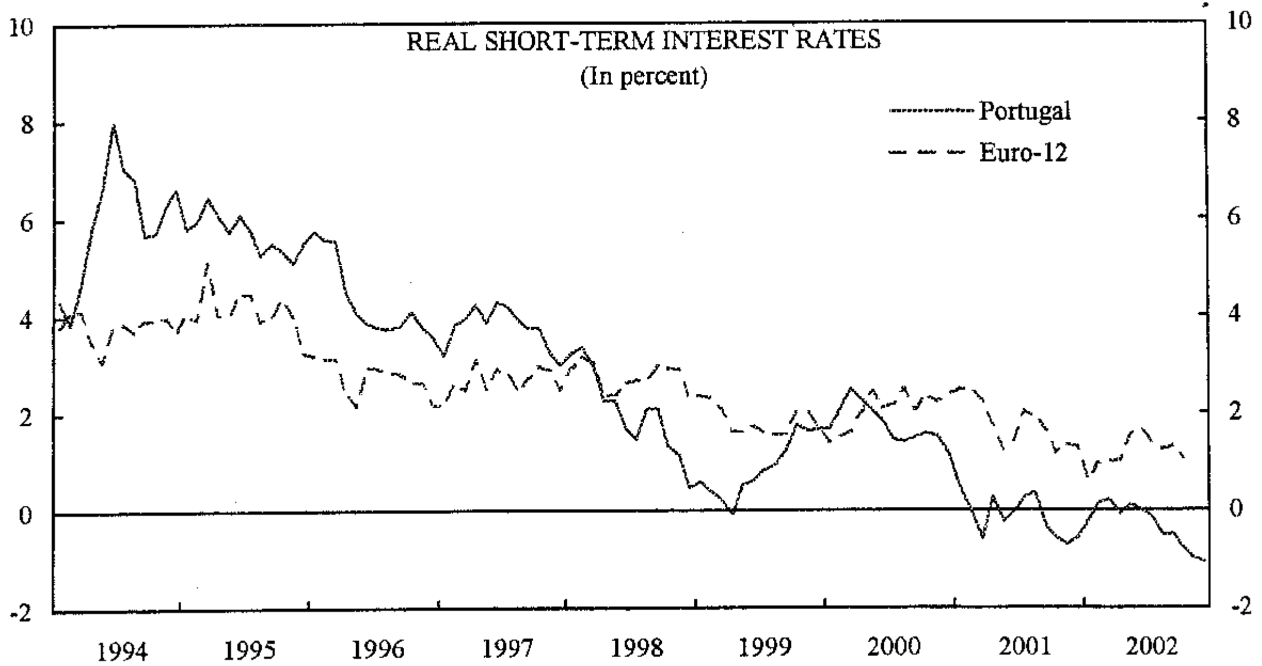
8. **The authorities concurred that the large external current deficit exposed the economy to potential risks—but expected a gradual, market-driven decline, supported by fiscal consolidation**. While the external current account deficit narrowed substantially in 2002, it remained the largest deficit among industrial countries, and estimates of net external indebtedness reached almost 40 percent of GDP. Against this background, discussions focused on the role of the current account as an indicator of imbalances in a monetary union, the likely evolution of the deficit, and possible policy implications:

- Concerning the **role of the external current account in a monetary union**, there was agreement that it remained a useful, albeit less proximate, indicator of domestic imbalances, and that deficits of the recent magnitudes were not sustainable over an extended period.[1] Concerns were heightened as the deterioration of the current account from broad balance in the mid-1990s had reflected foremost weaker saving (rather than higher investment).

[1] Staff's analysis suggests that the large widening of the current account deficit since the mid-1990s could not be attributed to factors related to monetary union (J. Decressin and P. Disyatat, "Capital Markets and External Current Accounts: What to Expect from the Euro," IMF Working Paper 00/154). For an alternative view, see O. Blanchard and F. Giavazzi, "Current Account Deficits in the Euro Area. The End of the Feldstein Horiaka Puzzle?" (August 2002).

Figure 4. Portugal: Monetary Conditions Index and Real Interest Rates, 1994:1–2002:12

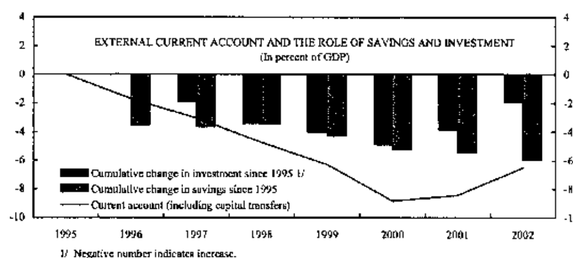




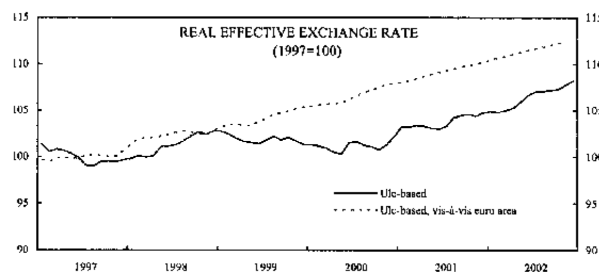
Sources: Bank of Portugal; National Statistics Office (INE); and Fund staff estimates.

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

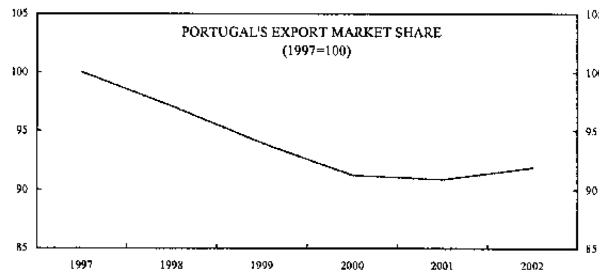
The large increase in the external current account deficit since the mid-1990s reflected foremost a decline of domestic saving



... and a loss of cost competitiveness since 1997, especially vis-à-vis the euro area



... contributed to declining market shares



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

- Views differed to some extent on the **prospective evolution** of the deficit and associated increases in foreign indebtedness. The authorities noted the improvement in 2002 and were hopeful of a relatively pronounced redirection of output from domestic to external markets. Staff's views were less sanguine, noting that gains in export market shares, after earlier losses, had only been marginal in 2002, with the improvement in the current account principally related to falling imports in the face of stagnating domestic demand. External competitiveness had also weakened in recent years (and, for unit labor costs vis-à-vis the euro area, since the mid-1990s)—and added competitive pressure could be expected after EU enlargement. On unchanged policies, staff projected the current account deficit to remain well above estimates of Portugal's medium-term equilibrium saving-investment balance[2]—with higher indebtedness adding to financing and interest rate risks.

- Against this background, there was broad agreement on the **policy implications**. The authorities stressed the role of improving public sector saving for strengthening the current account. They also noted the importance of reducing external financing risks, with supervisors having successfully guided banks toward longer-term funding. Reflecting its deeper concerns about competitiveness, staff emphasized wage restraint, which would facilitate relative price adjustments and resource reallocations toward the tradable sector. In this regard, the authorities agreed that

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[2] The saving-investment framework is discussed in P. Isard, H. Faruqee, G. Russell Kincaid, and M. Fetherston, "Methodology for Current Account and Exchange Rate Assessments," IMF Occasional Paper No. 209, 2001.

public sector wages could play an important signaling role. They also expected improvements in competitiveness from structural reforms, discussed below.

B. Fiscal Policy: Adjustment and Reform

A difficult legacy

9. **Following euro entry, fiscal consolidation stalled and, with rapidly rising expenditures, the structural deficits remained the highest in the euro area**. In stark contrast to almost all euro-area countries, primary current spending rose (in relation to GDP) since the mid-1990s (Figure 5), reflecting in part policy priorities (including increased education and social spending) but also large expenditure slippages relative to budgeted amounts. The opportunity to proceed with fiscal consolidation during a time of strong growth had been missed (see text table).

General Government Accounts, 1999–01
(In percent of GDP)

	1999		2000		2001	
	Budget	Actual	Budget	Est.	Budget	Est.
Overall balance	-1.9	-2.4	-1.5	-2.9	-1.2	-4.1
Structural balance 1/	-2.3	-2.9	-1.6	-3.7	-1.0	-4.6
Memorandum items:						
Real GDP growth (in percent)	3.5–4.0	3.8	3.3	3.7	3.3	1.6
Structural balance net of asset sales 1/ 2/	...	-2.9	...	-4.1	...	-4.7

Sources: Ministry of Finance; and Fund staff estimates.

1/ Structural balances are calculated using staff's estimates of potential output.
2/ Excludes UMTS receipts of 0.3 percent of GDP in 2000 and other asset sales for subsequent years.

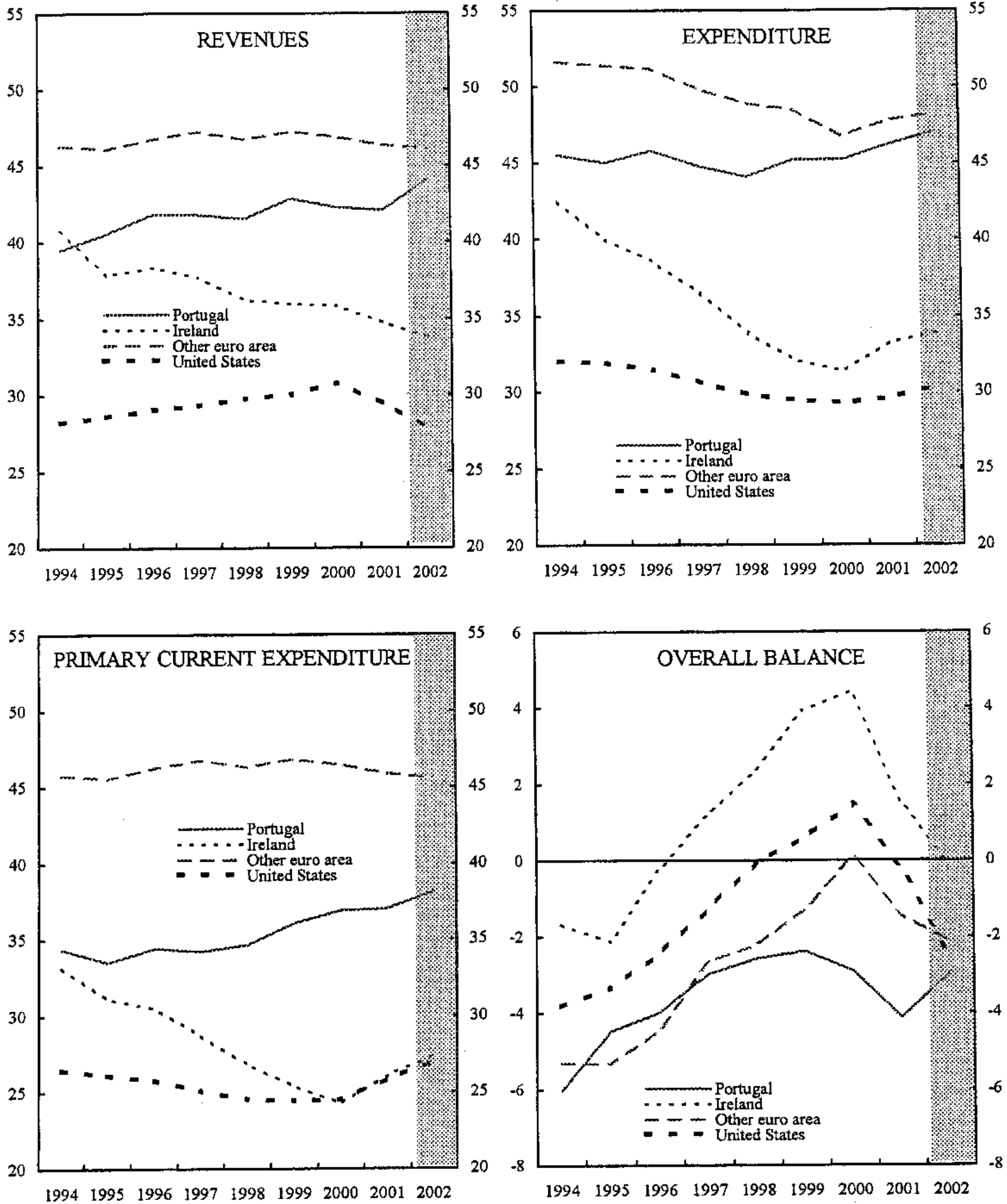
10. **A review of the fiscal accounts sharply revised up the fiscal deficit for 2001—well beyond the *Stability and Growth Pact's* 3 percent of GDP limit—and, absent adjustment measures, a further widening had been expected for 2002**. A commission, set up by the new government, estimated the 2001 fiscal deficit at 4.1 percent of GDP, almost twice the earlier official estimates of 2.2 percent (Box 2). While the staff's last *Country*

Box 2. Fiscal Account Revisions for 2001

The 2001 fiscal deficit was revised up from the authorities' February 2002 estimate of 2.2 percent to 4.1 percent of GDP. Following the election of the new government, the fiscal accounts were reviewed by a commission under the chairmanship of the Bank of Portugal's Governor, resulting in considerable upward revisions for the deficits of the last five years. For 2001, revisions went even beyond earlier staff estimates (*Country Report* No.02/90) and reflected mainly three factors: an overestimation of (principally nontax) revenues and underestimation of expenditures, including by subnational governments and on health care (over 1 percent of GDP); a reclassification of some recurring capital transfers, previously recorded below the line (¼ percent of GDP); and the adoption of new accounting rules for certain revenue categories (½ percent of GDP).[1]

[1] Through 2001, Portugal utilized a derogation from Eurostat's standard accounting rules, which require adjustments to accrual-based revenues using historical compliance rates.

Figure 5. Portugal: International Comparisons of Fiscal Trends, 1994–2002 1/
(In percent of GDP)



Sources: IMF, *World Economic Outlook*; and Fund staff estimates.
1/ Shaded area show staff projections.

Report (No. 02/90) had discussed sizable risks to the earlier estimates, revisions were ultimately larger than anticipated—reflecting more extensive revenue and expenditure slippages and, to a lesser extent, the effects of new accounting rules for some revenues. The authorities noted that, without new measures, the deficit would have increased further in 2002: expenditures were, once again, well above target in the early part of the year, while slower-than-anticipated growth was undermining revenues, especially for the corporate income tax.

11. **Against this background, the newly elected government implemented sizable measures aimed at reducing the fiscal deficit to 2.8 percent of GDP**. The ministry underscored that reducing the deficit to below the SGP's 3 percent of GDP ceiling was critical for restoring policy credibility. A supplementary budget in June increased the standard VAT rate by 2 percentage points to 19 percent, constrained some spending, abolished interest subsidies for housing loans, and attempted to limit local government borrowing. Recognizing that these measures were insufficient, the government was confident of securing the deficit target with a series of one-off measures introduced in late 2002, which it estimated to yield about 1½ percent of GDP. These included nearly €1 billion (0.8 percent of GDP) each from asset sales (the sale of the fixed-line telephone system, real estate assets, and future toll rights) and a tax amnesty (waiving past due interest on tax and social security arrears). Moreover, some capital expenditures were frozen.

12. **These measures secured a marked reduction of the structural fiscal deficit in 2002, although staff continued to see some risk that the overall deficit would exceed the government's target**. The staff's somewhat higher deficit estimate (around 3 percent of GDP) reflects risks on local government and health care spending (where information remains incomplete, but points again to some overruns) and on investment, where the large freezes of late 2002 may have proven difficult to implement. In any case, the improvement in the structural deficit (in relation to GDP) would be the largest in the past decade: excluding asset sales (which have little demand impact)—but including other one-off revenues of about 0.8 percent of GDP—staff estimates the structural deficit to fall by 1½ percentage points to 3¼ percent of GDP.

Pacing fiscal policy in a slow-growth period

13. **The authorities underscored their strong commitment to the Stability and Growth Pact, and to a medium-term balanced budget objective**. They noted that the immediate task was to bring the deficit to well within the SGP limits, avoiding the potential suspension of EU structural funds and fines. Over the medium term, the updated *Stability Program* confirms the target of broad budget balance, albeit delayed, in view of the earlier large slippages and weak growth, from 2004 to 2006 (Table 4). If, however, policies were to remain unchanged, the risks to domestic and external debt sustainability would be considerable: the public debt-to-GDP ratio would likely remain above 60 percent and external debt would rise further over the medium term. In view of these considerations, there was concurrence that budget balance would provide a broadly appropriate medium-term

target, provided that progress is secured in containing aging-related expenditures to address longer-term concerns.

14. **Building on a broad consensus about the medium-term objectives, discussions focused on the appropriate near-term pace for fiscal consolidation.** In this regard, two key concerns were reviewed:

- **Addressing the large macroeconomic imbalances**: As noted previously, the authorities ascribed an important role to fiscal consolidation in this regard—by raising domestic saving, freeing resources for the tradable goods sector, and, through the signaling role of public sector wages, securing gains in cost competitiveness. By themselves, these considerations argued for relatively large and possibly front-loaded fiscal consolidation.

- **Taking into account the cyclical weakness of the economy**: Fiscal consolidation was likely to further weaken near-term growth prospects even if the precise impact was uncertain (Box 3). The authorities concurred that this argued against strongly front-loaded consolidation and for carefully considering the demand impact of alternative measures, with durable expenditure reductions likely to impart smaller demand effects (see below).

15. **On balance, it was agreed that the different demands on fiscal policy called for a moderate front-loading of the structural fiscal adjustment.** Equally paced steps to eliminate the structural deficit by 2006 would require adjustments of close to 1 percentage point per annum. The authorities noted that some front loading would not only be appropriate from a domestic macroeconomic perspective, but also meet their commitments under the

Box 3. Fiscal Policy and Growth

- **Are fiscal consolidations always contractionary?** While standard Keynesian models predict contractionary effects with high multipliers, other models suggest various channels leading to insignificant or even negative multipliers (i.e., expansionary consolidations).[1]

- **Empirical estimates:** A three-variable VAR (covering GDP, fiscal spending, and taxes for annual data during 1953–2001) indicates multipliers between ½ and 1 for Portugal, similar to typical estimates for other countries.

Output Response to a Fiscal Consolidation of 1 Percent of GDP

	Impact	Cumulative
Spending cut	-0.8	-1.0
Tax increase	-0.5	-0.6

- **Qualifications:** While the estimates are sizeable, several important factors have changed during the estimation period (including, openness and financial liberalization). Some studies[2] report declining multipliers for several European countries and the United States, when more recent periods are covered.

[1] See R. Hemming, M. Kell, and S. Mahfouz, "The Effectiveness of Fiscal Policy in Stimulating Economic Activity—A Review of the Literature," IMF Working Paper 02/208, 2002.

[2] See, for example, D. Gros and others, "Fiscal and Monetary Policy for a Low-Speed Europe," 2002.

SGP. Looking ahead, they would review fiscal consolidation needs in light of unfolding developments, and were considering staff's suggestion to stand ready with accelerating consolidation, should macroeconomic imbalances not improve sufficiently rapidly.

16. **Turning to 2003, the budget targets a reduction in the deficit to 2.4 percent of GDP, broadly consistent with the consolidation strategy outlined above.** Under the *Stability Program's* growth projection and the staff's estimates for potential output, the structural deficit (net of asset sales) would improve by around 1¼ percent of GDP (see text table below). The adjustment counts on higher revenues (partly related to the VAT increase of mid-2002), with primary spending stabilizing (in relation to GDP) and interest payments rising, following a 4 percentage point increase in the public debt ratio in 2002.

General Government Accounts, 2001–03
(In percent of GDP)

	2001		2002			2003	
	Budget	Est.	Budget	Auth.	Staff	Auth.	Staff
Overall balance	-1.2	-4.1	-1.8	-2.8	-3.0	-2.4	-3.9
Structural balance 1/	-1.0	-4.6	-1.8	-2.5	-2.5	-1.8	-2.6
Memorandum items:							
Real GDP growth (in percent)	3.3	1.6	2.0	0.7	0.4	1.3	0.4
Structural balance net of asset sales 1/ 2/	...	-4.7	...	-3.2	-3.3	-2.0	-3.1

Sources: Ministry of Finance; and Fund staff estimates.

1/ Structural balances are calculated using staff's estimates of potential output.
2/ Excludes UMTS receipts of 0.3 percent of GDP in 2000 and other asset sales for subsequent years.

17. **On the basis of measures secured so far, however, the deficit could rise to almost 4 percent of GDP in 2003, with little progress in reducing the structural deficit.** In the staff's view, risks to the budget targets related to: (i) nontax revenues were projected to increase by ¼ percentage point of GDP, from levels that were boosted in 2002 by high one-off revenues (including from the tax amnesty); (ii) tax revenues in the December *Stability Program* were unchanged from the October budget, even though growth projections had been cut by ½ percentage point—and the budget had already been optimistic, in staff's view, for corporate taxes; (iii) the planned deceleration of current expenditures required additional measures that had not yet been adopted (notably, in the area of public sector wages, where wage drift, in addition to base and structural wage increases, has been substantial in the past); (iv) the projected revenues from asset sales (½ percent of GDP) counted on sizable real estate sales, which may prove difficult to secure, as suggested by the experience in 2002;and (v) some carryover was likely from overruns projected by staff for 2002. Additional risks stemmed from staff's weaker growth projections: expecting ¾ percentage points slower GDP growth than envisaged in the *Stability Program* would widen the fiscal deficit by an estimated ⅓ percentage point.

18. **The authorities agreed that achieving the 2003 budget target depended on further measures which had not yet been secured, including to contain primary spending, and intended to proceed forcefully.** Subsequent to the mission, they announced several initiatives (e.g., to suspend automatic career progression in the civil service and

extend the use of generic drugs) that would garner substantial savings, if fully implemented. Staff also argued for more progress in replacing one-off measures (estimated at around 1 percent of GDP). The authorities noted that reliance on these measures would decline in 2003 and that they provided a bridge until more durable expenditure savings could be secured.

Expenditure and budget reform

19. **Primary spending reduction (in relation to GDP) was at the center of the authorities' medium-term fiscal program, although no reduction was envisaged for 2003**. The *Stability Program* targeted a decline in primary current spending by 2¾ percent of GDP during 2003–06, with the decline starting in 2004. The staff thought that more substantive progress should and could be secured in 2003; the authorities argued that this was difficult—not least since some of structural measures took time to yield substantive benefits.

20. **The discussions focused on potential areas for savings as well as on the quality of adjustment measures**. The authorities agreed that the possible negative demand effects could be mitigated by credible current expenditure reductions. Concerning specific spending measures, the discussions covered:

- **General government wage bill**: Portugal's government wage bill is far above the euro-area average (in relation to GDP)—reflecting relatively high public sector employment shares and wage differentials—and, in contrast to most partner countries, has continued to rise in recent years. To address these trends, the new government has taken steps to: facilitate mobility within the sector, reduce the number of fixed-term employees, and, for 2003, sharply curtail planned wage increases (including wage drift and structural career adjustments, which had contributed to large wage increases in the past). They would also review OECD and staff recommendations for broader reforms, moving toward performance-based incentives and establishing multiyear employment reduction targets, taking full advantage of reductions arising from retirement and general turnover.

General Government Wage Bill
(In percent of GDP)

	2001	1998–2001 Change
Portugal	15.2	1.2
Ireland	8.0	-0.7
Spain	10.4	-0.3
Euro area	10.5	-0.3

Source: OECD database.

- **Subsidies**: The abolition of the mortgage subsidy (effective October 2002) will provide significant budgetary savings over time, and areas for additional savings were also being considered (for example on transport services, where improved efficiency and cost recovery have remained elusive).

- **Pensions**: Recent reforms have strengthened equity aspects of the public pension system (extending the contribution period for determining benefits) but also raised the benefit accrual rate—resulting in little net effect on longer-term spending trends. The new parliament quickly adopted legislation—currently reviewed by the courts—that would

Public Pension Expenditures
(In percent of GDP)

	2000	2001–2030 Change
Portugal	9.8	3.8
Ireland	4.6	3.0
Spain	9.0	2.4
EU	10.4	2.6

Source: EU (2001).

align relatively generous replacement rates for civil service pensions with those for the private sector, an important step toward curtailing future spending. With aging-related spending ratios rising faster than in the rest of the EU (even under, in the staff's view, relatively favorable assumptions), the authorities planned further reforms, probably during the first half of the current legislature.

- **Health care and social benefits**: While health care spending is not particularly high relative to other EU countries, the government saw room for significant savings and efficiency gains. Initiatives so far included steps to increase accountability of hospitals, to incorporate some into separate entities outside the general government, and to expand copayments for pharmaceuticals. The authorities acknowledged that the incorporation of hospitals would yield significant savings only if accompanied by efficiency gains, and intended to limit future state liabilities in this area. The staff also stressed the need for timely settlement of health care obligations, and the authorities were hopeful to break a legacy of spending arrears. On social benefits, they noted the tightening of eligibility criteria for unemployment and minimum income benefits, and indicated that other steps would address benefit abuse.

- **Capital spending**: Ad hoc cutbacks of capital spending played an important role in reducing the deficit in 2002. Notwithstanding continuing infrastructure needs, financed in part by EU transfers, the government saw some room for curtailing Portugal's relatively high public investment over the medium term.

21. **There was agreement that shortcomings in budget planning and control had contributed to weak fiscal performance in the past**. Budget plans had frequently been based on unduly optimistic assumptions and were largely limited to a 1-year horizon, without a comprehensive view of expenditure and tax policy priorities. Moreover, expenditure targets have proved ineffective—reflecting also a lack of budgetary control and statistical weaknesses, including for operations outside the state sector (i.e., the central administration). The authorities noted that some progress had already been secured, covering more timely reporting of nonstate operations and a tightening of local government's borrowing abilities, aimed at securing unchanged net indebtedness in 2003. The authorities intended to take up the staff's suggestion for introducing timely, quarterly general government accounts, and would review the case for binding expenditure ceilings within a multiyear framework. They intended to review these issues in the context of a fiscal module of a Report on the Observance of Standards and Codes in 2003.

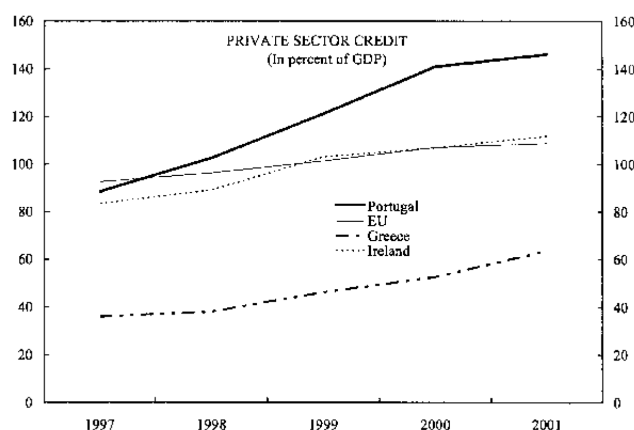
Tax policy

22. **Although plans to lower taxes were delayed, the government intended to implement cuts after 2003 and address weaknesses in tax administration**. Plans for tax cuts had been thwarted by much higher-than-anticipated fiscal deficits. The authorities intended to lower the corporate income tax rate from 30 percent to 20 percent by 2006, but agreed that tax reductions should be contingent on well identified expenditure savings, ensuring fiscal consolidation. To strengthen tax administration, fiscal benefits would be

suspended for all delinquent taxpayers, and the tax services' information system was being upgraded. The authorities indicated that the tax amnesty of late 2002 would not be repeated, with staff cautioning that such amnesties undermined market transactions and future tax compliance.

C. Financial Sector Issues

23. **Notwithstanding a marked slowdown, private sector credit growth again exceeded income growth in 2002.** The expiration of the mortgage subsidy and historically low real interest rates boosted mortgage lending; overall, however, private sector lending slowed significantly, following a decade of rapid credit growth that pushed credit-to-GDP ratios to well above EU levels.

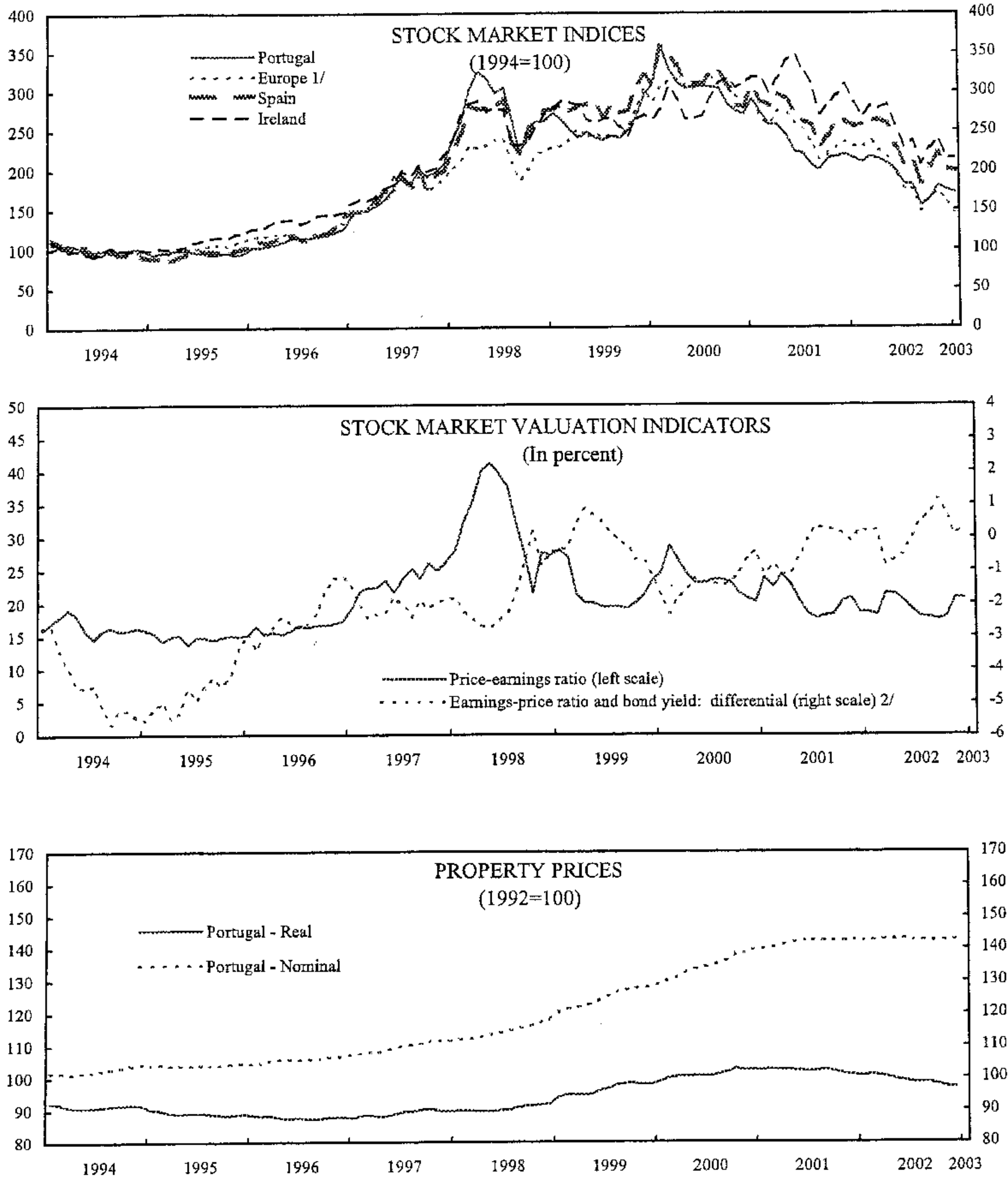


24. **Banks' funding needs remained above the growth in core deposits and the sector's profitability declined in 2001/02.** With sluggish deposit growth, the banking system's loan to resident deposit ratio rose further to 170 percent, well above levels in most EU countries (including emigrants' and other nonresidents' deposits, the ratio reached 125 percent). In financing the gap, banks have successfully extended the maturity profile, relying on international capital markets and foreign subsidiary deposits, as well as on preferred share and subordinated debt issues and securitization. The decline in bank profitability reflected narrowing interest margins, increasing administrative costs, and repercussions from equity market declines (Figure 6), including from banks' trading books and strategic equity investments.

25. **Loan portfolio quality was estimated to have deteriorated in 2002, although an assessment was hampered by the slow recognition of evolving credit risks in regulatory nonperforming loans (NPL).** NPL ratios have increased slightly from historically low levels (Table 5). However, NPLs include only overdue interest and principal payments and not, for example, the full loan amount after a certain period of delinquency (Appendix III). The staff noted that this severely limited the usefulness of NPLs for market participants as an indicator of loan quality, and argued for introducing an NPL definition and provision system closely linked with banks' internal loan ratings and consistent with international best practice. Recent regulatory changes have accelerated provisioning requirements (Appendix III),[3] but

[3] While the new regulations, issued at end-January 2003, tightened rules for specific provisions, they also reduced the general provisioning requirement on some mortgage loans. With the latter immediately effective but with specific provisions changes phasing in over time, it is likely that total provisions will decline in the near term.

Figure 6. Portugal: Asset Market Indicators, 1994:1–2003:1



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

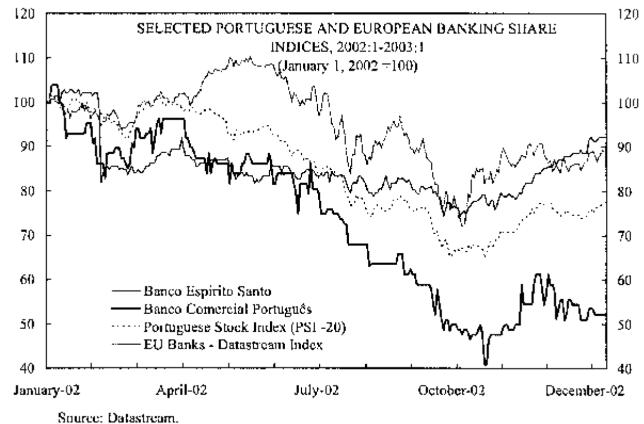
1/ FTSE Eurotop 100 (in euros).
2/ Differential calculated using 10-year bond rates.

with the continued backward-looking focus of NPLs and loan loss recognition, it remained difficult for staff to assess the adequacy of overall provisions, especially if economic weakness were to persist. The authorities were confident, however, on the adequacy of overall provisions, noting also the typically 1 percent general credit provision requirement (1.5 percent for consumer loans), which is higher than in most industrial countries.

26. **The capital ratios of all major banks remained above regulatory minima, and discussions focused on whether risk exposures warranted additional capital or provisions:**

- The consolidated banking system's **regulatory capital ratio** was 9.8 percent in mid-2002, and all major financial groups had ratios above 9 percent. While this was below the ratio recorded in many industrial countries, international comparisons are difficult. In particular, Bank of Portugal regulations defining bank Tier 1 and Tier 2 capital levels are stricter than Basel capital guidelines, but the slow recognition of nonperforming loans and backward-looking minimum provisioning requirements complicate an assessment of the adequacy of banks regulatory capital ratios. In assessing Portuguese banks' capital, some rating agencies have issued warnings when Tier 1 capital ratios fell below levels they often deemed acceptable in other countries.

- **Financial sector risks** related in part to financial groups' asset concentrations toward a few companies (with financial groups' insurance units adding to their bank's exposures) and specific sectors (especially construction). Credit risks stemmed also from weak economic prospects, especially if these were to lead to a substantial rise in unemployment and business failures, and to potential repercussions from fiscal consolidation, including on the construction sector. At the same time, direct exposures to emerging markets were low compared with other euro-area countries, although there were important indirect exposures, principally reflecting domestic companies' foreign direct investments in Brazil. Market participants' concerns about overall risk developments had contributed to the underperformance of Portuguese vis-à-vis European banking shares in 2002.



Source: Datastream.

- The **Bank of Portugal** noted that its stress tests indicated the banks' resilience even to considerably worse-than-anticipated macroeconomic developments. In any case, evolving risks would be monitored closely, with past guidance to banks for raising capital and extending funding maturities being but two examples of their interventions. Staff recalled the

Fund's suggestion for undertaking an FSAP at the conclusion of the last consultation, and the authorities were considering participation, possibly in late 2003.

27. **The health of the Portuguese insurance and pension fund industry has deteriorated significantly in recent years, mirroring to some extent developments in other countries.** Aside from life insurance, policy premia were insufficient to cover realized losses in both 2000 and 2001. Moreover, investment portfolio performance has suffered as equity markets declined, and solvency margins dropped, a trend that was estimated to have continued through 2002. Supervisors were closely monitoring developments and were confident that financial groups would proceed with recapitalizations, as needed.

D. Structural Policies to Support Economic Adjustment and Growth

28. **The authorities agreed that structural reforms would be critical to address the large macroeconomic imbalances and raise productivity growth.** With no independent monetary policy and fiscal policy focused on consolidation, structural policies have gained added importance—in particular with a view to raising productivity. As discussed in more detail in previous country reports, Portugal's growth has historically relied on increased factor inputs (capital and labor), with relatively small contributions from technical progress (total factor productivity). With factor usage already high—and high labor force participation one of the hallmarks of Portugal's earlier successes—future growth is likely to require stronger productivity growth, and more efficient resource use would also facilitate the unwinding of macroeconomic imbalances.

29. **Against this background, the authorities expected some efficiency gains from a new labor code, even if it did not address Portugal's relatively severe dismissal restrictions.** The new labor code would increase the flexibility of working arrangements and allow expanded use of fixed-term contracts, consistent with earlier OECD advice. Staff noted, however, that Portugal's employment protection regulations, ranked as the most severe among OECD countries, were likely to entail substantial output and efficiency costs[4]—a shortcoming that was not addressed by the current labor reforms. The authorities and social partners accepted that relatively high dismissal costs may hinder economic efficiency, but had not forged a consensus on these issues amid disputes over other elements of labor market reform. Labor unions also stressed the importance of strengthening education and vocational training, and the *Stability Program* placed considerable emphasis on education reform.

30. **The authorities have initiated several steps to strengthen competition and efficiency in product markets.** A new competition authority is to be set up, and staff agreed that this could entail sizable benefits, provided the authority would become politically

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[4] H. Takizawa, "How Costly are Dismissal Restrictions? The Case of Portugal" (forthcoming IMF Working Paper).

independent and endowed with adequate investigative and enforcement authority. While important details remained to be decided, other initiatives offered the prospect of enhancing competition and facilitating foreign direct investment, including plans to reform industrial licensing, streamline relatively lengthy bankruptcy proceedings, and privatize state holdings in industry and network industries.

E. Statistical and Other Issues

31. **The authorities recognized extensive weaknesses in Portugal's statistics**. In the fiscal area, recent improvements included the more timely coverage of some operations outside the state sector, and plans called for producing quarterly general government statistics. Little progress was, however, envisaged in other areas, notwithstanding staff's renewed call for determined efforts to address long-standing shortcomings, for example on external and real sector statistics (Appendix II).

32. **Trade policy discussions focused on the effect of liberalization of textile trade under the Uruguay Round and steps to increase market access for developing country exports**. The authorities explained that the Portuguese textile sector was in secular decline and increased competition, following the liberalization, would only accelerate the (inevitable) shake out in the sector. Staff noted the sector's sizable share of Portugal's exports (about 20 percent), and the authorities concurred that steps to increase flexibility more broadly (including in the labor market) were needed to ensure a relatively smooth reallocation of employment and export capacities. On trade liberalization for the least developed countries, the authorities expressed a preference to proceed within a multilateral framework.

33. **The authorities strongly supported recent anti-money laundering measures and initiatives to combat the financing of terrorism**, prepared under the aegis of the EU. In the financial sector, the National Council of Supervisors had coordinated efforts and was charged with implementing the Financial Action Task Force (FATF) countermeasures concerning noncooperative countries and jurisdictions.

IV. Staff Appraisal

34. **The new government's economic agenda appropriately focuses on safeguarding economic stability and reestablishing the conditions for strong medium-term growth**. The difficulty of the tasks—and the urgency for progress—are underscored by high and still rapidly rising external indebtedness; the largest structural fiscal deficit in the European Union and rising public sector debt; and historically (and in international comparisons) high levels of private sector indebtedness, notwithstanding a considerable deceleration of private credit growth. Each of these imbalances by itself would raise concerns, but it is their confluence—together with a sharp slowdown of economic growth—that makes the policy challenges particularly difficult. The government's agenda focuses on fiscal consolidation to strengthen domestic saving, aiming for budget balance over the medium term. It envisages primary expenditure restraint, following the rapid increases in recent years, and counts on market-

oriented structural reforms. And in the financial sector, steps continue toward strengthening the sector's resilience.

35. **In 2002, fiscal consolidation advanced substantially, relying heavily on one-off measures—understandably in light of the magnitude of the task at hand and the limited time available for the new government**. The fiscal deficit is likely to have declined to around 3 percent of GDP and the decline in the structural balance was well above any adjustment in Portugal in the run-up to monetary union. These adjustments have also yielded first successes in reining-in the large macroeconomic imbalances. However, the deficit improvement relied principally on revenue (including one-off) measures and stop gap freezes on capital spending, while primary current spending increased again strongly in relation to GDP.

36. **The principal fiscal task is to proceed with consolidation while improving the quality of adjustment—a task not adequately addressed by the 2003 budget**. The targeted decline in the structural balance would, if secured, contribute importantly to further reductions of the macroeconomic imbalances. But the budget's measures are insufficient to achieve its targets, notwithstanding further recourse to sizable one-off measures. Recognizing this, the government recently presented additional plans, with steps to address the perennially large wage drift particularly welcome. Still, in light of sizable risks, implementation of further primary expenditure measures is urgently needed, with a view to at least stabilize these expenditures in relation to GDP. The recourse to a tax amnesty in 2002 was regrettable and should be avoided in the future.

37. **Durable expenditure cuts will be critical for securing fiscal consolidation**. Following years of rapid increases, public sector wage expenditures are the highest (in relation to GDP) in the euro area—and it is in this area that corrective steps are particularly needed. This will require both reductions in employment and meaningful wage restraint (covering all components of wage drift), and will need to be implemented forcefully at all levels of the public sector. With a view to longer-term challenges, plans to address aging-related expenditures early in the current legislature are welcome; already, a strong signal was set with recent legislation aligning relatively generous public sector with private sector pensions. On health care, a further expansion of copayments may be warranted, if savings from recent initiatives fell short of current plans. Moreover, the decentralization of hospitals should not lead to new contingent liabilities for the state. Achieving the envisaged fiscal adjustment requires consistent efforts by local governments, which should be helped by the recent tightening of their borrowing limits.

38. **Establishing binding multiyear expenditure ceilings and strengthening budget planning and control would facilitate fiscal consolidation and increase efficiency**. The pending fiscal module of a Report on the Observance of Standards and Codes should provide helpful guidance to address weaknesses in these areas.

39. **In the financial sector, credit growth has decelerated markedly, but the sector's potential risk exposures are large**. While credit growth has decelerated, it continued to

outpace deposit growth, with banks successfully extending the maturity structure of other funding instruments. However, high indebtedness of the private sector, rising unemployment, and slow growth prospects signal additional risks to a sector characterized by high loan risk concentrations, including in construction.

40. **Against this background, additional steps and continued vigilance will be needed to address evolving risks.** The sector's (and particular institutions') risk exposures may warrant further increases in capital and provisioning. Moreover, additional reforms to the present definition of nonperforming loans and to the system of loan loss provisioning are called for to improve the role of nonperforming loans as indicators of evolving credit quality and align bank loan valuations with forward looking criteria. This would be achieved by moving to definitions and provisioning that is more closely aligned with banks' internal loan ratings and is consistent with international best practices. Steps to monitor carefully developments in the insurance sector and of pension funds are well placed, in view of recent adverse developments and potential risks. It would be most helpful to assess financial sector issues in more depth within the context of an FSAP.

41. **Recent initiatives to strengthen market-oriented reforms in product and labor markets could underpin stronger productivity growth.** The renewed emphasis on privatization, the strengthening of bankruptcy procedures, steps to facilitate investment (including foreign direct investment), and the establishment of a competition authority—which should be politically independent and endowed with adequate investigative and enforcement authority—are all helpful in this regard. In the labor market, the proposed new labor code would increase flexibility in some areas, but progress is also needed to reduce Portugal's relatively severe dismissal restrictions, which hinder the now needed sectoral adjustments toward the tradable sector. In moving forward, it would be helpful if progress could be secured in a consultative process, involving all social partners.

42. Portugal is encouraged to play an active role in reducing international **trade barriers** and abolishing them for exports from the least developed countries, and to increase its relatively low **official development assistance**.

43. **Statistical weaknesses** continue to hamper a timely assessment of macroeconomic developments, and improvements are urgently needed, going well beyond current, welcome plans to improve public finance and some other statistics (Appendix II).

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

Table 1. Portugal: Selected Economic Indicators, 1997–2003 1/
(Changes in percent, except as otherwise indicated)

	1997	1998	1999	2000	2001	2002 Est.	2003 Proj.
Domestic economy							
Real GDP	3.8	4.6	3.8	3.7	1.6	0.4	0.4
Real domestic demand	5.2	6.8	6.0	3.1	1.1	-0.7	0.0
Private consumption	3.3	5.0	5.1	2.6	1.2	0.3	0.4
Gross fixed investment	13.9	11.5	6.4	4.4	0.0	-4.4	-0.5
Foreign sector contribution	-1.6	-2.8	-2.8	0.2	0.4	1.1	0.4
Employment	1.9	9.4	1.8	1.7	1.6	0.5	-0.5
Unemployment rate	6.7	5.0	4.4	4.0	4.1	4.7	5.6
Output gap	-1.4	0.3	1.2	2.1	1.1	-1.1	-3.1
Compensation per worker (manufacturing)	4.8	4.8	4.5	5.1	5.4	4.6	3.8
Unit labor costs (manufacturing)	2.1	2.8	3.9	2.3	4.3	4.3	3.5
Consumer prices (national index)	2.2	2.8	2.3	2.9	4.4	3.6	2.8
Consumer prices (harmonized index)	1.9	2.2	2.2	2.8	4.4	3.7	2.8
GDP deflator	3.8	3.8	3.1	3.2	4.7	4.1	2.9
External accounts							
Export volume (goods)	10.1	6.7	5.2	8.1	0.7	1.4	3.4
Import volume (goods)	13.2	15.2	10.3	6.1	0.9	-1.7	1.6
Export unit value (goods and services)	2.6	0.8	0.2	5.4	2.7	-1.5	-3.3
Import unit value (goods and services)	2.7	-1.2	-0.3	8.5	0.8	-2.0	-3.3
Trade balance (in percent of GDP)	-9.2	-10.9	-11.9	-13.0	-12.1	-10.6	-9.8
Capital transfers (net, US$ billions)	2.8	2.5	2.5	1.5	1.1	2.3	2.2
Current account including capital transfers (US$ billions)	-3.2	-5.3	-7.2	-9.4	-9.3	-7.9	-8.4
(in percent of GDP)	-3.1	-4.7	-6.3	-8.8	-8.4	-6.5	-6.0
Nominal effective exchange rate	-2.1	-1.1	-1.4	-2.9	0.6	0.7 4/	...
Real effective exchange rate (CPI based)	-1.8	0.2	-0.5	-2.5	2.4	2.3 4/	...
General government finances (in percent of GDP) 2/							
Revenues	41.8	41.5	42.9	42.3	42.1	44.1	44.0
Expenditures	44.8	44.1	45.2	45.2	46.3	47.0	47.9
Of which: capital expenditures	6.3	6.0	5.9	5.1	6.1	5.6	5.6
Overall balance	-3.0	-2.6	-2.4	-2.9	-4.1	-3.0	-3.9
Structural balance, excluding asset sales	-2.4	-2.7	-2.9	-4.1	-4.7	-3.3	-3.1
Primary balance	1.3	0.9	0.8	0.3	-1.1	0.1	-0.6
Privatization receipts	4.7	3.8	1.4	2.5	0.3	0.0	...
Government debt, Maastricht definition	59.1	55.0	54.3	53.1	55.4	59.3	63.1
Financial variables 3/							
National contribution to euro area M3	6.3	7.8	9.8	6.9	5.8	3.3 4/	...
Domestic credit	11.6	16.8	19.9	24.1	13.7	6.5 4/	...
Credit to the private sector 5/	20.7	25.0	26.2	23.9	12.2	7.3 4/	...
Interest rates (percent)							
Overnight rate	5.1	3.3	3.0	5.2	3.9	3.0	...
Deposit rate, 91–180 days	4.6	3.3	2.8	4.4	3.3	3.0	...
Lending rate, 91–180 days	8.4	6.0	5.1	6.4	5.2	4.7	...
Government benchmark bond	5.7	4.1	5.5	5.2	5.1	4.5	...

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

1/ Unless otherwise noted, 2002 and 2003 data are staff estimates or projections.
2/ Structural balances exclude UMTS receipts in 2000 and asset sales in subsequent years.
3/ End-of-period data.
4/ Data for 2002 refers to November.
5/ Comprises all domestic credit except that to the central government and includes securitized loans.

Table 2. Portugal: General Government Accounts, 1997–2003

	1997	1998	1999	2000	2001		2002			2003	
					Budget	Est.	Budget	Auth. Est.	Staff	Budget	Staff
					(In millions of euros)						
Total revenues	38,894	41,940	46,309	48,848	54,627	51,729	57,461	56,635	56,701	59,967	58,468
Current receipts	36,720	40,351	44,388	47,191	51,487	49,420	51,070	53,233	53,407	56,549	55,049
Tax revenue	22,358	24,391	27,111	28,702	31,508	29,726	32,181	31,679	32,216	33,253	33,013
Social security contributions	10,350	11,455	12,275	13,608	14,357	14,800	15,659	15,547	15,687	16,523	16,324
Other current revenues	4,012	4,505	5,002	4,881	5,622	4,894	3,230	6,007	5,503	6,773	5,712
Capital revenue	2,174	1,589	1,921	1,657	3,139	2,309	4,007	3,402	3,294	3,419	3,419
Total expenditures	41,660	44,542	48,880	52,206	56,006	56,809	59,768	60,319	60,499	63,273	63,609
Primary current expenditures	31,826	35,012	38,991	42,651	44,287	45,551	47,120	49,261	49,352	51,543	51,740
Interest payments	3,934	3,490	3,464	3,680	3,781	3,770	4,001	3,930	3,930	4,403	4,403
Capital expenditures	5,900	6,040	6,425	5,875	7,937	7,488	8,647	7,128	7,218	7,327	7,466
Overall balance	-2,767	-2,602	-2,571	-3,358	-1,379	-5,080	-2,308	-3,684	-3,799	-3,306	-5,142
Excluding asset sales	...	...	...	-3,920	...	-5,197	...	-4,662	-4,770	-4,009	-5,845
					(In percent of GDP)						
Total revenues	41.8	41.5	42.9	42.3	45.7	42.1	44.6	43.8	44.1	44.4	44.0
Current receipts	39.5	40.0	41.1	40.8	43.1	40.2	41.5	41.1	41.5	41.9	41.5
Tax revenues	24.0	24.2	25.1	24.8	26.4	24.2	25.0	24.5	25.1	24.6	24.9
Social security contributions	11.1	11.3	11.4	11.8	12.0	12.0	...	12.0	12.2	12.2	12.3
Other current revenues	4.3	4.5	4.6	4.2	4.7	4.0	2.5	4.6	4.3	5.0	4.3
Capital revenue	2.3	1.6	1.8	1.4	2.6	1.9	3.1	2.6	2.6	2.5	2.6
Total expenditures	44.8	44.1	45.2	45.2	46.8	46.2	46.4	46.6	47.0	46.8	47.9
Primary current expenditure	34.2	34.7	36.1	36.9	37.0	37.0	36.6	38.1	38.4	38.2	39.0
Interest payments	4.2	3.5	3.2	3.2	3.2	3.1	3.1	3.0	3.1	3.3	3.3
Capital expenditures	6.3	6.0	5.9	5.1	6.6	6.1	6.7	5.5	5.6	5.4	5.6
Overall balance	-3.0	-2.6	-2.4	-2.9	-1.2	-4.1	-1.8	-2.8	-3.0	-2.4	-3.9
Excluding asset sales	...	...	...	-3.3	...	-4.2	...	-3.6	-3.7	-3.0	-4.4
Memorandum items:											
Structural balance net of asset sales 1/	-2.4	-2.7	-2.9	-4.1	-1.0	-4.7	-1.8	-3.2	-3.3	-2.0	-3.1
Primary balance	1.3	0.9	0.8	0.3	2.0	-1.1	1.3	0.2	0.1	0.8	-0.6
Primary structural balance 1/	2.2	1.5	0.3	-0.9	1.9	-1.6	1.3	-0.1	-0.2	1.2	0.2
Asset sales (in millions of euros) 2/	...	...	...	562	...	117	...	971	971	703	703
Public Debt (Maastricht definition)	54.0	55.0	54.0	53.1	...	55.4	...	58.9	59.3	60.5	63.1
Nominal GDP (in millions of euros)	93,014	100,963	108,030	115,546	119,562	122,978	128,792	129,404	128,526	135,100	132,734
Change in nominal GDP (in percent)	7.0	8.5	7.0	7.0	6.1	6.4	4.7	5.2	4.5	4.4	3.3
Real GDP growth (in percent)	4.0	4.6	3.8	3.7	3.3	1.6	2.0	0.7	0.4	1.3	0.4

Sources: Ministry of Finance; and Fund staff estimates and projections.

1/ Structural balances are calculated using the staff's estimates of potential output. Asset sales, including UMTS receipts, are netted out for purposes of calculating structural balances.

Table 3. Portugal: Balance of Payments, 1996–2002

	1996	1997	1998	1999	2000	2001	2001 Jan-Nov	2002 Jan-Nov
	(In billions of U.S. dollars)							
Current account	-4.3	-6.1	-7.9	-9.7	-10.9	-10.3	-9.6	-9.0
Trade balance	-9.0	-9.8	-12.3	-13.7	-13.9	-13.4	-12.2	-11.4
Exports fob	24.7	24.4	25.8	25.5	25.2	25.2	23.4	24.6
Imports fob	33.8	34.2	38.0	39.2	39.1	38.6	35.6	36.1
Services, net	1.4	1.4	1.9	1.9	1.9	2.6	2.3	2.8
Exports	7.7	7.6	8.9	8.7	8.5	8.8	8.0	8.8
Imports	6.4	6.2	6.9	6.8	6.6	6.2	5.7	6.0
Of which:								
Tourism	2.4	2.5	3.2	3.0	3.0	3.4	3.1	3.3
Exports	4.7	4.6	5.5	5.3	5.2	5.5	5.0	5.4
Imports	2.2	2.1	2.3	2.3	2.2	2.1	2.0	2.1
Income	-1.0	-1.5	-1.6	-1.8	-2.3	-3.1	-2.6	-3.2
Current transfers, net	4.3	3.8	4.1	3.9	3.4	3.5	2.9	2.9
Private remittances, net	3.3	3.3	3.3	3.3	3.2	3.3	3.0	2.7
Official transfers, net	1.0	0.5	0.8	0.6	0.2	0.2	-0.1	0.2
Capital account	2.2	2.8	2.5	2.5	1.5	1.1	0.8	1.4
Current account (including capital transfers)	-2.1	-3.2	-5.3	-7.2	-9.4	-9.3	-8.8	-7.6
Financial account	3.9	4.7	5.5	8.8	10.3	9.6	9.5	8.5
Direct investment	0.7	0.6	-0.7	-1.8	-1.1	-1.9	-2.2	-0.1
Portuguese investment abroad	-0.8	-1.9	-3.9	-3.1	-7.7	-7.8	-7.3	-3.5
Foreign investment in Portugal	1.5	2.5	3.1	1.3	6.6	5.9	5.1	3.5
Portfolio investment, net	-1.6	0.6	-0.7	3.3	-1.8	2.0	2.0	0.6
Equity securities	0.9	1.8	1.2	-1.4	-0.6	-1.3	-1.7	0.1
Long-term debt securities	-2.1	-3.7	-0.6	3.5	-2.0	1.3	2.6	0.4
Money market instruments	-0.4	2.5	-1.3	1.3	0.8	2.1	1.0	0.1
Financial derivatives	0.0	0.0	0.1	0.2	0.3	0.3	0.2	0.0
Other investment, net	5.5	4.8	7.3	7.4	13.3	10.1	10.2	9.0
Of which:								
Monetary financial institutions	5.8	3.6	8.6	7.8	10.9	13.4	11.7	9.1
Of which:								
Short-term	5.6	4.9	7.1	3.8	8.2	5.5	3.0	2.0
Long-term	0.3	-1.4	1.4	4.0	2.7	7.9	8.7	7.1
Reserve assets	-0.7	-1.3	-0.5	-0.3	-0.4	-0.9	-0.7	-1.1
Errors and omissions	1.8	1.4	0.2	1.5	0.9	0.3	0.7	0.9
	(In percent of GDP)							
Memorandum items:								
Current account	-3.8	-5.7	-7.0	-8.4	-10.2	-9.4	...	...
Current account (including capital transfers)	-1.9	-3.1	-4.7	-6.3	-8.8	-8.4	...	...
Net international investment position 1/	-9.2	-15.8	-23.4	-30.7	-38.6	-40.0	...	...

Sources: Bank of Portugal; and Fund staff calculations.

1/ End-of-period data.

Table 4. Portugal: Stability and Growth Program and Staff's Medium-Term Scenario, 2002–06

(In percent of GDP, unless otherwise indicated)

	2002	2003	2004	2005	2006
	Est.	Projections			
Stability and growth program					
GDP (percent change)	0.7	1.3	2.7	3.1	3.5
Consumer prices (HICP, period average, percent change)	3.5	2.5	2.2	2.2	2.0
Gross domestic investment	-2.1	0.2	6.6	6.4	7.3
General government balance	-2.8	-2.4	-1.9	-1.1	-0.5
Revenues	43.8	44.5	43.9	43.6	43.0
Expenditures	46.6	46.9	45.8	44.7	43.5
General government primary balance	0.2	0.8	1.2	1.9	2.5
General government debt	58.8	58.7	57.5	55.3	52.6
Staff projections (unchanged policy scenario) 2/					
GDP (percent change)	0.4	0.4	1.9	3.2	3.3
Output gap (percent of potential output)	-1.1	-3.1	-3.7	-3.1	-2.3
Consumer prices (HICP, period average, percent change)	3.7	2.8	2.2	2.2	2.2
Gross fixed investment	-4.4	-0.5	1.6	3.1	3.9
Current account balance (including capital transfers)	-6.5	-6.0	-5.9	-5.8	-5.9
General government balance 1/	-3.0	-3.9	-4.3	-4.0	-3.7
General government primary balance 1/	0.1	-0.6	-0.9	-0.7	-0.3
General government debt 1/	59.3	63.1	64.6	65.1	65.1
Memorandum items:					
Previous Stability Program (December 2001)					
GDP (percent change)	1.8	2.5	3.0	3.0	...
General government balance	-1.8	-1.0	0.0	0.4	...

Sources: Ministry of Economy and Finance, " Stability and Growth Programme: Update for the period 2003–06" (December 2002); and Fund staff estimates and projections.

1/ The fiscal projections for 2003 assume that fiscal measures have the effects estimated in the 2003 budget, adjusted for differences between the authorities' and the staff's macroeconomic framework . Fiscal projections for 2004 –06 assume a constant structural primary balance (including asset sales).

2/ This illustrative scenario is based on an unchanged and ultimately unsustainable policy scenario. In particular the fiscal deficit would remain above 3 percent of GDP during 2003–06, and the current acount deficit including capital transfers around 6 percent.

Table 5. Portugal: Indicators of External and Financial Vulnerability, 1997–2002 1/
(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002	
						Est.	Date
External indicators							
Exports (annual percent change, in U.S. dollars)	-1.6	5.5	-1.2	-0.9	0.1	4.3	
Imports (annual percent change, in U.S. dollars)	1.7	11.2	3.1	-0.1	-1.4	1.4	
Terms of trade (annual percent change)	-0.1	2.0	0.5	-2.9	1.9	0.5	
Current account balance	-5.7	-7.0	-8.4	-10.2	-9.4	-8.0	
Current account balance (including capital transfers)	-2.9	-4.7	-6.3	-8.8	-8.4	-6.5	
Capital and financial account balance	7.0	7.2	9.8	11.1	9.7	8.0	
Of which: Inward portfolio investment (debt securities, etc.)	7.6	4.8	8.7	2.7	7.6	6.9	
Inward foreign direct investment	2.3	2.8	1.1	6.2	5.3	3.2	
Other investment liabilities (net)	4.5	6.5	6.4	12.5	9.2	6.6	
Official reserves (in billions of U.S. dollars, end-of-period) 2/	20.5	21.6	14.1	14.2	15.1	17.2	December
Broad money to reserves 3/	3.6	3.9	1.6	1.5	1.4	1.5	September
Central Bank foreign liabilities (in billions of U.S. dollars) 2/	2.1	2.9	10.7	7.5	9.1	10.4	November
Foreign assets of the financial sector (in billions of U.S. dollars) 4/	8.1	56.2	57.1	52.9	53.0	65.9	November
Foreign liabilities of the financial sector (in billions of U.S. dollars) 4/	42.7	56.8	57.9	73.2	83.0	111.4	November
Official reserves in months of imports 2/	7.2	6.8	4.3	4.4	4.7	5.3	December
General government non-euro denominated debt 5/	7.7	5.3	7.9	6.4	7.2	...	
Exchange rate (per U.S. dollars, period average)	175.3	180.1	187.9	217.0	223.8	212.4	
Financial market indicators							
Public sector debt (Maastricht definition)	59.1	55.0	54.3	53.1	55.4	59.3	
Money market rate (period average in percent)	5.8	4.3	2.7	4.1	4.4	3.3	December
Money market rate (real, in percent)	2.6	2.1	-0.1	1.8	1.4	-0.4	December
Stock market index (1995=100)	182.8	286.8	264.7	317.5	244.7	194.2	December
Share prices of financial institutions	168.3	297.2	266.9	306.9	222.8	176.5	December
Spread of 10-year benchmark bond with German rate (percentage points)	0.6	0.3	0.3	0.4	0.3	0.1	December
Financial sector risk indicators							
Foreign exchange loans (in billions of U.S. dollars) 6/	3.3	4.1	3.4	2.8	2.9	2.8	September
Share of foreign exchange loans in total lending (percent) 6/	3.7	3.4	2.6	1.9	1.8	1.4	September
Deposits in foreign exchange (in billions of U.S. dollars) 7/	1.5	2.3	3.0	4.0	4.7	3.5	September
Share of foreign deposits in total deposits (percent) 7/	1.4	1.9	2.6	3.5	4.5	2.9	September
Share of real estate sector in private credit 8/	35.6	38.0	40.1	39.9	40.5	42.5	November
Share of nonperforming loans in total loans 4/	4.5	3.4	2.4	2.0	2.1	2.2	November
Share of nonperforming loans in total assets 4/	1.7	1.5	1.2	1.1	1.1	1.2	November
Risk-based capital asset ratio 9/	11.5	11.1	10.8	9.2	9.5	9.8	June
Return on equity for the banking system 10/	14.8	13.6	14.7	15.1	14.9	15.3	June

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 for subsequent years.
4/ Banks only.
5/ External debt concept for euro-area members.
6/ Share of loans in non-euro currencies.
7/ Share of deposits in non-euro currencies.
8/ Real estate credit is defined as the sum of total credit by monetary financial institutions to individuals for housing and to nonfinancial corporations for construction; private credit is defined as total domestic credit excluding the general government.
9/ Capital over risk-weighted liabilities. Consolidated data for the banking system.
10/ Consolidated data for the banking system.

PORTUGAL: FUND RELATIONS

(As of January 31, 2003)

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	538.37	62.07
Reserve position in Fund	329.07	37.94
Financial Transaction Plan transfers (net)	16.00	

III. **SDR Department**:	SDR Million	Percent Allocation
Net cumulative allocation	53.32	100.00
Holdings	55.82	104.69

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/02/31, 3/25/02.

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

1. Portugal subscribed to the Special Data Dissemination Standards (SDDS), and the relevant metadata have been posted on the Dissemination Standards Bulletin Board. Portugal's publication policy is characterized by a high degree of openness and with extensive use of the Internet. The Bank of Portugal, Ministry of Finance, and National Statistics Office (INE) have several 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.

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

3. **Real sector** statistics were improved in the fall of 2000, when INE published a full set of national accounts based on ESA95 methodology, including quarterly GDP estimates. However, statistical weaknesses remain and the Bank of Portugal continues to produce separate, and at times considerably different, estimates of the annual national accounts. Gaps in timely and high quality monthly and quarterly data on output, employment, and total wage compensation hamper the monitoring of within-year developments in the labor market. Unemployment data also suffer from statistical problems caused, inter alia, by frequent revisions to the measurement of unemployment and sampling rotations.

4. **Fiscal sector** data have undergone a number of revisions during the transition to ESA95, sizably altering revenues and expenditures and hampering comparisons across years and on a cross country basis. Some progress was made and the 2001–03 budgets were presented fully consistent with recent changes in national and fiscal accounting methodology. Fiscal outturn figures on a cash basis are available with only considerable time lags—except for the central administration, which covers some 50 percent of expenditures and 70 percent of revenues. In 2002, cash-based social security accounts have become available with a lag of two months. No data of accrual-based developments are available on a quarterly basis. Forecasts for the yearly outturn for the general government (including autonomous funds, such as the National Health Service) are disseminated semiannually. However, recent plans envisage the production of quarterly general government statistics.

5. **External sector** data are provided according to the IMF's Fifth *Balance of Payments Manual*. The liberalization of capital movements and tax-induced capital transactions have complicated the interpretation of balance of payments flows. The difficulties and related data weaknesses 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 roll over of financial positions which generates large gross inflows and outflows.

Portugal: Core Statistical Indicators
as of January 31, 2003

	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	01/31/03	9/30/02	12/31/02	12/31/02	12/31/02	01/31/03	Dec. 2002	Nov. 2002	Nov. 2002	Dec. 2002	2002 Q3	Nov. 2002
Date Received	1/31/03	3rd week of January	3rd week of January	3rd week of January	3rd week of January	01/15/03	3rd week of January	3rd week of January	3rd week of January	3rd week of January	End January	3rd week of January
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.

PORTUGAL: NONPERFORMING LOANS AND LOAN LOSS PROVISIONING

A. Nonperforming Loans and Loan Loss Provisions: Rules Prior to February 2003

1. Under Bank of Portugal rules, loan payment amounts delinquent by more than 30 days must be recorded as nonperforming loans (NPLs). Under this regulatory definition, only required principal and interest payments overdue more than 30 days are reflected in banks' NPL balances. NPL balances grow as more scheduled payments become delinquent.

2. Under the provisioning system that was in effect until February 2003, banks were required to make a general credit risk provision equal to 1 percent of the value of credit extended except in the case of consumer loans where the required provision is 1.5 percent.

3. Specific loan loss provisions are linked to the type of loan, the existence of different types of guarantees or collaterals, the length of time that required loan payments are delinquent, and the NPL amount that has accumulated on the loan. For non mortgage related loans, minimum provisions were set according to the following schedule:

Length of Time in Default	NPL Provisioning Rate for Loans Without Collateral	NPL Provisioning Rate for Loans with Personal Guarantee	NPL Provisioning Rate for Loans with Collateral
		(In percent)	
3–6 months	25	10	10
6–12 months	50	25	25
12–18 months	100	50	50
18–36 months	100	100	50
over 36 months	100	100	100

4. For residential mortgage loans, or real estate lease transactions with the same purpose, provisions were made according to the following schedule:

Length of Time in Default	Mortgage on a Owner-Occupied Residence	Other Mortgage Loans
	(In percent)	
3–6 months	10	10
6–12 months	25	25
12–48 months	50	50
48–60 months	50	100
Over 60 months	100	100

5. These minimum provisioning requirements apply on a loan-by-loan basis and not on a borrower's consolidated loan position, unless the loans are classified as "other doubtful debts." Under this system, for example, if a borrower has three loans from a single bank but

is only delinquent more than 30 days on one of the loans, the amount recorded as an NPL would represent only the specific payments that are overdue on the single loan. Moreover, should the single loan continue in delinquency, it is only that loan that would require specific loan loss provisions under Bank of Portugal rules—at least initially. If the borrower remained current on the remaining two loans, these loans would neither be reflected in NPL measures nor in specific loan loss provisions. If, however, the magnitude of the NPL amount increases sufficiently, the provisioning rules are modified and the basic provisions are augmented by an additional provisioning requirement.

6. The method for calculating minimum required loan loss provisions changes if either:

(1) The NPL amount on a single loan exceeds 25 percent of the loan's balance; or,

(2) The NPL amount on the consolidated loans of a single bank borrower exceeds 25 percent of the consolidated amount of the outstanding value of funds borrowed by the entity.

If either of these conditions holds, the non delinquent portion of a creditor's loan balance becomes classified as "other doubtful debts," and while these balances are not included in a bank's reported NPLs, they do require additional specific provisions.

7. To explain the additional provision calculations for "other doubtful debts", it is useful to define the residual loan balance (RLB) as the difference between a loan's outstanding balance and the NPL amount recorded for a loan. If (1) occurs, the provisions are calculated as described previously, but the base provision amount is augmented by an additional provision equal to ½ the provisioning rate used on the NPL balance applied to the RLB.

8. If (2) occurs, the base provisions are calculated on the individual loans as described previously and cumulated, but to this sum is added an additional provision for "other doubtful debts" equal to ½ the average provisioning rate used on the individual loan NPLs applied to the sum of RLB values for all of a borrower's loans at the bank. In all cases, a bank's NPLs and provisioning for a particular borrower are based only on the borrower's delinquency vis-à-vis this specific bank; for example, a delinquency of a borrower on loans to bank A does not affect NPLs or provisioning of bank B or any other bank.

9. It should also be noted that the rules regarding NPL recognition allow a bank to continue to accrue interest on nonperforming loans secured by collateral or on nonperforming loans guaranteed by the following entities: Portuguese Government; Bank of Portugal; bodies of the Portuguese General Government; Deposit Guarantee Fund; Agricultural Credit Guarantee Fund; European Communities and respective Institutions; Central Governments of other Zone A (essentially OECD) countries; Central Banks of other Zone A countries and other similar bodies of the same countries or of the European Community; European Investment Bank; Bank for International Settlements; International Monetary Fund; and Multilateral Development Banks.

B. Recent Changes in the Bank of Portugal's NPL and Provisioning Rules

10. As of February 2003, the Bank of Portugal's definition of NPL and its general and specific loan loss provisioning rules have been modified. The major changes enacted include:

- The general credit risk provision has been reduced from 1 percent to 0.5 percent for mortgages or leases on owner-occupied residences.
- Delinquent mortgages with loan-to-value (LTV) ratios of 75 percent (or greater) are treated as a separate provisioning category.
- The period of time after which 100 percent provisioning of NPL is required is reduced for some loan categories and a 75 percent provisioning "bucket" has been added.
- New specific provisioning rules have been introduced that require additional provisions when NPL balances are not fully collateralized or guaranteed.
- The provisioning regime for "other doubtful debts" has been modified.
- "Other doubtful debt" balances will be included in the definition of NPLs under certain circumstances.

11. The newly enacted NPL provisioning rates for the alternative loan categories are:

<table>
<tr><th rowspan="5">Length of Time in Default</th><th rowspan="4">Without Guarantee</th><th colspan="6">With Guarantee</th></tr>
<tr><th rowspan="3">Secured by Personal Guarantee</th><th rowspan="3">Nonmortgage Collateral</th><th colspan="3">Mortgages</th></tr>
<tr><th rowspan="2">Other Cases</th><th colspan="2">Mortgages on an Owner-Occupied Residence</th></tr>
<tr><th>LTV ≥ 75%</th><th>LTV ≤ 75%</th></tr>
<tr><th colspan="7">(In percent)</th></tr>
<tr><td>Up to 3 months</td><td>1</td><td>1</td><td>1</td><td>1</td><td>0.5</td><td>0.5</td></tr>
<tr><td>3–6 months</td><td>25</td><td>10</td><td>10</td><td>10</td><td>10</td><td>10</td></tr>
<tr><td>6–9 months</td><td>50</td><td rowspan="2">25</td><td rowspan="2">25</td><td rowspan="2">25</td><td rowspan="3">25</td><td rowspan="4">25</td></tr>
<tr><td>9–12 months</td><td>75</td></tr>
<tr><td>12–15 months</td><td rowspan="8">100</td><td>50</td><td rowspan="2">50</td><td rowspan="2">50</td></tr>
<tr><td>15–18 months</td><td>75</td><td rowspan="2">50</td></tr>
<tr><td>18–24 months</td><td rowspan="6">100</td><td rowspan="2">75</td><td rowspan="2">75</td><td rowspan="3">50</td></tr>
<tr><td>24–30 months</td><td rowspan="3">75</td></tr>
<tr><td>30–36 months</td><td rowspan="4">100</td><td rowspan="4">100</td></tr>
<tr><td>36–48 months</td><td rowspan="2">75</td></tr>
<tr><td>48–60 months</td><td rowspan="2">100</td></tr>
<tr><td>Over 60 months</td><td>100</td></tr>
</table>

12. In the case of delinquent collateralized loans, or delinquent loans with guarantees, when collateral values are estimated to be less than the NPL amount, or if the value of the

guarantee is judged to be less than the NPL amount, the bank must provide for the difference between the value of the NPL and the value of the guarantee or collateral, using the provisioning rate applicable to loans with no guarantee.

13. The provisioning requirements for "other doubtful loans" have been modified to include a time-in-delinquency threshold that applies as an additional criterion for determining when supplemental loan loss provisions are required. Under the new rules, specific loan loss provisions are determined as previously described (paragraphs 7 and 8), but with an additional requirement that provisions for "other doubtful loans" are also required when the time in delinquency exceeds: 6 months for a loan with an original maturity of less than 5 years; 12 months on a loan with an original maturity between 5 and 10 years; and 2 years on a loan with an original maturity of greater than 10 years.

14. When a loan's time in delinquency exceeds the threshold, or when a loan's NPL balance exceeds 25 percent of the credit's value, a specific loan loss provision for "other doubtful loans" must be created and the entire loan amount must now be classified as an NPL and be provided for at the rates reported in paragraph 11.

15. Past due credits subject to a provisioning rate of 50 percent or more as of January 31, 2003, will remain under the old regulations if they relate to a loan with (i) no collateral, (ii) a personal guarantee, or (iii) a mortgage on an owner-occupied residence with less than 75 percent LTV. All credits subject to provisioning rates less than 50 percent, mortgages not for owner-occupied residences, or mortgages with LTV greater than 75 percent must be provided for under the new rules. Banks have up to thirty six months to implement the new rules.

16. The new regulations are effective from February 2003 except for those relating to the definition of "doubtful," which will become effective in July 2003.

INTERNATIONAL MONETARY FUND

PORTUGAL

Staff Report for the 2002 Article IV Consultation
Supplementary Information

Prepared by the European I Department

(In consultation with the Policy Development and Review Department)

Approved by Ajai Chopra and G. Russell Kincaid

March 24, 2003

1. This supplement to the staff report for the 2002 Article IV consultation with Portugal (SM/03/63, 02/12/03) provides an update of developments and prospects. Although the thrust of the staff appraisal remains unchanged, some elaboration is warranted regarding fiscal policy.

Economic developments

2. Recent indicators point to weaker economic activity in the last part of 2002 and early 2003 than anticipated in the staff report:

- Preliminary estimates by the National Statistical Institute (INE) indicate **GDP growth** of 0.5 percent in 2002, broadly in line with the staff report's estimate. However, INE revised substantially upward its estimate for GDP growth in the first half of 2002, while the economy contracted by more than staff had anticipated during the second half of the year. Short-run indicators point to a further weakening of activity in the first part of 2003.

- The **unemployment rate** increased sharply in the fourth quarter of 2002, to 6.2 percent from 4.5 percent a year ago, as employment fell by 1.2 percent (year-on-year).

- **Inflation** (HICP) has remained at around 4 percent (year-on-year) during the first two months of 2003, about 1¾ percentage points above the euro-area average.

- Preliminary estimates indicate a **current account** deficit (including capital transfers) of 6¼ percent of GDP in 2002. This was somewhat below the 6½ percent anticipated in the staff report—reflecting a stronger trade balance, as exports recorded notable gains in market shares.

- Private sector **credit growth** has remained broadly unchanged through January 2003 (at 7¼ percent, year-on-year).

3. These developments, together with revisions to the external assumptions in the context of the World Economic Outlook exercise, indicate weaker GDP growth and higher inflation in 2003 than projected in the staff report. Staff now anticipates a small decline of GDP in 2003 (by 0.3 percent versus growth of 0.4 percent in the staff report), largely owing to statistical carry over from the GDP decline in the second half of 2002. At the same time, inflation may not moderate below 3¼ percent (HICP, annual average, versus 2.8 percent in the staff report). The growth projections remain subject to considerable downside risks, as described in the staff report.

Fiscal developments

4. In their end-February notification to the EC on government deficits and debt for 2002, the Portuguese authorities estimated a fiscal deficit of 2.6 percent of GDP and a public debt ratio of 58.0 percent. Eurostat revised the deficit estimate upward to 2.7 percent of GDP, excluding €140 million in receipts related to the liquidation of the EFTA development fund, which had been set up in 1976.

5. The 2002 fiscal deficit outturn was below the estimate of 3 percent of GDP in the staff report, reflecting a smaller deficit in the capital balance. Efforts to curtail investment expenditures considerably outweighed shortfalls on capital revenues, and the capital balance improved by over €500 million (0.3 percent of GDP) relative to staff's earlier estimate. Some shortfalls on tax and social security contributions, attributable to the marked weakening in activity in late 2002, were largely offset by higher-than-anticipated tax amnesty receipts.

6. Absent additional measures, staff continues to estimate a fiscal deficit of close to 4 percent of GDP for 2003. This estimate is in line with that of the staff report, reflecting the balance of three factors: (i) the recent public sector wage agreement[1] provides a good basis for meeting the budget target (reducing spending by over 0.1 percent of GDP vis-à-vis the staff report); (ii) the better outturn of the capital balance in 2002 indicates that the capital balance target could also be met in 2003 (lowering staff's deficit estimate by about 0.1 percent of GDP); and (iii) the downward revisions to staff's growth projections would reduce revenues in 2003 by an estimated ¼ percentage point. The authorities are considering additional adjustment measures, including steps to rein in health care spending and subsidies.

Staff assessment

7. The authorities' latest estimates indicate an even larger fiscal adjustment in 2002 than anticipated earlier—particularly remarkable in light of the weakening in economic activity during the second half of 2002. For 2003, the task is to build on this success, balancing three

[1] Public sector wages were frozen for employees earning above €14,000 per annum, and a 2 percent increase will be received by all other employees. Given the salary distribution among employees and the authorities' estimate of a wage drift of 2 percent, the wage bill is estimated to rise by about 2½ percent in 2003.

important considerations. First, as discussed in the staff report, the quality of the adjustment needs to be improved, following the extensive reliance on one-off measures in 2002. This calls principally for steps to restrain current primary spending. Second, the size of the fiscal measures should be sufficient to meet the cyclically-adjusted fiscal balance target envisaged in the original budget. The public sector wage policy for 2003 was an important step in this regard; however, additional, sizable steps—of the same order of magnitude as envisaged in the staff report—need to be implemented early to secure the structural deficit target. Third, if growth in 2003 were to turn out weaker than anticipated in the budget (as seems likely), automatic fiscal stabilizers should be allowed to play fully. Taken together, these considerations would ensure that cyclically-adjusted deficit reduction continues in 2003, while avoiding an undue further deceleration of economic activity.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 03/48
April 9, 2003

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

IMF Concludes 2002 Article IV Consultation with Portugal

On March 26, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Portugal.[1]

Background

After an extended strong economic expansion, GDP growth stalled in 2002 and, at 0.5 percent, fell below the euro-area average for the first time in almost a decade. The growth slowdown reflected a broad-based decline in domestic demand as households began to adjust to high indebtedness levels and a deteriorating employment outlook. Investment continued to fall amid slowing demand prospects and rising global and domestic uncertainty. The weakness in domestic demand led to a decline of imports, while exports are likely to have increased somewhat faster than foreign demand. These external trade developments contributed to a narrowing of the external current account deficit, but the deficit (including capital transfers) remained one of the largest (in relation to GDP) among industrial countries.

Inflation has continued to exceed the euro-area average, reflecting mainly relatively high cost pressures in Portugal, accentuated in the second half of 2002 by an increase in the standard VAT rate in June. The unemployment rate increased strongly in the second half of 2002, reaching 6.2 percent in the last quarter (compared with 4.2 percent a year earlier).

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

In the financial sector, credit growth decelerated significantly in 2002, although it again exceeded nominal income growth. With housing credit demand remaining relatively strong prior to the abolishment of the interest subsidy at end-September, private sector indebtedness levels continued to rise and bank credit (in relation to GDP) is well above the euro-area average. The credit expansion has outstripped the growth in core deposits, and banks have continued to finance themselves extensively on international capital markets.

The fiscal deficit declined markedly in 2002 to an estimated 2.7 percent of GDP, following substantial slippages in the previous year that had pushed the 2001 deficit to 4.2 percent. The decline in 2002 came against the background of weak growth, and the structural deficit reduction was the largest recorded during the past decade. This reflected sizable adjustment measures introduced by the newly elected government, which took office in April 2002, including an increase in the standard VAT rate, a freezing of some capital expenditures, and one-off revenue measures of about 1.5 percent of GDP, related to asset sales and revenues from a tax amnesty. The 2003 budget envisages a decline in the fiscal deficit to 2.4 percent of GDP, but staff estimates that substantial, additional measures need to be implemented to achieve the target. The updated Stability Program confirms budget balance as a medium-term objective.

Executive Board Assessment

Directors welcomed the determined efforts by the new government to address Portugal's current economic difficulties through actions to reverse fiscal slippages as well as carry forward structural reforms. These actions, together with adjustments by the private sector, had begun to correct the large macroeconomic imbalances in the economy; in particular, the rise in relatively high household indebtedness levels had decelerated; the fiscal deficit had been reduced substantially; and the current account deficit had declined, although it was still one of the largest among advanced economies. Directors observed, however, that substantial challenges remain in all these areas. They emphasized the importance of steady progress on fiscal and structural reforms for overcoming the sharp decline in economic growth and rise in unemployment, strengthening competitiveness, and raising living standards toward EU average levels.

Directors commended the authorities for achieving a substantial reduction in the fiscal deficit in 2002—the largest fiscal adjustment in Portugal in many years—despite an environment of weakening economic growth. They noted that the adjustment relied extensively on one-off measures (including both asset sales and a tax amnesty), but recognized that this reflected importantly the sheer magnitude of the slippage in 2001 and also the limited time remaining in 2002 after the new government had assumed office.

Directors stressed the need for further fiscal consolidation in 2003, as envisaged in the budget targets. They emphasized that the quality of fiscal adjustment is crucial to ensure a relatively smooth unwinding of the macroeconomic imbalances, and called for quickly replacing the one-off measures with durable expenditure reductions.

Directors expressed concern that the fiscal measures identified so far might not be sufficient to achieve the budget targets for 2003. They welcomed the recent steps to curtail the public sector

wage bill, which is (in relation to GDP) well above EU levels, and stressed the importance of proceeding with plans to slow the growth in health care and social security spending. Notwithstanding this progress, Directors stressed that additional measures need to be implemented early to secure progress on fiscal consolidation. Many Directors emphasized the importance of meeting the budget targets and favored frontloaded adjustment, especially for fostering confidence.

Concerning the medium term, Directors considered the *Stability and Growth Program's* objective of expenditure-based fiscal consolidation and achieving structural budget balance by 2006 as broadly appropriate. Directors underscored that this strategy would strengthen public saving and free up resources for the tradable sector, thereby facilitating further reduction of the external current account deficit. Sustainable progress on fiscal consolidation would require containing aging-related expenditures, and Directors welcomed plans to address these issues early in the present legislature. Directors also emphasized, in this connection, that tax cuts should not be undertaken until adequate expenditure savings have been identified. They also stressed the importance of strengthening budget planning and control, and encouraged the authorities to adopt a multi-year framework for the budget process.

Directors welcomed the recent steps to improve the resilience of the financial sector, including ongoing improvements in banking supervision, the extension of the maturity structure of banks' funding instruments, and the strengthened capital bases at some institutions. A few Directors also observed that financial institutions continued to be profitable. Nevertheless, Directors referred to continued risks, as loans were concentrated in sectors with weak growth prospects, and credit growth—although declining—continued to outpace deposit growth.

Directors underscored that financial sector risks warrant continued supervisory vigilance. They welcomed the recent acceleration of specific credit provisioning requirements, but noted that these steps had been accompanied by a relaxation of general provisions for mortgage loans. A number of Directors recommended actions to improve the definition of nonperforming loans and the system of loan loss provisioning, with a view to facilitate forward-looking risk assessments. A number of other Directors, however, observed that the present provisions are in line with practices in other countries, and welcomed recent steps that would allow the Bank of Portugal to impose an increase in provisions based on banks' auditor reports. Directors also called for closely monitoring the insurance sector and pension funds, where, as in many other advanced economies, performance had deteriorated. Directors welcomed the interest of the authorities to review financial sector issues in the context of a Financial Sector Assessment Program in the near future, and stressed the usefulness of this exercise. Directors commended the authorities' recent measures to combat money laundering and the financing of terrorism, in line with EU guidelines.

Directors welcomed recent initiatives aimed at liberalizing product and labor markets and strengthening competition. They noted that steps in these areas could raise Portugal's relatively low productivity level and improve external competitiveness, which would be critical for durable income convergence to EU levels. They also welcomed recent initiatives to create a new, independent competition authority and reform the labor code. In this regard, they stressed that an easing of Portugal's relatively severe dismissal restrictions would facilitate reallocations

toward the tradable sector and have a positive effect on private sector productivity. Directors also suggested that more emphasis in education and training would improve labor productivity.

Directors welcomed progress in improving the timeliness and coverage for some fiscal data, but expressed concern that policy decisions are still hampered by long-standing statistical weaknesses in several areas. They encouraged the authorities to address these shortcomings promptly.

Directors encouraged the authorities to support the full liberalization of imports from the least developed countries and to raise official development assistance to the UN target. A number of Directors called on the authorities to work in favor of a reform of the EU's Common Agricultural Policy, contributing to the success of the Doha trade round.

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 2002 Article IV Consultation with Portugal is also available.

Portugal: Selected Economic Indicators

	1999	2000	2001	2002 1/	2003 2/
Real economy (change in percent)					
Real GDP	3.8	3.7	1.6	0.5	-0.3
Domestic demand	6.0	3.1	1.1	-0.4	-0.8
CPI (year average, harmonized index)	2.3	2.9	4.4	3.7	3.2
Unemployment rate (in percent)	4.4	4.0	4.1	5.1	6.8
Gross national saving (percent of GDP)	19.9	18.9	18.7	18.2	18.4
Gross domestic investment (percent of GDP)	28.3	29.2	28.1	25.8	25.1
Public finance (percent of GDP)					
General government balance	-2.4	-2.9	-4.2	-2.7	-3.9
Primary balance	0.8	0.3	-1.1	0.3	-0.6
Public debt	54.3	53.3	55.5	58.1	61.8
Money and credit (end-period, percent change)					
Total domestic credit	19.9	24.1	13.7	6.2	...
National contribution to euro area M3 3/	8.9	6.5	6.9	-1.8	...
Interest rates (end-period)					
Deposit rate, 91–180 days	2.8	4.4	3.3	3.0	...
Ten-year government bond yield	5.5	5.3	5.1	4.5	...
Balance of payments (percent of GDP)					
Trade balance	-11.9	-13.0	-12.1	-10.2	-9.2
Current account (including capital transfers)	-6.3	-8.8	-8.4	-6.2	-5.1
Net official reserves (in US$ billions, end of period)	14.1	14.2	15.1	17.2	...
Exchange rate					
Exchange rate regime		Euro-area member			
Present rate (March 26, 2003)		US$1.07 per euro			
Nominal effective rate (1995 = 100)	95.7	92.9	93.4	94.2	...
Real effective rate (1995 = 100)	98.9	96.4	98.7	101.1	...

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

1/ Estimate.

2/ Staff Projections.

3/ Excludes currency in circulation.