

Portugal: 2003 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion for Portugal

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with Portugal, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **December 15, 2003**, 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 19, 2004.** 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 10, 2004** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its March 15, 2004 discussion** of the staff report that concluded the Article IV consultation.

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

Selected Issues

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

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

INTERNATIONAL MONETARY FUND

PORTUGAL

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the 2003 Consultation with Portugal

Approved by José Fajgenbaum and G. Russell Kincaid

February 18, 2004

- The Article IV discussions were held during December 3–15, 2003. The staff—Mr. Krueger (head), Mr. Lutz, Ms. Ruiz-Arranz (all EUR), and Ms. Madrid (MFD)—met with the Ministers of Finance, Health, and Public Works, Transport, and Housing; the Governor of the Bank of Portugal; and other officials and representatives of regulatory agencies, local governments, financial markets, and labor and business organizations.
- A coalition government took office in April 2002, and the next elections must be held by 2006.
- Portugal has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions, except for those maintained solely for the preservation of national or international security and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51); see Appendix I.
- In concluding the last Article IV consultation, Directors stressed themes (<http://www.imf.org/external/np/sec/pn/2003/pn0348.htm>) that had also been at the center of Fund policy advice in recent years, focusing on policies to safeguard macroeconomic stability and enhance longer-term growth prospects. However, as described in last year's report (see Box 1 of IMF *Country Report* 03/99, April 2003) policy implementation—especially for fiscal consolidation, but also on the structural side—fell appreciably short of Fund advice in recent years. The authorities noted that this had, to some extent, reflected different policy priorities by the previous government, but also difficulties to pursue reforms that, while beneficial in the longer run, would have entailed significant short-term economic and social costs. Over the past year, some progress was made on the fiscal front (for example, in reducing public employment and containing expenditure growth); however, addressing the challenges arising from past excesses and long-term aging-related spending is far from complete. In the financial sector, supervisors have continued to respond to evolving risks. The Fund repeatedly urged the authorities to undertake a FSAP, and the Governor expressed now his intention to do so in 2005.
- The authorities intend to publish this report.

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EXECUTIVE SUMMARY

Recent developments and prospects

The economy entered into a recession in mid-2002, and recent indicators point to only a slow recovery in 2004. A euro-entry-related boom ended in 2002, as domestic demand collapsed amid high private sector indebtedness and rising unemployment. For 2004, real GDP growth is expected to turn positive, but remain well below the euro-area average. The fall in domestic demand led to a sharp decline in the external current account deficit. At the same time, competitiveness weakened further; however, inflation and wage differentials vis-à-vis the euro area have narrowed appreciably.

Fiscal consolidation has advanced considerably since 2001, with large one-off measures contributing to deficit reduction. Notwithstanding revenue weakness in the context of slow economic activity, expenditure restraint and sizable one-off measures helped to lower the fiscal deficit to below 3 percent of GDP in 2002/03.

Key policy requirements

There was broad agreement between the authorities and staff on many, but not all, policy requirements, with fiscal consolidation issues at the center of the discussions:

Strengthening competitiveness. The authorities were concerned about a further erosion of competitiveness, and thus agreed with the central role of wage restraint. Staff took the view that a strengthening of competitiveness would be necessary for robust medium-term growth.

Securing fiscal consolidation. There was agreement on the pace of fiscal consolidation (about ½ percentage point of GDP per annum in structural terms during 2004–07). However, many of the measures needed to secure the targets, including for 2004, are still pending. Staff called for a clear strategy and timetable for phasing out all one-off measures during the current legislature, preferably in the context of multiyear fiscal targets.

Public expenditure and other fiscal reforms. The government aims at sizable expenditure cuts (in relation to GDP), including for the public sector wage bill, and some progress has already been made. Staff considered reining in aging-related spending as indispensable for fiscal solvency, but little progress is likely in this area in the near term. To foster growth, the government is reducing the corporate income tax rate.

Safeguarding the financial sector. Available indicators suggest that the financial sector has been relatively resilient during the recession. However, high indebtedness and risk concentrations, especially to the real estate sector, pose sizable potential vulnerabilities, and discussions focused on specific steps to ensure financial stability.

Raising Portugal's low productivity level. Initiatives in this area include steps to improve basic and vocational training as well as to strengthen competition and resource allocation.

I. REPORT ON THE DISCUSSIONS

A. Adjustment to Past Excesses: Structural and Cyclical Impediments to Growth

1. **A euro-entry related boom faltered by mid-2002, and Portugal recorded the largest real GDP decline among advanced economies in 2003** (Table 1; and Figure 1). The

diagnosis of recent economic developments was broadly shared: during the second half of the 1990s, strong domestic demand growth was fueled by euro-entry-related declines in interest rates and probably also overly optimistic expectations of the growth-benefits from monetary union. This was accompanied by an accumulation of large imbalances—

rapidly rising household indebtedness, which underpinned a consumption and construction boom; and a very high external current account deficit. With some private sector entities becoming overleveraged, domestic demand collapsed in 2002/03. Moreover, fiscal consolidation had failed to advance during the boom years, and was, within the strictures of the *Stability and Growth Pact* (SGP), tightened in parallel with falling private sector demand in 2002

(Table 2). In addition, Portugal's trade pattern made it particularly susceptible to the slowdown in Europe. Against this background, employment declined in 2003 and the unemployment rate increased from 4½ percent in the first half of 2002 to over 6½ percent.

2. **Following a drop in real GDP in 2003, the authorities and staff expected a gradual recovery in 2004, but with growth remaining below potential and contingent on a strengthening of external demand.** In 2003, real GDP declined by an estimated 1 percent, as a large drop in domestic demand was only partly cushioned by a positive foreign sector contribution. For 2004, the authorities expected the following factors to continue to restrain domestic demand:

- *Balance sheet adjustments:* with household indebtedness high by international standards, further adjustments are likely to constrain consumers. Staff also saw the possibility

Selected Indicators for Portugal and the Euro Area, 2002–04

	2002		2003		2004	
	Portugal	Euro area	Portugal	Euro area	Portugal	Euro area
	(Annual percentage change)					
Real GDP	0.4	0.9	-1.1	0.5	1.0	1.9
CPI	3.7	2.3	3.3	2.0	2.1	1.6
Unemployment rate	5.1	8.4	6.4	9.1	7.0	9.2
	(In percent of GDP)					
External current account 1/	-5.6	1.1	-3.2	1.2	-2.8	1.5
Private sector credit 2/	147.5	96.0	148.7	97.6	...	...
Structural fiscal balance 3/	-2.8	-2.0	-3.3	-1.7	-3.4	-1.4

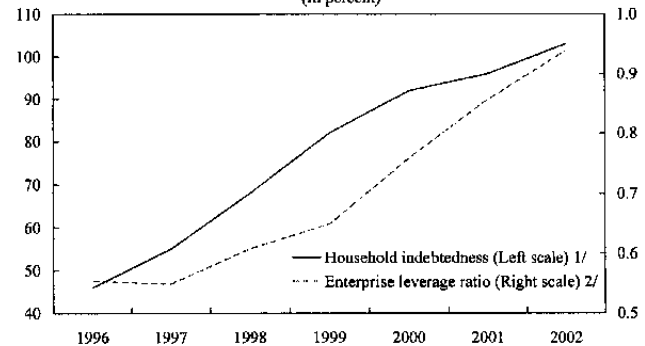
Sources: IMF, *International Financial Statistics*; *World Economic Outlook* (September 2003) for euro area; and Fund staff estimates and projections for Portugal.

1/ For Portugal, includes capital transfers.

2/ For 2003, data refer to October for Portugal; and November for euro area.

3/ For Portugal, excludes asset sales.

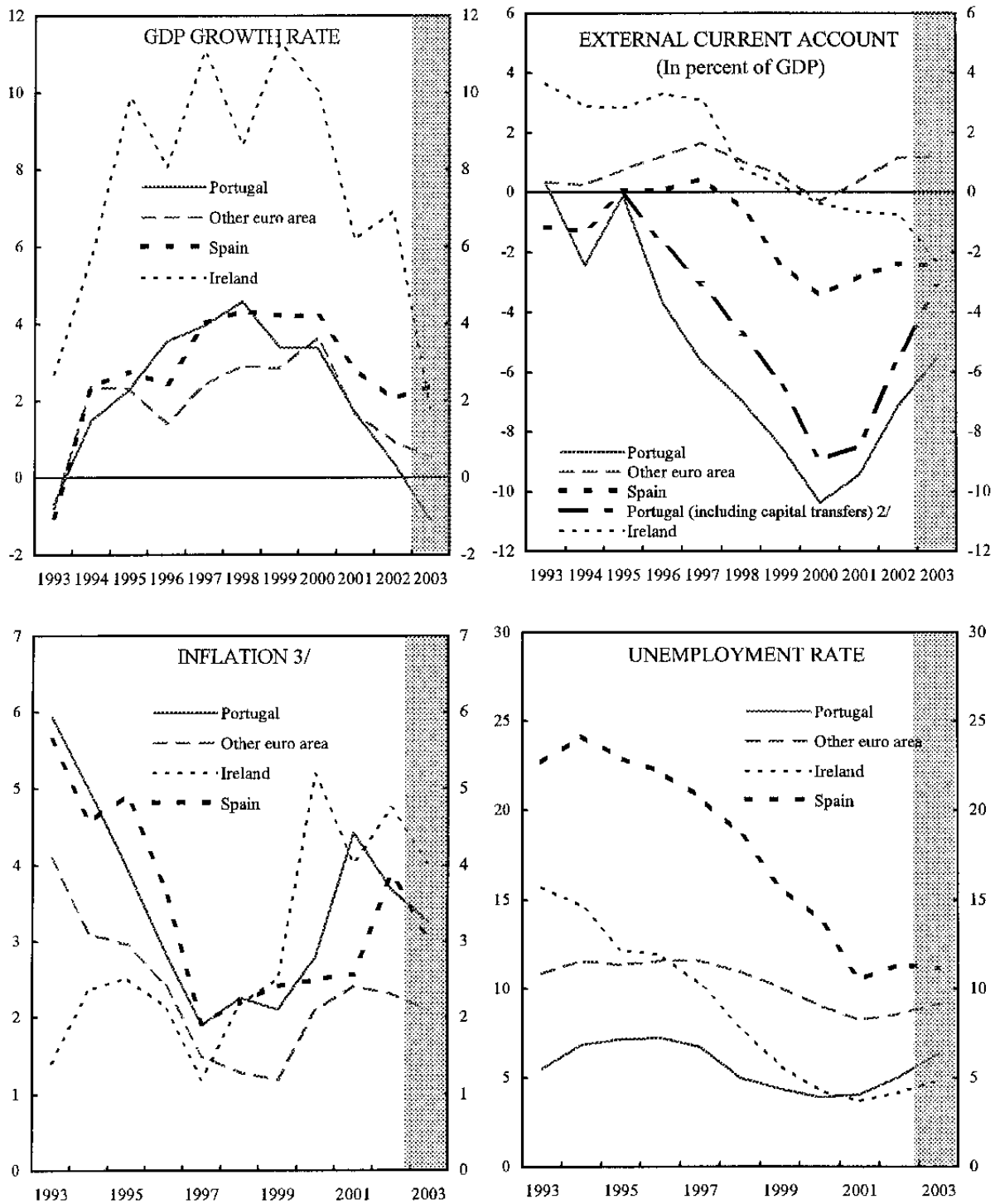
Portugal: Household Indebtedness and Enterprise Leverage Ratios, 1996-2002
(In percent)



1/ In percent of disposable income.

2/ Debt-to-equity ratio, nonfinancial corporations.

Figure 1. Portugal: Comparison of Selected Economic Indicators, 1993–2003 1/
(In percent)



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

1/ Shaded areas show staff projections.

2/ Data from 1995 onwards.

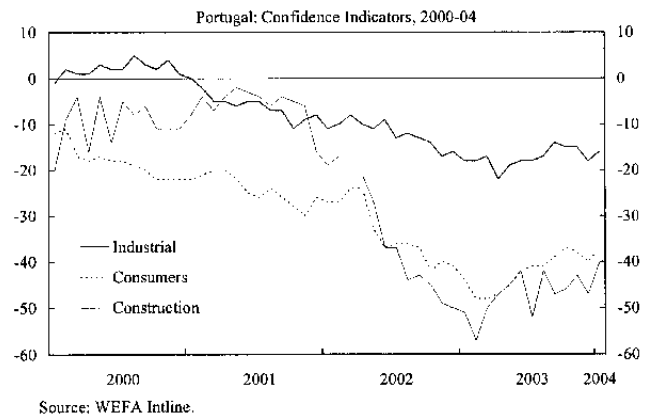
3/ Based on the harmonized index of consumer prices.

that investment would be held back by the earlier, relatively large increase in leverage ratios (as explored in more detail in the accompanying Selected Issues paper).

- *Fiscal consolidation:* the 2004 budget targets a broadly unchanged headline deficit, which would result in a significant decline of the structural deficit (see below).

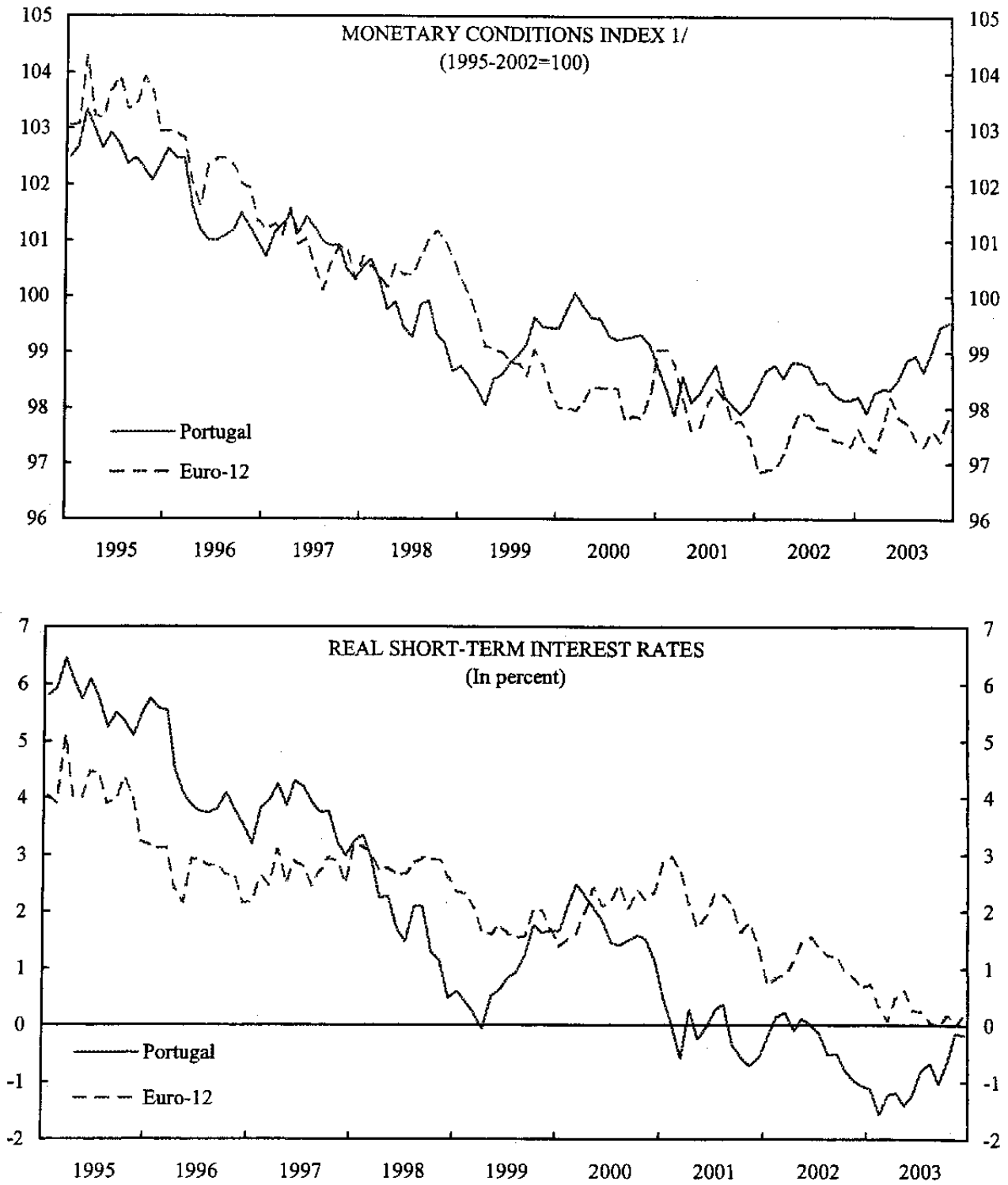
At the same time, the economy was seen as benefiting from low interest rates—with ex post real interest rates (due to higher inflation) below the euro-area average (Figure 2)—and from the projected global recovery. In all, the authorities expected real GDP growth of around ¾–1 percent in 2004, broadly in line with other forecasts, including staff’s.

3. **It was agreed, however, that a recovery was subject to downside risks.** While confidence indicators (after reaching historical lows) and tradable goods data (for exports and industrial production) have strengthened, concrete signs of a broad-based upswing remained few. In particular, real GDP growth was still negative in the third quarter of 2003 (the latest available data).¹ Moreover, there was a consensus that balance sheet adjustment could be more pronounced than envisaged, while external downside risks related to the strength of the projected recovery in Europe and a possible further euro appreciation. At the same, growth could surprise on the upside, should the recovery in world demand gain additional momentum and domestic investment rebound more strongly, in the face of possible capacity constraints (following a drop of investment by almost 15 percentage points during 2002–03).



¹ Real GDP fell by 0.9 percent (year-on-year) in the third quarter of 2003—and by around 2 percent quarter-on-quarter (annualized, seasonally adjusted), although the latter data are volatile and not considered reliable by the authorities.

Figure 2. Portugal: Monetary Conditions Index and Real Interest Rates, 1995-2003

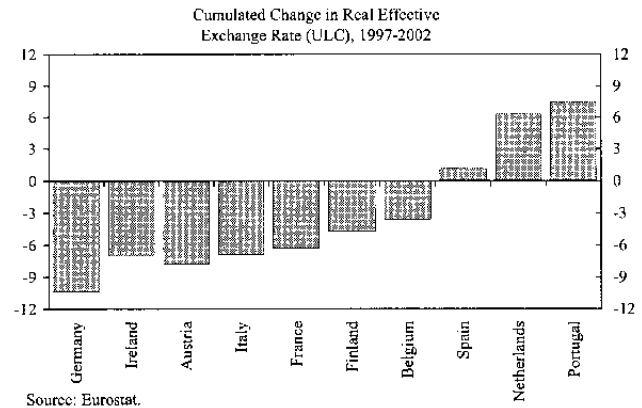


Sources: Bank of Portugal; National Statistics Office (INE); and Fund staff estimates.

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

4. **There was some debate regarding the extent to which weakened competitiveness and external indebtedness could undermine future growth prospects:**

- Competitiveness has deteriorated considerably in recent years, as labor cost and price increases exceeded the euro-area average (see text figure). However, Portugal's relatively weak cyclical position seemed to finally narrow the differentials (Figures 3–4): consumer price inflation declined to close to the euro-area average by end-2003; and contract wage increases moderated in 2003, although they remained above those in the euro area. Even so, and with the euro appreciating, the (consumer-price-based) real effective exchange rate rose by over 4 percent year-on-year through October 2003. For 2004, the authorities expected some further wage moderation, as the full extent of the recession had now become apparent to the social partners.

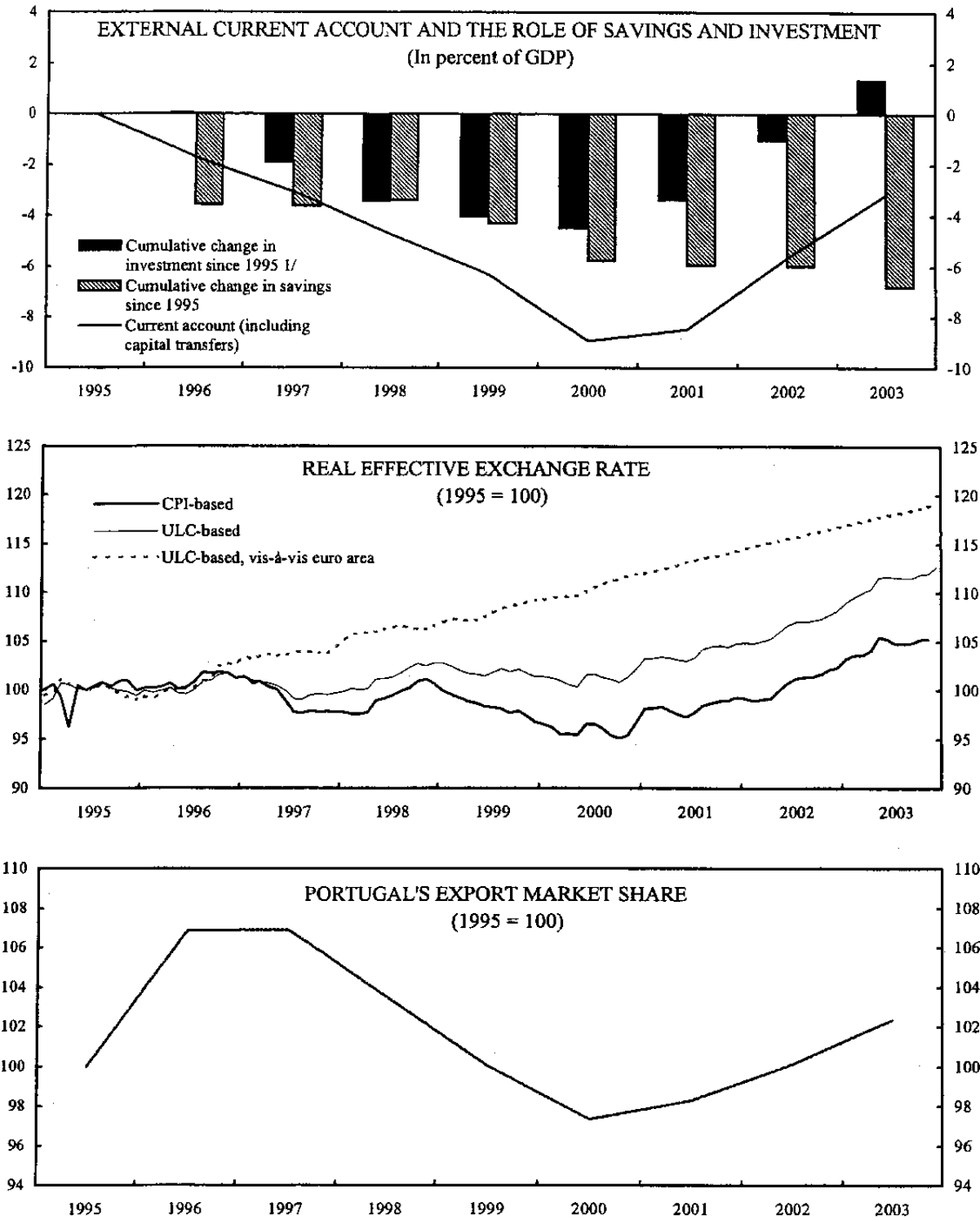


- The external current account deficit has narrowed markedly, from 8½ percent of GDP (including capital transfers) in 2001 to an estimated 3¼ percent of GDP in 2003. The decline reflected mainly falling imports—and, to a lesser extent, rising exports, net services, and EU transfers (Table 3). Longer-term bank borrowing remained the major financing source of the current account deficit.

- While declining, external borrowing needs remained sizable, adding to already high net external indebtedness (45 percent of GDP in 2002). This left the economy exposed to potential vulnerabilities, even if these have changed in the context of monetary union and with an external debt that is largely denominated in euros (see Appendix III).

5. **The authorities expressed some concern for future growth prospects should competitiveness weaken further—while staff saw a strengthening of competitiveness as necessary for robust medium-term growth.** Staff's concern related to several factors: the effects of recent declines in competitiveness had not become fully visible (with the risks further aggravated by the euro appreciation subsequent to the discussions in Lisbon); recent gains in market shares were likely secured amid falling profit margins in the export sector and may thus not be sustainable; the external current account deficit, while narrowing, remained sizable at a time when the output gap in Portugal was larger than in partner countries, temporarily narrowing the deficit; in terms of saving-investment balances, a fall in investment was the main factor behind the recent current account deficit adjustments (Figure 3, which could be at risk once investment rebounds; and, over time, expected increases in euro-area interest rates (and thus in external debt service payments), competition

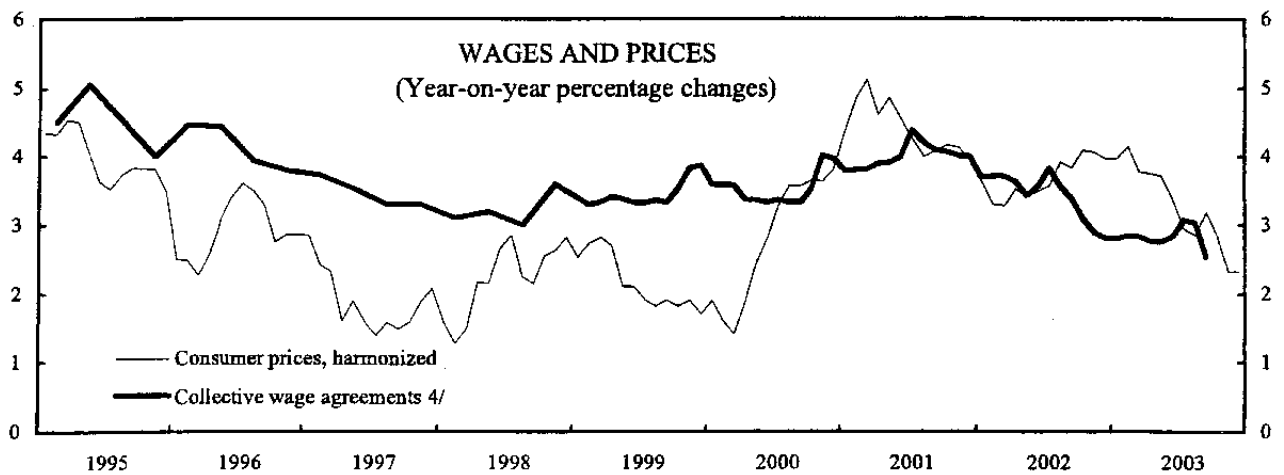
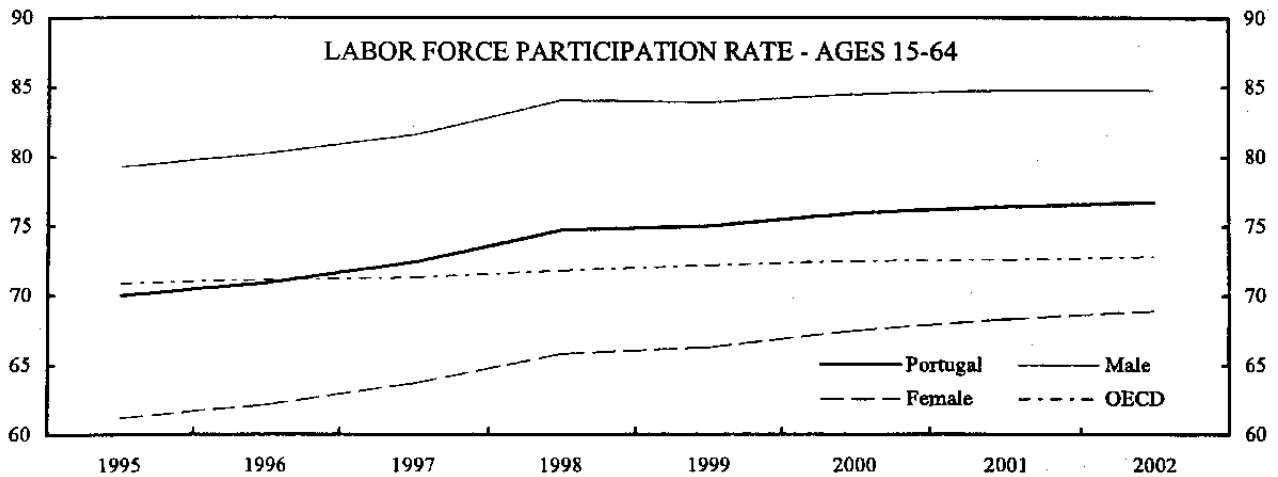
Figure 3. Portugal: External Sector Developments and Exchange Rates, 1995–2003 1/



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

1/ Negative number indicates an increase.

Figure 4. Portugal: Labor Market Conditions and Price Developments, 1995–2003
(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.

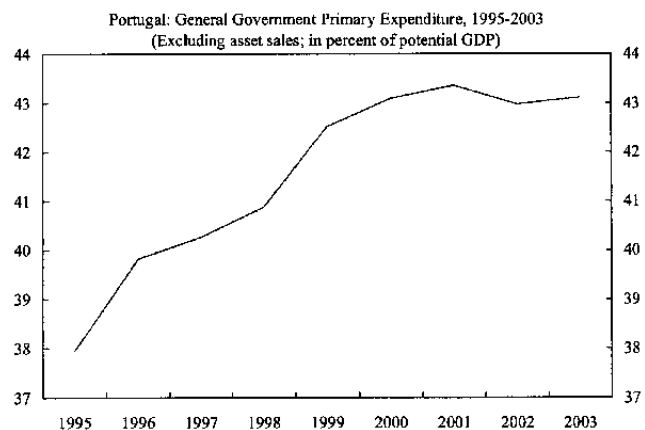
4/ Three-month moving average weighted by the number of workers covered in each month.

from EU accession countries, and eventually a decline in EU structural funds were all likely to weigh on the external accounts. Still, Bank of Portugal officials thought that balance sheet adjustments (following the earlier rapid rise in indebtedness) would be the dominating driving force, provided that a further erosion of competitiveness could be prevented. In this regard, there was agreement between staff and the authorities on the pivotal role of wage restraint. Labor union representatives stressed also the role of improving competitiveness through steps to raise productivity (see below).

B. Fiscal Policy

Recent developments

6. **Fiscal consolidation advanced considerably since 2001.** After exceeding 4 percent of GDP in 2001, the general government deficit fell to 2¾ percent of GDP in 2002, and both the staff's and the authorities' latest estimates for the 2003 deficit were just below 3 percent.² The decline in the deficit since 2001 reflected mainly: (i) an increase in the standard VAT rate in mid-2002; (ii) cuts in capital expenditures in 2002; (iii) steps to contain the public sector wage bill; and (iv) recourse to extensive one-off measures. The deficit reduction came despite sharply deteriorating economic conditions and related revenue shortfalls—although staff noted that the revenue underperformance vis-à-vis the budget had also reflected overly optimistic assumptions in the original budget as well as possible weaknesses in tax administration. Efforts to keep spending within budgetary limits were largely successful in 2003, and the steady upward trend in public spending ratios was arrested after 2001 (see text chart above).



7. **However, deficit reduction has relied extensively on one-off measures— notwithstanding progress in instituting some expenditure measures that should yield considerable savings over time.** One-off measures that reduce the Maastricht-based fiscal deficit have included asset sales, a general tax amnesty in 2002, and the takeover of the postal pension fund as well as securitization of tax and social security arrears in 2003.³ The

² A supplement to this report will cover the authorities' updated estimates, to be presented at end-February.

³ Securitization involved the transfer of the claims on tax and social security arrears to a special purpose vehicle, owned by a private commercial bank. With fiscal receipts recorded
(continued...)

authorities noted that these measures had prevented a more pronounced increase in the public debt and helped Portugal meet its obligations under the SGP—and while the authorities viewed recent actions at the euro-area level as undermining the effectiveness of the Pact’s rules, they still considered these rules as appropriate for Portugal from a domestic perspective. With respect to one-off measures, staff agreed that some could play a useful role during times of weak domestic demand, as they typically had smaller near-term growth effects. But it also stressed that their sheer magnitude (an estimated 2½ percent of GDP in 2003) implied that the fiscal consolidation task was far from complete, a view fully shared by the authorities. Indeed, staff’s estimates suggested that, excluding one-off measures, the structural fiscal deficit had not declined in 2003 (see text table). The authorities noted, however, that this view did not capture some of the progress achieved on the expenditures side. Staff agreed that important savings—for example, from reducing public employment in 2003⁴ or ending the mortgage subsidy scheme in 2002—would only accrue over time, a feature not captured in these structural deficit estimates.

Portugal: General Government Developments, 2001-03
(In percent of GDP)

	2001	2002	2003	
			Budget	Staff
Overall balance	-4.2	-2.7	-2.4	-2.9
Structural balance 1/				
Net of asset sales 2/	-4.4	-2.8	-2.0	-3.3
Net of all one-off measures 2/	-4.4	-3.5	-2.2	-3.5
Memorandum items:				
GDP growth (in percent)	1.7	0.4	1.3	-1.1
Asset sales 2/	0.1	0.7	0.5	2.3
Primary expenditures (net of asset sales) 1/	43.4	43.0	43.1	43.1

1/ In percent of staff’s estimate of potential GDP.

2/ In 2003, the transfer of the postal pension fund and securitization are added to the asset sales

Securing fiscal sustainability and the authorities’ consolidation strategy

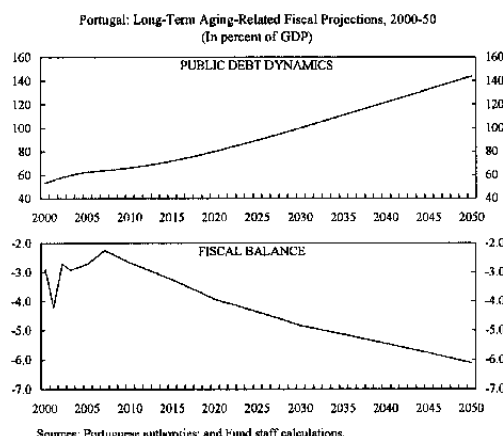
8. **The authorities agreed that further fiscal consolidation was imperative to secure fiscal solvency.** With the structural deficit large and aging-related spending set to increase substantially, further steps are needed to prevent a significant rise in the public debt-to-GDP ratio; indeed, in the absence of such steps, this ratio would exceed 100 percent by 2030 (see text box below). The authorities also argued that reducing the fiscal deficit had an important role to play in reducing the external current account deficit (and thus the economy’s reliance on foreign saving).

on a cash basis in Portugal, securitization revenues are, under Eurostat rules and provided the risk is effectively transferred, recorded as revenues in the year they are received. Concerning the postal pension fund, the transfer of its assets to the general government sector was recorded, under Eurostat rules, as revenues in 2003; future pension outlays, which considerably exceed the fund’s assets, will be recorded as government expenditures on a cash basis.

⁴ Public employment was estimated to have declined during 2003, mostly due to regular and early retirement. Given the relatively generous retirement benefits for most of these civil servants, their retirement initially entails no budgetary savings.

Box. Securing Fiscal Solvency

Challenges to secure fiscal solvency relate in part to presently high fiscal deficits, but also to aging-related spending pressures. Staff projections—incorporating the authorities’ aging-related spending projections and macroeconomic assumptions; a constant non-aging-related structural primary balance at its 2003 level; and a real interest rate of 3 percent—suggest that the public debt-to-GDP ratio (presently around 60 percent) would exceed 100 percent by 2030, with further increases thereafter. Moreover, these debt dynamics are based on assumptions for economic growth and productivity that are relatively optimistic by historical standards (important shorter-term risks, including for growth, are discussed in Appendix III). These projections and associated risks clearly illustrate the urgency for addressing both the current deficits as well as aging-related spending pressures.



9. **Against this background, the *Stability Program (SP)* targets a steady, gradual reduction of the structural fiscal deficit—and staff emphasized also the need for a clear strategy to phase out one-off measures.** The SP envisages a reduction of the structural fiscal deficit by ½ percentage point of GDP per annum during 2004–07, reaching a small structural surplus in the latter year. The staff welcomed the general strategy, but noted that the required measures (and their initial negative fiscal demand effects)⁵ were considerably larger, since they would also have to replace the one-off measures. The minister noted that given their magnitude in 2003 and current economic weakness, recourse to one-off measures would likely be necessary for some time, and efforts were underway to identify potential revenue sources in this area, including from asset sales. Nevertheless, it was agreed that durable expenditure savings would have to replace the one-off measures over time—and the authorities were considering staff’s suggestion of providing a clear timetable for phasing out all one-off measures, preferably in the context of multiyear expenditure targets and by the end of the current legislature (in 2006), with the precise timing depending in part on the strength of the economic recovery. Concerning fiscal stabilizers, the authorities agreed that they had a role to play along the structural deficit reduction path—but expressed resolve to intervene with offsetting measures, should the play of stabilizers jeopardize the SGP’s 3 percent of GDP deficit limit.

⁵ Staff estimates that short-run fiscal demand multipliers in Portugal were historically in the 0.5–1 range.

10. **The 2004 budget targets are broadly consistent with the fiscal consolidation strategy outlined above, but staff thought that insufficient measures were in place to secure these targets.** The budget envisaged a reduction of the overall structural deficit of 0.6 percent of GDP—notwithstanding (i) a reduction in the corporate income tax rate from 30 percent to 25 percent (estimated by the authorities to cost 0.1 percent of GDP in 2004 and 0.3 percent in 2005), and (ii) a decline in one-off measures by about 1½ percentage points to 1 percent of GDP (mainly from asset sales). Staff, however, estimated that the 2004 deficit target would be exceeded by some 2 percent of GDP, absent further measures: the 2003 revenue base (net of securitization) was well below the assumptions underlying the 2004 budget, and some risk related also to spending on wages and by local governments. The authorities did not disagree with the need for additional measures—although of a smaller magnitude than envisaged by the staff—and indicated that they would secure those, as needed, to meet the deficit target.

Portugal: Fiscal Outlook, 2003-04
(In percent of GDP)

	2003		2004	
	Staff	Budget	Budget	Staff
Overall balance	-2.9	-2.8	-2.8	-4.7
Structural balance 1/	-1.0	-0.7	-0.7	-2.4
Net of asset sales 2/	-3.3	-1.7	-1.7	-3.4
Net of all one-off measures 2/	-3.5	-1.7	-1.7	-3.4
Memorandum items:				
GDP growth (in percent)	-1.1	1.0	1.0	1.0
Asset sales 2/	2.3	1.0	1.0	1.0
Primary expenditures (net of asset sales) 1/	43.1	42.1	42.1	42.9

1/ In percent of staff's estimate of potential GDP.

2/ The transfer of the postal pension fund in 2003 and securitization in 2003 and 2004 are added to the asset sales.

Expenditure and tax reform

11. **The updated *Stability Program* places a decline in the public expenditure ratio at the center of the authorities' fiscal policy strategy** (Table 4). The expenditure-to-GDP ratio is to fall by 3½ percentage points of GDP during 2004–07, with public consumption to decline by more than 2 percentage points. This would create room to achieve both the fiscal consolidation targets and a reduction of the tax-to-GDP ratio by almost 1 percentage point.

12. **The mission welcomed the targeted expenditure restraint, and discussions focused on selected areas where progress would be essential to secure these objectives.** While some steps have been taken, there was a consensus that the main tasks still lay ahead if the expenditure targets are to be met.

13. **Containing Portugal's exceptionally high public sector wage bill was the main focus of the government's expenditure-reduction strategy.** Following a protracted rise (in relation to GDP) in earlier years (see text table), the government introduced several measures to contain wage expenditures during 2002/03. These included a hiring freeze (although with exemptions covering education, health, and security services); a suspension of career reclassifications; steps to facilitate internal job mobility, which would help reduce external recruitment; and, for 2003, a partial wage freeze (wage increases were zero for monthly wages above €1,000 and 1.5 percent for lower wages). As a result, the 2003 wage bill was kept below budget targets—

General Government Wage Bill
(In percent of GDP)

	2002	1998–2002 Change
	Portugal	15.4	1.5
Ireland	8.3	-0.2
Spain	10.2	-0.5
Euro area	10.6	-0.1

Source: European Commission.

and the estimated number of civil servants declined, reflecting also a surge in retirements. The government intended to maintain the hiring freeze in 2004 and to limit strictly wage increases, which were still under discussion with the unions. In addition, draft laws envisaged far-reaching public administration reforms, including steps to strengthen the role of performance-based incentives (especially at the managerial level) and to facilitate outsourcing. These steps generally went in the direction of earlier staff recommendations, but the authorities agreed that their effectiveness depended critically on the (still pending) implementation measures.

14. **The discussion also covered savings in other spending areas.** For 2004, the authorities aimed in general for a reduction in operating expenditures by 10 percent. On health care, expenditure savings were to arise from efficiency gains following the corporatization of 31 hospitals in 2003, which provided these entities with greater autonomy and performance-based incentives; and from changes in pharmaceutical reimbursements that encouraged greater use of generics. On education, tight spending caps relied on closing small schools and improving cost recovery at the tertiary level. In light of the experience in other countries, staff also saw room for savings from expanding centralized, electronic procurement, and the authorities planned to utilize this room. Finally, the *Stability Program* envisaged a gradual decline in public investment (in relation to GDP) from relatively high levels—as EU transfers were expected to fall off and the room for public-private partnerships would be fully exploited.

15. **The mission underscored that reforms of aging-related spending would be critical to secure fiscal sustainability—but little progress was likely in this area in the near term.** Aging-related spending pressures are broadly comparable to those in other EU countries; staff cautioned, however, that, for Portugal, the projected costs (in relation to GDP) benefited from an envisaged sharp increase in productivity growth (as discussed in the Selected Issues papers). The authorities noted that recent reforms had addressed large disparities between the generosity of public and private sector pensions (although older civil servants remained grandfathered under the previous rules), but other steps (including higher accrual rates of low wage earners) offset potential savings. The staff called for early progress, possibly with a combination of reforms, including an increase in retirement ages mirroring increases in life expectancy, a cut in effective indexation, and a reduction of the large tax exemptions for retirees. The authorities stressed, however, that their efforts were focused on reducing the fiscal deficit in coming years, and that opening up a politically costly dispute over pensions could prove counterproductive. This was especially the case since the need for reform was, after the earlier steps, not widely recognized among the social partners; moreover, ongoing fiscal consolidation efforts had already solicited considerable public opposition.

	Public Pension Expenditures (In percent of GDP)	
	2000	2001–2030 Change
Portugal	9.8	2.7
Ireland	4.6	3.0
Spain	9.0	2.4
EU	10.4	2.6

Sources: EU (2001), and Rodrigues (2002).

16. **Implementing recommendations of a recent fiscal Review of Standards and Codes (ROSC) could facilitate the efficient achievement of fiscal objectives.** The authorities welcomed the review's findings and were considering several proposals, including for strengthening budget preparations, introducing a binding multiyear framework (with some progress already underway) and risk analysis, and improving the information system (covering also arrears and guarantees). The needs were highlighted by continued difficulties to monitor and control spending at the local government level; by again rising arrears of health services; and by the accumulation of large state liabilities to public-private partnerships in the past.

17. **Turning to tax policy, the government viewed tax reductions as important for raising long-term growth, and focused on tax administration to preserve the revenue base.** The main objective was to establish a competitive corporate tax environment, not least in view of tax levels (and reform plans) in some EU accession countries. The corporate income tax rate would be cut to 20 percent in 2006, following its reduction to 25 percent in 2004. Staff agreed that tax reductions could entail some growth benefits—especially with the revenue burden now close to the (high) euro-area average (Figure 5). However, it cautioned that the benefits depended on durable expenditure cuts—commensurate to safeguard also the fiscal consolidation targets. While it was not clear that these conditions were in place in 2004, the authorities noted that the initial revenue impact of the corporate tax reductions would be limited (as discussed above). Steps to reform local property taxation were also underway. On tax administration, staff raised concerns about the apparent underperformance of several taxes vis-à-vis their base. The authorities aimed to address these issues, including with expanded cross checking.

C. Financial Sector Issues

18. **Private sector loan growth has continued to decline, but still outpaced income growth in 2003.** Private sector credit growth fell from about 10 percent at end-2002 to 6½ percent in November 2003. Levels of bank credit to enterprises remained essentially unchanged since the spring of 2003, but mortgage lending continued to rise at double digit rates. Overall, the private sector credit-to-GDP ratio—already among the highest in the EU (see text chart)—continued to increase, with the impact on current debt service contained by the fall in interest

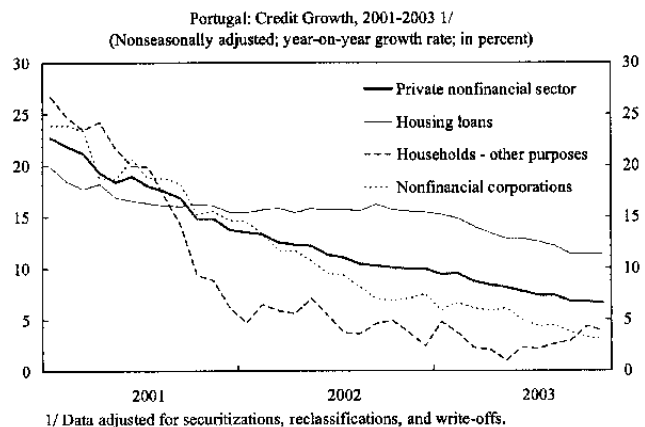
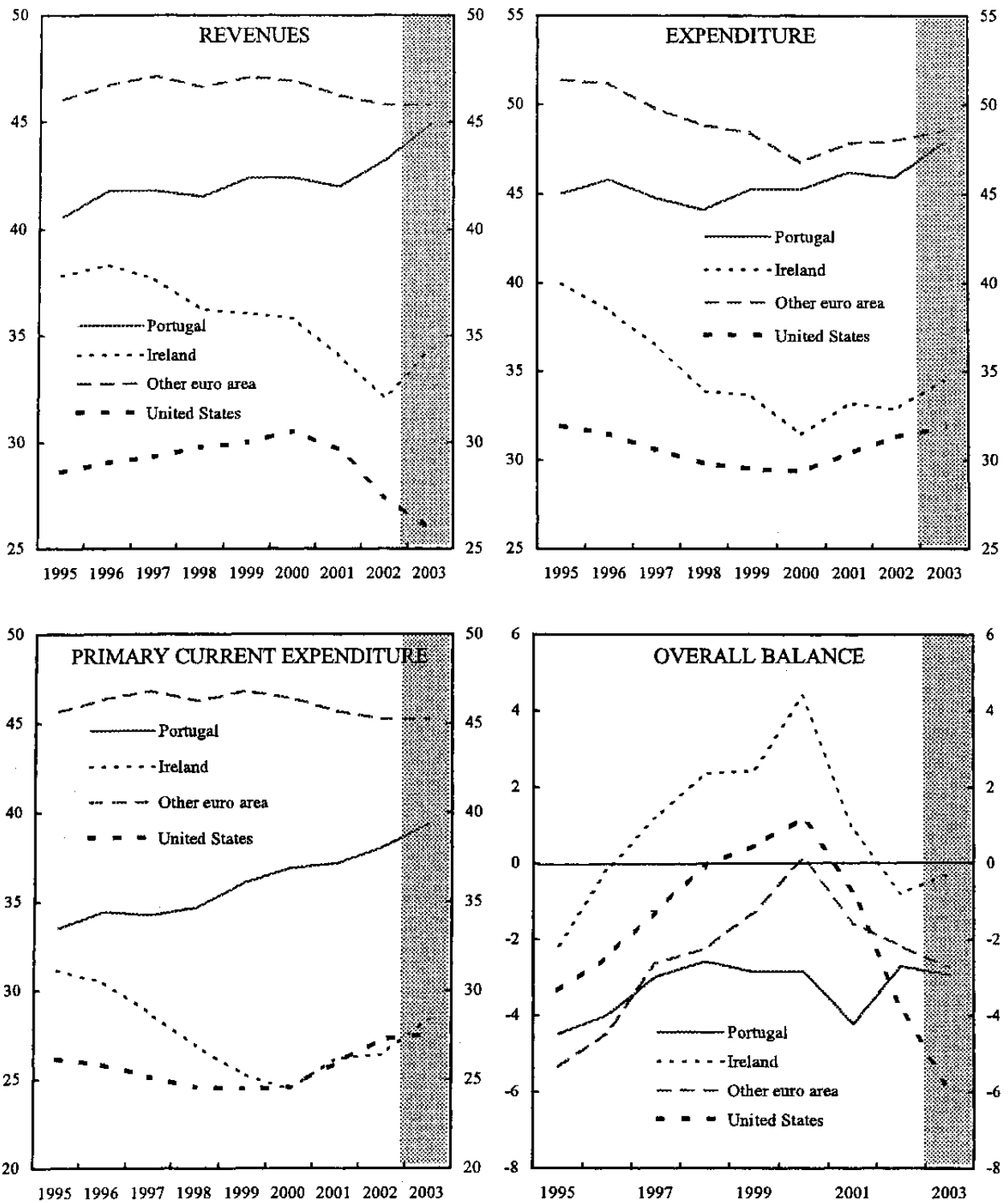


Figure 5. Portugal: International Comparisons of Fiscal Trends, 1995–2003 1/
(In percent of GDP)



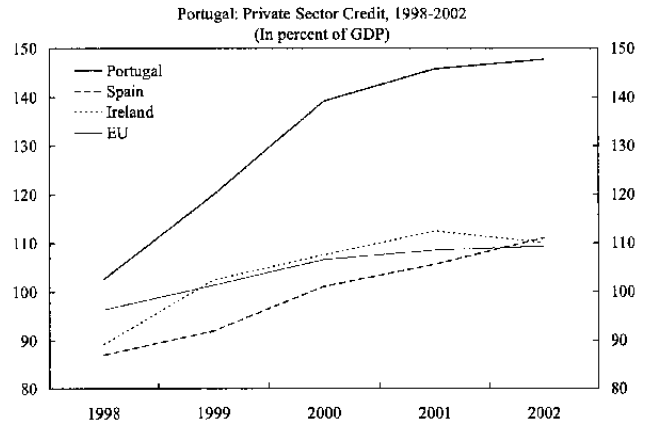
Sources: IMF, *World Economic Outlook*; and Fund staff estimates.

1/ Shaded area show staff projections.

rates. Deposit growth continued to lag the growth in credit. The gap was financed primarily with medium- and long-term debt securities and also with loan securitization, and the banks' regulatory liquidity ratio increased.

19. The weakening economy has led to some increase in the regulatory nonperforming loans (NPLs) measure and specific provisions, but recorded profits of financial institutions held up quite well (Tables 5–6).

While still near historical lows, the NPL ratio has increased gradually, notwithstanding significant loan write-offs. New rules entailed a welcome acceleration of specific provisions—covered to some extent by reallocations from general provisions, which were reduced as part of the overall reform of the provisioning system, cushioning the impact on profitability.⁶ Profitability of financial institutions also benefited from the rebound in equity markets as well as from rising banking commissions and cost containment, while banks' capital adequacy ratios remained stable in 2003. At the end of 2002, all insurance companies and pension funds met regulatory requirements, although some had required additional capital injections; aggregate data on insurance sector solvency ratios for 2003 were not yet available, but large companies reported improvements.



Portugal: Financial Soundness Indicators for the Banking Sector, 2000-03 1/
(In percent, unless otherwise indicated)

	2000	2001	2002	2003 2/
<i>Capital Adequacy</i>				
Regulatory capital to risk-weighted assets	9.2	9.5	9.8	9.8
Regulatory tier 1 capital to risk-weighted assets	7.6	7.3	7.1	7.2
<i>Asset composition and quality</i>				
Housing, real estate, and construction loans 3/	59.3	62.4	64.1	65.2
Nonperforming loans (NPLs) to gross loans 4/	2.2	2.1	2.3	2.6
NPLs net of specific provisions to capital (tier 1) 4/	8.8	9.8	12.4	12.5
<i>Profitability and liquidity</i>				
Return on average assets 5/	0.9	0.8	0.7	0.8
Return on average equity 5/	15.2	14.9	11.7	13.3
Liquid assets to total interbank liabilities 6/	88.7	91.5	87.4	95.4
Of which: domestically controlled institutions	86.8	93.4	98.9	105.5

Sources: Bank of Portugal; and Fund staff calculations.

1/ Data are for consolidated accounts of financial groups comprising at least one deposit taking institutions (excluding those with head offices in the Madeira off-shore center and carrying out activities predominantly with nonresidents).

2/ Data are for September, except for regulatory capital indicators, which are for June.

3/ As a share of total loans to resident nonfinancial sector. Real estate includes rental and supply of services to companies.

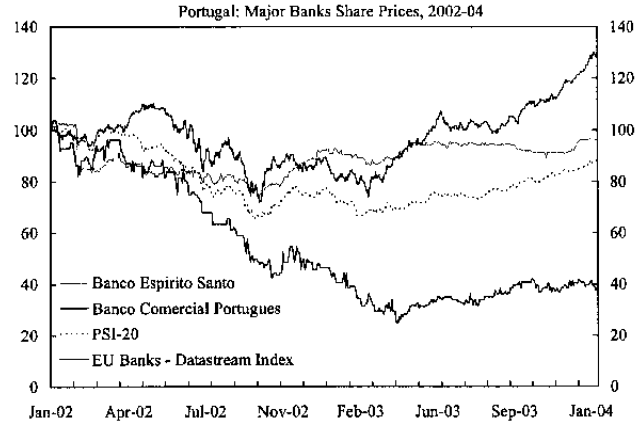
4/ NPLs are defined as interest and principal overdue more than 30 days.

5/ Net income is before deduction of minority interest. 2003 returns are annualized.

6/ Liquid assets are defined as cash, interbank assets (including in central banks), and government securities.

⁶ See last year's staff report, Appendix IV.

20. **The authorities agreed, however, that financial sector risk exposures required continued supervisory monitoring.** Historically high household and enterprise indebtedness (typically at floating rates) entailed considerable risks, especially if euro-interest rates were to rise before a robust rebound were underway in Portugal. Concerns were amplified by loan concentrations to the real estate sector (although the authorities stressed that there was no evidence of an earlier price bubble; see Figure 6) and, in some cases, by consolidated concentrations to individual companies, reflecting also strategic investments. These risk factors contributed to a continued underperformance of some Portuguese banking shares (see text chart).



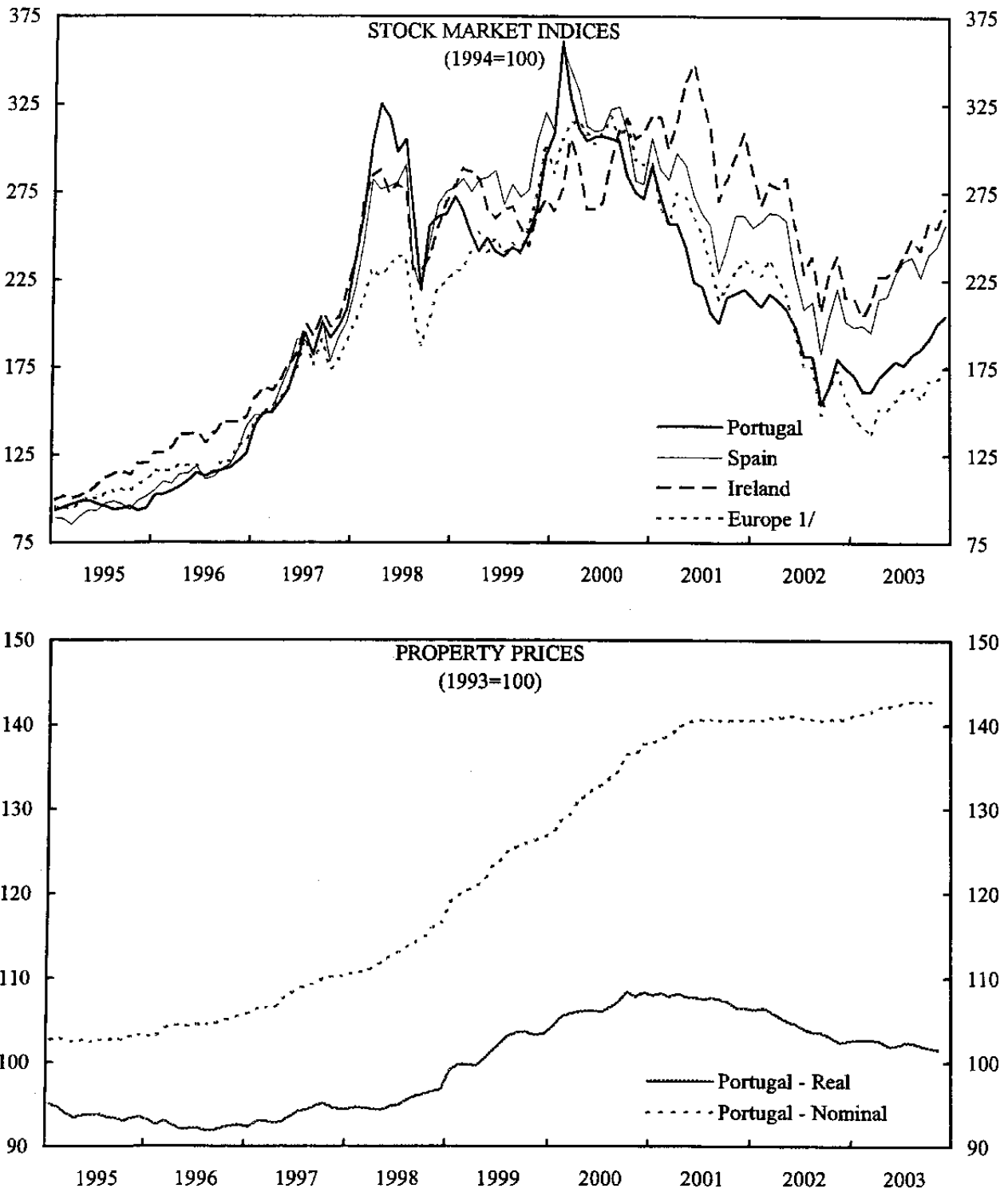
21. **Against this background, discussions focused on steps that would build on important earlier supervisory and regulatory initiatives and further strengthen financial sector resilience:**

- *Capital and provisioning:* Staff noted that uncertainty about the adequacy of banks' loan provisioning—reflecting the backward-looking focus of the regulatory NPL measure and loan-loss requirements, flagged in last year's staff report—had diminished with the continued improvement in banks' risk management, the generally positive assessments of external auditors on economic provisioning (although with some caveats concerning limited data), and the supervisor's active role in reviewing the adequacy of regulatory provisions in light of the auditors' reports. The authorities underscored also the advantages of the current minimum requirements in cases where a robust internal rating system was not yet in place or feasible. While the staff shared this view, it continued to see a useful role for moving over time to a more forward-looking risk assessment scheme for loan classifications and provisioning, as banks improve their internal ratings systems in line with likely Basel II requirements. In any case, it was agreed that the vulnerabilities outlined above, the potential lag in measuring latent credit risks under current rules, and ongoing financial innovation necessitated continued heightened monitoring and supervisory cooperation. This also concerned the adequacy of Tier 1 capital (which was close to the EU average), and evolving risks could call for further guidance to raise capital in some cases.

- *Disclosure:* The authorities were reviewing steps to strengthen disclosure guidelines on credit risk exposures, with staff seeing a need for early progress in this area. Moreover, and not unique to Portugal, it was agreed that aggregate data on the insurance and pension sectors should be collected and disclosed on a more timely basis.

- *Stress tests:* To assess better potential risks and financial institutions' resilience, the authorities concurred that regular and broad-based stress tests would be helpful (at the

Figure 6. Portugal: Asset Market Indicators, 1995-2003



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

1/ FTSE Eurotop 100 (in euros).

supervisory level as well as at the major financial institutions). Particular attention needed to be placed on loan default risks, especially related to real estate lending.

The staff urged a more comprehensive review of financial sector issues in the context of a *Financial Sector Assessment Program* (FSAP), and the authorities indicated their intention to formally request an FSAP for 2005.

D. Structural Policies to Boost Productivity and Real Convergence

22. **Portugal's labor productivity remains the lowest among EU countries—and the task to secure real convergence has to be pursued amid increasing competition from EU accession and emerging market economies.** With capital-output and employment rates quite high, durable strong growth will require a shift from the factor-intensive growth of the 1990s to total factor productivity-led growth. The authorities and market participants were well aware that this required addressing the competitive challenges posed by many of the EU accession countries, which will compete on the strength of factors that have been the domain of Portuguese exports, including relatively low labor costs (see text table, and the analysis in the Selected Issues paper). There was little disagreement about the key structural weaknesses that were at the root of Portugal's productivity malaise:

	Productivity 1/ (EU=100)	Wage Level 2/ (EU=100)	Schooling (Years)
Portugal	45.7	35.8	5.9
Spain	76.8	62.6	7.3
European Union	100.0	100.0	9.0
Czech Republic	27.9	17.2	9.5
Hungary	33.1	16.9	9.1
Poland	26.1	19.7	9.8

Note: Productivity, wages, and schooling data are respectively for 2002, 2000, and 2000.

Sources: IMF, WEO; Eurostat; and Barro Lee (2002) dataset.

1/ GDP (at market prices) per employed.

2/ Data refer to manufacturing and services.

- *Low educational attainment*: the workforce has relatively little formal education, and even current students score poorly by international comparison (OECD, *Portugal*, Economic Surveys, February 2003).
- *Research and Development (R&D)*: as a share of GDP, R&D spending is the second lowest in the EU.
- *Regulations and civil service efficiency*: a staff study (Takizawa, 2002) suggested that Portugal's exceptionally strict employment dismissal restrictions could severely impact productivity. The authorities have also pointed to civil service inefficiencies and bureaucratic hurdles as hindering growth.
- *FDI*: competition from EU accession countries and emerging market economies has contributed to a decline in Portugal's share of FDI investment from its peak in the early 1990s.

- *Taxation*: the tax burden in Portugal has risen significantly over the past decade to close to the EU average (Figure 5), and is well above levels in many of its competitors, including Ireland and Spain. The authorities viewed this as one of the features that had fostered relatively extensive underground (and other “informal”) activities.
- *Competition*: the OECD has stressed the need to strengthen competition in product markets and facilitate firm entry and exit, and Bank of Portugal staff argued that relatively slow progress in strengthening competition in some service sectors had contributed to a positive inflation differential vis-à-vis the euro area.

23. **The authorities were well aware of these challenges and steps were underway to raise productivity and strengthen competition.** Initiatives to raise productivity included: simplified licensing procedures and a new bankruptcy law, holding out the promise of addressing long-standing impediments to firm entry and exit—which could also help in attracting FDI; public administration reform as well as cuts in the tax burden; and measures aimed at stimulating R&D. Moreover, an independent competition agency was, after repeated delays, established in 2003. The authorities expected increased competition from a unified Iberian electricity market, to be established during 2004, although limited cross-border transmission capacity would hamper foreign market penetration initially. The government considered further privatization as an integral part of its program to raise productivity; after stalling in 2003, proceeds of close to ½ percent of GDP were targeted for 2004.

24. **All interlocutors agreed on the critical role of human capital formation for raising productivity.** With education spending (in relation to GDP) higher than the EU average, efforts focused on securing efficiency and included steps to restructure the school network, reform the secondary school curriculum, and reduce relatively high drop-out rates. The social partners pointed to extensive weaknesses in vocational training, which was frequently not well aligned with market demands. Market participants expected that a new labor code would facilitate more efficient work arrangements—it expanded the use of fixed-term contracts, allowed for more flexible working time allocations, and was intended to address collective bargaining stalemates. Staff regretted, however, that it did not ease relatively restrictive dismissal restrictions.

E. Other Issues

25. **The authorities expressed disappointment with the failure of the trade negotiations in Cancun, but hoped for future progress in the spirit of reciprocity.** They noted that Portugal would be significantly affected by the pending liberalization of textile trade (an important segment of its exports) under the Uruguay round. While they saw room to expand trade liberalization along the lines of recent EU proposals, the authorities also stressed the need to strengthen protection for intellectual property rights and geographic names. Portugal’s **official development assistance** (ODA) has remained lower (in relation to GDP) than in the majority of advanced economies.

26. The authorities remained strongly committed to **anti-money laundering** (AML) measures and initiatives to combat the **financing of terrorism** (CFT). Recent EU directives in this area were awaiting final parliamentary approval. Portugal assessed itself in full compliance on all but three of the new special recommendations for AML/CFT (on reporting suspicious transactions related to terrorism, clarifying legislation is currently with parliament; on wire transfers, outstanding issues are being addressed within the EU context; and the eighth recommendation, covering nonprofit organizations, awaits clarifications from the Financial Action Task Force). Portugal is a signatory to the OECD **anti-bribery** convention.

27. The authorities had no plans to issue New York law-governed sovereign bonds in the near future, but agreed in principle that such issues should incorporate **collective action clauses**.

28. **Notwithstanding some improvements, the authorities acknowledged significant remaining statistical weaknesses** (Appendix II). Inter alia, the absence of data on total wage compensation hampered an assessment of competitiveness and labor market developments. In the fiscal area, more timely information has become available for some subsectors of the general government (on a cash basis)—but assessments are still hampered by a lack of higher frequency data on an accruals basis for the general government; preparations are underway to address this issue.

II. STAFF APPRAISAL

29. **Amid difficult economic circumstances, policy adjustments have generally proceeded in the right direction.** On the fiscal side, progress was made in addressing relentless expenditure increases and the deficit has fallen from its peak in 2001. In the financial sector, available indicators suggest that performance held up relatively well during the recession, helped by earlier regulatory and supervisory initiatives. Some advances were also secured on the structural front.

30. **However, the tasks of correcting past excesses and laying the foundation for sustained income convergence are far from complete.** Continued high structural fiscal deficits and aging-related spending pressures underscore the need for further fiscal adjustment. Important risks also remain in the financial sector, including those related to borrowers' debt servicing capacity, should interest and unemployment rates rise substantially. Looking beyond the current economic weakness, Portugal's key economic challenge is to raise productivity and income levels within an increasingly competitive global environment.

31. **Weak external competitiveness poses downside risks to a robust economic recovery, and these risks need to be addressed in future wage agreements.** Labor cost increases have remained above the euro-area average, and the euro's strengthening adds to competitiveness concerns—amid relatively high (mostly euro-denominated) external indebtedness and still sizable, albeit rapidly narrowing, external current account deficits. Addressing these concerns hinges critically on wage moderation—and further public efforts

are needed to impress on social partners the constraints imposed by monetary union. Moreover, as in 2003, the public sector will need to lead by example.

32. **The government's fiscal consolidation targets for 2004–07 are broadly appropriate.** The pace of deficit reduction envisaged in the *Stability Program* (about ½ percent per annum of structural deficit reduction) would contribute importantly to securing fiscal solvency and raising domestic saving. While fiscal consolidation is likely to entail negative near-term demand effects, these could be contained by laying out a credible consolidation path. In this context, it would be helpful to establish a clear timetable for reducing the extensive reliance on one-off measures (such as asset sales and securitization), aiming for their complete elimination by the end of the current legislature.

33. **Notwithstanding important progress, many of the measures needed to secure the deficit-reduction targets must still be put in place.** For 2004, sizable budgetary risks relate in part to lower-than-budgeted revenues (net of securitization operations) in 2003, and in part to potential expenditure overruns, including on wages and (again) at the local government level. Looking beyond 2004, important savings are likely to accrue from measures that were already implemented—notably, some employment reductions and the termination of the mortgage subsidies. Quantitatively, however, the majority of the needed measures remains to be secured.

34. **The government's strategy for fiscal consolidation rightly aims at expenditure restraint, with savings to arise in part from efficiency improvements in public services.** Most pressing is the need to lower the public sector wage bill, which is high (in relation to GDP) even by EU standards. Steps to lower employment take time to yield significant savings, but there remains considerable room to extend strict hiring limits to all parts of the public sector. Lest the quality of public services be undermined, there is a need to improve public administration efficiency—and the civil service reform agenda goes in the right direction and should be implemented forcefully. In other areas, initial results from the corporatization of many hospitals are encouraging—but on health care and in other areas, a more determined effort is needed to address payment arrears. Plans to consolidate procurement across agencies and increase competition should, as in other countries, allow significant savings.

35. **Further reforms of aging-related spending must be a key component of a strategy to secure fiscal sustainability, requiring a determined political effort.** While earlier reforms improved equity aspects of the pension system, aging-related spending is still set to rise substantially (in relation to GDP) over time. The magnitude of the challenge is similar to other EU countries' and is likely to require steps in several areas. The widespread lack of urgency to address aging-related challenges is worrisome, not least since many reform steps need to be taken early to contain long-run spending.

36. **Durable expenditure cuts could create room for growth-oriented tax reforms.** The case for the latter stems in part from the level of the overall revenue burden in Portugal,

which has risen to close to the EU average. However, the growth-enhancing effects of tax cuts depend crucially on the durability of accompanying expenditure reductions—and it is not clear that these conditions are in place for the corporate tax reductions of 2004. At the same time, the surprisingly weak revenue performance of recent years suggests a need to strengthen tax administration further.

37. **Fully implementing the recommendations of the fiscal Review of Standards and Codes (ROSC) would facilitate the achievement of fiscal policy objectives.** Extending recent initiatives, it would be helpful to move toward comprehensive, binding multiyear budget targets. Moreover, effective budget planning and implementation would benefit from introducing uniform information and strengthened budgetary control systems, covering all levels of government and also arrears and state guarantees.

38. **While the financial sector has weathered the recession quite well, risk exposures remain sizable and require continued supervisory vigilance.** Credit growth has declined markedly, but historically high private sector indebtedness and risk concentrations, especially to the real estate sector, entail considerable potential vulnerabilities. At the same time, available information suggests that financial sector performance has, so far, generally held up well during the recession, benefiting also from earlier supervisory and regulatory responses. Building on these steps, there remains a need for continued careful monitoring of capital and provisioning levels in light of evolving risks. Moreover, market-based discipline could be enhanced by strengthening disclosure requirements in some areas, and stress tests should become a regular feature of supervisory activity. The intention to request a more in-depth financial sector review in the context of an FSAP in 2005 is most welcome.

39. **Raising productivity remains the main long-run policy challenge—and, with productivity far below the EU average, the room for progress is vast.** Success will critically depend on raising human capital levels, with progress needed both to improve general education as well as vocational training programs. Stronger competition could also lead to more efficient resource allocations. In this regard, the integration of the Iberian electricity market as well as the establishment of a fully independent competition authority are important steps—and the latter needs to become a forceful guardian of competition. Significant room remains also for privatization and outsourcing, including at the local level.

40. Portugal's experience provides a good example of the benefits from **trade liberalization**. It is encouraged to actively support progress under the Doha round, especially concerning trade liberalization for the least developed countries, and to increase its **ODA** to the UN target level.

41. **Statistical shortcomings** in some areas continue to hamper surveillance. The planned provision of quarterly accrual-based fiscal data is welcome, and progress is also needed to address weaknesses in other areas, including for the real sector.

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

Table 1. Portugal: Selected Economic Indicators, 1997–2004 1/
(Changes in percent, except as otherwise indicated)

	1997	1998	1999	2000	2001	2002	2003 Est.	2004 Proj.
Domestic economy								
Real GDP	3.8	4.6	3.8	3.4	1.7	0.4	-1.1	1.0
Real domestic demand	5.2	6.7	5.9	2.9	1.3	-0.6	-2.6	0.8
Private consumption	3.3	5.0	5.1	2.9	1.3	0.6	-0.7	0.9
Gross fixed investment	13.9	11.5	6.4	3.8	0.1	-5.6	-9.1	0.6
Foreign sector contribution	-1.5	-2.6	-2.6	0.1	0.2	1.1	1.8	0.2
Employment	1.9	9.4	1.8	1.7	1.6	0.2	-0.8	-0.3
Unemployment rate	6.7	5.0	4.4	4.0	4.1	5.1	6.4	7.0
Output gap	-0.7	0.5	1.1	1.4	0.3	-1.6	-4.7	-5.7
Compensation per worker (manufacturing)	4.8	4.8	4.5	4.8	5.4	4.8	3.7	2.5
Unit labor costs (manufacturing)	2.1	2.8	3.9	2.3	4.1	4.5	4.3	1.8
Consumer prices (national index)	2.2	2.8	2.3	2.9	4.4	3.6	3.3	2.1
Consumer prices (harmonized index)	1.9	2.3	2.3	2.8	4.4	3.7	3.3	2.1
GDP deflator	3.8	3.8	3.1	3.5	4.8	4.7	2.4	1.9
External accounts								
Export volume (goods)	10.1	6.7	5.2	8.2	2.4	2.7	4.9	3.9
Import volume (goods)	13.2	15.2	10.3	6.2	2.0	-1.0	-0.6	2.5
Export unit value (goods and services)	2.6	0.8	0.2	5.4	2.3	0.9	-2.1	-3.4
Import unit value (goods and services)	2.7	-1.2	-0.3	8.2	0.4	-2.0	-2.1	-3.9
Trade balance (in percent of GDP)	-9.2	-10.9	-11.9	-13.0	-12.1	-9.7	-8.4	-7.6
Capital transfers (net, US\$ billions)	2.8	2.5	2.5	1.5	1.1	3.6	3.4	3.6
Current account including capital transfers (US\$ billions)	-3.3	-5.3	-7.3	-9.5	-9.3	-6.9	-4.7	-4.8
(in percent of GDP)	-3.1	-4.7	-6.3	-8.9	-8.5	-5.6	-3.2	-2.8
Nominal effective exchange rate	-2.1	-1.1	-1.4	-2.9	0.6	0.8	2.8 6/	...
Real effective exchange rate (CPI based)	-1.8	0.1	-0.8	-2.5	2.5	2.4	4.1 6/	...
General government finances (in percent of GDP)2/								
Revenues	41.8	41.5	42.4	42.4	42.0	43.2	44.9	42.8
Expenditures	44.8	44.1	45.3	45.3	46.2	45.9	47.8	47.5
<i>Of which: capital expenditures</i>	6.3	6.0	5.9	5.1	6.0	4.7	5.4	4.8
Overall balance	-3.0	-2.6	-2.8	-2.8	-4.2	-2.7	-2.9	-4.7
Structural balance, excluding asset sales	-2.7	-2.8	-3.3	-3.9	-4.4	-2.8	-3.3	-3.4
Primary balance	1.3	0.9	0.4	0.4	-1.1	0.3	0.0	-1.7
Privatization receipts	4.7	3.8	1.4	2.5	0.3	0.0	...	...
Government debt, Maastricht definition	59.1	55.0	54.3	53.3	55.5	57.9	59.8	63.3
Financial variables 3/								
National contribution to euro area M3 4/	6.3	5.3	8.9	6.5	6.9	-1.6	2.9 6/	...
Credit to the private sector 5/	20.7	25.0	26.2	23.9	13.9	9.8	6.4 6/	...
Interest rates (percent)								
Overnight rate	5.1	3.3	3.0	4.8	3.3	3.0	2.2 7/	...
Deposit rate, up to 2 years 8/	4.6	3.3	2.8	4.4	3.3	3.0	2.0 6/	...
Lending rate, up to 1 years 9/	8.4	6.0	5.1	6.4	5.2	4.7	5.1 6/	...
Government benchmark bond	5.7	4.1	5.5	5.2	5.1	4.5	4.4 7/	...

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

1/ Unless otherwise noted, 2003 and 2004 data are staff estimates or projections.

2/ Asset sales, including UMTS receipts, the transfer of the postal pension fund and securitization are netted out for purposes of calculating structural balances.

3/ End-of-period data.

4/ Excludes the currency in circulation held by nonbank private sector.

5/ Includes securitized loans. 2001 onwards it is also corrected for loan write-offs and reclassifications.

6/ As of November 2003.

7/ As of December 2003.

8/ Data refer to new deposits for 1997-2002 and to the stock of outstanding deposits thereafter. Before 2003 deposit rate with 91-180 day maturity is reported.

9/ Data refer to new loans for 1997-2002 and to the stock of outstanding loans thereafter. Before 2003 lending rate with 91-180 day maturity is reported.

Table 2. Portugal: General Government Accounts, 1997-2004

	1997	1998	1999	2000	2001	2002	2003		2004	
							Budget	Staff	Budget	Staff
(In millions of euros)										
Total revenues	38,894	41,940	45,832	49,021	51,752	56,023	59,967	58,966	59,636	57,811
Current receipts	36,720	40,351	43,911	47,364	49,408	53,381	56,549	53,963	55,829	54,004
Tax revenue	22,358	24,391	26,619	28,702	29,743	31,945	33,253	30,747	32,343	31,225
Social security contributions	10,350	11,455	12,266	13,608	14,655	15,772	16,523	16,107	17,278	16,436
Other current revenues	4,012	4,505	5,026	5,054	5,010	6,181	6,773	7,108	6,208	6,343
Capital revenue	2,174	1,589	1,921	1,657	2,344	2,642	3,419	5,003	3,807	3,807
Total expenditures	41,660	44,542	48,905	52,287	56,944	59,523	63,273	62,803	63,512	64,133
Primary current expenditures	31,826	35,012	38,991	42,651	45,780	49,506	51,543	51,895	53,203	53,703
Interest payments	3,934	3,490	3,490	3,761	3,829	3,885	4,403	3,794	3,990	3,990
Capital expenditures	5,900	6,040	6,424	5,875	7,335	6,133	7,327	7,115	6,319	6,441
Overall balance	-2,767	-2,602	-3,073	-3,266	-5,191	-3,500	-3,306	-3,838	-3,876	-6,322
Excluding asset sales 1/	...	...	...	-3,828	-5,308	-4,471	-4,009	-6,857	-5,138	-7,584
(In percent of GDP)										
Total revenues	41.8	41.5	42.4	42.4	42.0	43.2	44.4	44.9	43.6	42.8
Current receipts	39.5	40.0	40.6	41.0	40.1	41.2	41.9	41.1	40.8	40.0
Tax revenues	24.0	24.2	24.6	24.8	24.1	24.7	24.6	23.4	23.7	23.1
Social security contributions	11.1	11.3	11.4	11.8	11.9	12.2	12.2	12.3	12.6	12.2
Other current revenues	4.3	4.5	4.7	4.4	4.1	4.4	5.0	5.4	4.5	4.7
Capital revenue	2.3	1.6	1.8	1.4	1.9	2.0	2.5	3.8	2.8	2.8
Total expenditures	44.8	44.1	45.3	45.3	46.2	45.9	46.8	47.8	46.5	47.5
Primary current expenditure	34.2	34.7	36.1	36.9	37.2	38.2	38.2	39.5	38.9	39.7
Interest payments	4.2	3.5	3.2	3.3	3.1	3.0	3.3	2.9	2.9	3.0
Capital expenditures	6.3	6.0	5.9	5.1	6.0	4.7	5.4	5.4	4.6	4.8
Overall balance	-3.0	-2.6	-2.8	-2.8	-4.2	-2.7	-2.4	-2.9	-2.8	-4.7
Excluding asset sales 1/	...	...	...	-3.2	-4.3	-3.5	-3.0	-5.2	-3.8	-5.7
Memorandum items:										
Structural balance 2/	-2.7	-2.8	-3.3	-3.9	-4.4	-2.8	-2.0	-3.3	-1.7	-3.4
Primary balance	1.3	0.9	0.4	0.4	-1.1	0.3	0.8	0.0	0.1	-1.7
Primary structural balance 2/	1.5	0.7	-0.1	-0.6	-1.3	0.2	1.2	-0.5	1.2	-0.5
Asset sales (in millions of euros) 1/	...	...	...	562	117	970	703	3019	1262	1397
Public debt (Maastricht definition)	54.3	55.0	54.3	53.3	55.5	57.9	59.8	59.8	60.0	63.3
Nominal GDP (in millions of euros)	93,014	100,963	108,030	115,548	123,210	129,557	135,100	131,258	136,673	135,142
Change in nominal GDP (in percent)	7.0	8.5	7.0	7.0	6.6	5.2	4.4	1.3	3.5	3.0
Real GDP growth (in percent)	4.0	4.6	3.8	3.4	1.7	0.4	1.3	-1.1	1.0	1.0

Sources: Ministry of Finance; and Fund staff estimates.

1/ The transfer of the postal pension fund in 2003 and securitization in 2003-04 are added to the asset sales.

2/ Structural balances are calculated using the staff's estimates of potential output. Asset sales, including UMTS receipts, the transfer of the postal pension fund and securitization are netted out for purposes of calculating structural balances.

Table 3. Portugal: Balance of Payments, 1997–2003

	1997	1998	1999	2000	2001	2002	2002	2003
							Jan-Nov	Jan-Nov
	(In billions of euros)							
Current account	-5.3	-7.0	-9.1	-12.0	-11.6	-9.3	-8.5	-6.6
Trade balance	-8.6	-10.9	-12.9	-15.0	-14.9	-12.6	-11.4	-10.2
Exports fob	21.5	23.0	23.9	27.4	28.2	29.0	26.9	27.5
Imports fob	30.2	33.9	36.8	42.4	43.1	41.6	38.4	37.6
Services, net	1.3	1.7	1.8	2.1	2.8	3.2	2.9	3.3
Exports	6.7	7.9	8.2	9.3	9.9	10.3	9.4	9.7
Imports	5.5	6.2	6.4	7.2	7.1	7.1	6.6	6.4
<i>Of which:</i>								
Tourism	2.2	2.8	2.8	3.3	3.8	3.8	3.5	3.6
Exports	4.1	4.9	5.0	5.7	6.1	6.2	5.7	5.9
Imports	1.8	2.1	2.1	2.4	2.4	2.4	2.2	2.2
Income	-1.3	-1.5	-1.7	-2.7	-3.3	-3.3	-3.1	-2.9
Current transfers, net	3.3	3.7	3.6	3.7	3.8	3.5	3.2	3.1
Private remittances, net	2.9	3.0	3.1	3.5	3.6	3.1	2.9	2.7
Official transfers, net	0.4	0.7	0.5	0.2	0.2	0.3	0.3	0.4
Capital account	2.4	2.2	2.3	1.7	1.2	2.0	1.6	2.1
Current account (including capital transfers)	-2.9	-4.7	-6.8	-10.3	-10.4	-7.3	-6.9	-4.5
Financial account	4.0	4.9	8.4	10.9	10.5	8.7	7.9	5.7
Direct investment	0.5	-0.6	-1.8	-0.8	-1.9	0.8	0.4	2.3
Portuguese investment abroad	-1.7	-3.5	-3.0	-8.2	-8.5	-3.7	-3.5	-0.3
Foreign investment in Portugal	2.2	2.8	1.2	7.4	6.6	4.5	3.9	2.6
Portfolio investment, net	0.5	-0.6	3.4	-2.1	2.5	3.1	0.4	-3.2
Equity securities	1.6	1.1	-1.2	-0.7	0.8	2.1	0.1	5.4
Long-term debt securities	-3.3	-0.6	3.4	-2.3	-1.5	0.1	0.6	-4.9
Money market instruments	2.2	-1.1	1.2	0.9	3.2	0.9	-0.3	-3.8
Financial derivatives	0.0	0.1	0.2	0.3	0.3	0.0	-0.1	0.3
Other investment, net	4.2	6.5	6.9	13.8	10.6	5.9	8.2	1.4
<i>Of which:</i>								
Monetary financial institutions	3.1	7.6	7.4	11.3	14.3	8.8	9.7	2.4
<i>Of which:</i>								
Short-term	4.3	6.3	3.7	9.0	6.0	-1.2	2.0	-9.3
Long-term	-1.2	1.3	3.8	2.3	8.4	10.0	7.6	11.6
Reserve assets	-1.1	-0.5	-0.3	-0.4	-1.0	-1.1	-1.2	5.0
Errors and omissions	1.2	0.2	1.6	0.5	0.1	1.4	1.0	1.2
	(In percent of GDP)							
Memorandum items:								
Current account	-5.7	-6.9	-8.5	-10.4	-9.4	-7.1	...	...
Current account (including capital transfers)	-3.1	-4.7	-6.3	-8.9	-8.5	-5.6	...	...
Net international investment position 1/	-16.4	-22.3	-32.6	-38.4	-42.4	-45.2	...	...

Sources: Bank of Portugal; and Fund staff calculations.

1/ End-of-period data.

Table 4. Portugal: Stability and Growth Program and An Illustrative Medium-Term Staff Scenario, 2003–07

(In percent of GDP, unless otherwise indicated)

	2003 Est.	2004	2005	2006	2007
		Projections			
Stability and growth program					
Real GDP (percent change)	-0.7	1.0	2.5	2.8	3.0
Consumer prices (HICP, period average, percent change)	3.3	2.0	2.0	2.0	2.0
Gross domestic investment	-7.0	2.5	5.0	6.2	6.5
General government balance	-2.9	-2.8	-2.2	-1.6	-1.1
Revenues	44.1	43.7	43.2	42.9	42.5
Expenditures	47.0	46.6	45.5	44.5	43.5
General government structural balance	-1.7	-1.1	-0.6	-0.1	0.4
General government primary balance	-0.1	0.1	0.9	1.5	2.0
General government debt	59.5	60.0	59.7	58.6	57.0
Staff projections (unchanged policy scenario)1/					
Real GDP (percent change)	-1.1	1.0	2.7	3.3	3.3
Consumer prices (HICP, period average, percent change)	3.3	2.1	1.9	2.2	2.2
Current account balance (including capital transfers)	-3.2	-2.8	-2.6	-2.4	-3.0
General government balance 1/	-2.9	-4.7	-4.5	-4.0	-3.5
General government primary balance 1/	0.0	-1.7	-1.5	-1.1	-0.6
General government debt 1/	59.8	63.3	64.7	65.0	64.9
Memorandum items:					
Previous Stability Program (December 2002)					
Real GDP (percent change)	1.3	2.7	3.1	3.5	...
General government balance	-2.4	-1.9	-1.1	-0.5	...

Sources: Ministry of Finance, "Stability and Growth Program: Update for 2004–07" (December 2003); and Fund staff estimates and projections.

1/ This illustrative scenario is based on an unchanged policy stance (i.e., a constant structural primary balance, including asset sales) from 2005 onwards.

Table 5. Portugal: Indicators of External and Financial Vulnerability, 1997–2003 1/
(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002	2003	Date
External indicators								
Exports (goods, annual percent change in U.S. dollars)	-1.6	5.5	-1.1	-0.9	0.0	8.5	21.6	
Imports (goods, annual percent change in U.S. dollars)	1.7	11.0	3.3	-0.3	-1.4	1.8	16.4	
Terms of trade (goods and services, annual percent change)	-0.1	2.0	0.5	-2.6	1.9	3.0	0.0	
Current account balance	-5.7	-6.9	-8.5	-10.4	-9.4	-7.1	-5.6	
Current account balance (including capital transfers)	-3.1	-4.7	-6.3	-8.9	-8.5	-5.6	-3.2	
Capital and financial account balance	6.9	7.1	9.9	10.9	9.5	8.2	5.6	
Of which: Inward portfolio investment (debt securities, etc.)	7.6	4.9	8.8	2.6	8.8	8.2	6.1	
Inward foreign direct investment	2.3	2.8	1.1	6.4	5.3	3.5	2.1	
Other investment liabilities (net)	4.4	6.5	6.4	11.9	8.6	4.6	4.2	
Official reserves (in billions of U.S. dollars, end-of-period) 2/	20.5	21.6	15.0	14.1	15.3	15.9	11.5	December
Broad money to reserves 3/	5.2	5.1	7.7	7.5	7.2	7.1	12.3	September
Central Bank foreign liabilities (in billions of U.S. dollars) 2/	2.1	2.9	10.7	7.5	7.3	8.9	11.8	November
Foreign assets of the financial sector (in billions of U.S. dollars) 4/	8.1	56.2	57.1	52.9	53.2	60.8	84.3	November
Foreign liabilities of the financial sector (in billions of U.S. dollars) 4/	42.7	56.9	58.1	73.2	84.3	105.1	131.4	November
Official reserves in months of imports 2/	7.2	6.8	4.6	4.3	4.8	4.9	3.0	November
General government non-curo denominated debt (in percent of total) 5/	7.7	5.3	7.9	6.4	7.2	3.5	...	
Exchange rate (per U.S. dollars, period average) 6/	175.3	180.1	0.94	1.08	1.12	1.06	0.88	
Financial market indicators								
Public sector debt (Maastricht definition)	59.1	55.0	54.3	53.3	55.5	57.9	59.8	
Money market rate (period average in percent)	5.8	4.3	2.7	4.1	4.4	3.3	2.3	December
Money market rate (real, in percent)	3.5	1.5	0.4	1.2	0.0	-0.3	-0.9	December
Stock market index (2000=100)	76.7	96.8	109.0	100.0	81.0	64.2	75.4	December
Share prices of financial institutions (2000=100)	...	...	...	100.0	85.4	64.2	66.8	December
Spread of 10-year benchmark bond with German rate (percentage points)	0.6	0.3	0.3	0.4	0.3	0.1	0.1	December
Financial sector risk indicators								
Foreign exchange loans (in billions of U.S. dollars) 7/	3.3	4.1	3.4	2.8	2.8	2.7	2.5	November
Share of foreign exchange loans in total lending (percent) 7/	3.7	3.4	2.6	1.9	1.8	1.4	1.2	November
Deposits in foreign exchange (in billions of U.S. dollars) 8/	1.5	2.3	3.0	4.0	4.7	3.2	2.8	November
Share of foreign deposits in total deposits (percent) 8/	1.4	1.9	2.6	3.5	4.3	2.5	2.2	November
Share of real estate sector in private credit 9/	34.9	37.6	38.8	38.6	39.5	41.5	42.5	November
Share of nonperforming loans in total loans 4/	4.5	3.3	2.4	2.0	1.9	2.1	2.3	November
Share of nonperforming loans in total assets 4/	1.7	1.5	1.2	1.0	1.1	1.2	1.2	November
Risk-based capital asset ratio 10/	11.5	11.1	10.8	9.2	9.5	9.8	9.8	June
Return on equity for the banking system	14.8	13.6	14.7	15.2	14.9	11.7	13.3	September

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 1999 onwards.

4/ Banks only.

5/ External debt concept for euro-area members.

6/ Portuguese escudos per U.S. dollar until 1998, euro per U.S. dollar thereafter. The irrevocable PTE/euro conversion rate is 200.482.

7/ Share of loans in non-euro currencies.

8/ Share of deposits in non euro area currencies.

9/ Real estate defined as the sum of total credit by monetary financial institutions to individuals for housing and to nonfinancial corporations for construction; private credit defined as total domestic credit excluding the general government.

10/ Capital over risk-weighted liabilities. Consolidated data for the banking system.

Table 6. Portugal: Financial Soundness Indicators for the Bank and Nonbank Sectors, 1999-2003
(In percent, unless otherwise indicated)

	1999	2000	2001	2002	Jun-03	Sep-03	Nov-03
Banks 1/							
<i>Capital adequacy</i>							
Regulatory capital to risk-weighted assets 2/	10.8	9.2	9.5	9.8	9.8	n.a.	n.a.
Regulatory tier 1 capital to risk-weighted assets 2/	8.0	7.6	7.3	7.1	7.2	n.a.	n.a.
Capital (net worth) to assets	6.3	5.8	5.5	5.6	5.5	5.8	n.a.
<i>Asset composition and quality</i>							
Sectoral distribution of loans to total loans 2/ 3/	57.6	59.3	62.4	64.1	64.5	65.2	64.9
Housing	39.7	39.0	38.9	40.2	41.0	41.4	41.0
Real estate, rental and supply of services to companies	10.2	11.6	14.3	14.9	14.4	14.6	14.7
Construction	7.7	8.7	9.2	8.9	9.1	9.1	9.2
Geographical distribution of (nonresident) assets to total assets of domestic banks	21.1	18.9	18.0	16.9	17.9	n.a.	n.a.
Developed countries	14.2	10.0	12.7	12.8	15.4	n.a.	n.a.
Of which: Europe	11.7	8.4	10.3	10.5	13.5	n.a.	n.a.
Offshore centers	5.5	7.6	3.8	2.7	1.6	n.a.	n.a.
Developing countries	1.4	1.2	1.5	1.4	0.9	n.a.	n.a.
Of which: Africa and Middle East	0.5	0.5	0.7	0.7	0.5	n.a.	n.a.
Of which: Latin America and the Caribbean	0.7	0.5	0.6	0.5	0.3	n.a.	n.a.
Of which: Brazil	0.6	0.4	0.5	0.3	0.2	n.a.	n.a.
Foreign exchange (FX) loans (exc. interbank) to total loans 4/	2.9	2.0	1.3	1.0	0.8	0.7	0.7
Nonperforming loans (NPLs) to gross loans 2/ 5/	n.a.	2.2	2.1	2.3	2.5	2.6	n.a.
NPLs net of provisions to capital (tier 1) 2/ 5/	n.a.	8.8	9.8	12.4	13.3	n.a.	n.a.
Large exposures to capital 2/	n.a.	n.a.	n.a.	170.0	172.0	n.a.	n.a.
<i>Earnings and profitability</i>							
Return on average assets (ROAA) 2/ 6/ 7/	0.9	0.9	0.8	0.7	0.8	0.8	n.a.
Return on average equity (ROAE) 2/ 6/ 7/	14.7	15.2	14.9	11.7	14.3	13.3	n.a.
Interest margin to gross income 2/	64.8	62.9	65.8	65.0	61.0	60.4	n.a.
Noninterest expenses to gross income 2/ 8/	63.1	58.2	57.6	59.1	56.9	56.8	n.a.
Personnel expenses to noninterest expenses	61.6	61.8	59.5	59.3	60.2	59.7	n.a.
Trading income to gross income	7.1	7.5	4.6	4.8	5.3	5.4	n.a.
Spread between loan and deposit rates 9/	3.3	3.6	3.0	2.7	2.6	2.5	2.4
<i>Liquidity</i>							
Liquid assets to total assets 2/ 10/	22.3	19.6	19.6	17.2	17.6	19.2	n.a.
Liquid assets to total interbank liabilities 2/ 10/ 11/	101.4	88.7	91.5	87.4	87.8	95.4	n.a.
Customer deposits to total (noninterbank) loans	97.3	87.5	82.7	78.3	76.2	77.3	77.3
FX liabilities to total liabilities 12/	3.9	4.0	5.5	3.6	3.3	3.1	3.1
<i>Sensitivity to market risk</i>							
Net open positions in FX to capital 2/	n.a.	n.a.	11.3	10.1	8.0	n.a.	n.a.
Net open positions in equities to capital	n.a.	n.a.	2.7	2.5	2.1	n.a.	n.a.
Insurance							
Solvency ratio 13/	352.0	239.0	156.0	152	n.a.	n.a.	n.a.
Life	125.0	123.0	133.0	138	n.a.	n.a.	n.a.
Nonlife	280.0	224.0	170.0	168	n.a.	n.a.	n.a.
Composites	579.0	334.0	169.0	155	n.a.	n.a.	n.a.
ROAE	4.9	46.3	3.2	-4.4	n.a.	n.a.	n.a.
Life	13.1	15.0	9.5	-3.8	n.a.	n.a.	n.a.
Nonlife	3.0	5.5	2.4	-0.3	n.a.	n.a.	n.a.
Composites	3.9	61.1	-0.2	-7.3	n.a.	n.a.	n.a.
Pension funds							
Return on investments	7.9	3.1	-2.2	n.a.	n.a.	n.a.	n.a.
Solvency ratio 13/	211.0	234.6	147.9	132.3	n.a.	n.a.	n.a.
Nonfinancial corporate sector 14/							
Debt to GDP	72.1	80.3	89.1	92.4	n.a.	n.a.	92.7
Savings to GDP	10.6	8.0	8.7	8.4	n.a.	n.a.	10.1
Interest payments to GDP	3.5	4.1	4.9	4.4	n.a.	n.a.	3.9
Debt to (market value) equity	64.9	75.2	87.0	96.5	n.a.	n.a.	n.a.

Table 6. Portugal: Financial Soundness Indicators for the Bank and Nonbank Sectors, 1999-2003
(In percent, unless otherwise indicated)

	1999	2000	2001	2002	Jun-03	Sep-03	Nov-03
Households 14/							
Debt to GDP	57.0	63.9	66.9	71.2	n.a.	n.a.	77.0
Interest payments to GDP	3.1	3.7	4.4	3.9	n.a.	n.a.	3.5
Debt to disposable income	83.2	91.7	96.8	103.4	n.a.	n.a.	110.8
Interest payments to disposable income	4.5	5.3	6.3	5.6	n.a.	n.a.	5.0
Debt burden to disposable income	10.1	12.1	13.6	13.6	n.a.	n.a.	13.5
Real estate markets							
House prices 15/	7.9	6.5	3.6	1.1	1.3	1.4	1.6
Commercial real estate (office) prices 15/	2.6	3.6	3.3	0.5	-0.5	-0.3	-0.2
Commercial real estate (shopping facilities) prices 15/	4.9	2.5	1.5	0.0	-0.2	-0.3	-0.3
Housing loans to total loans	39.7	39.0	38.9	40.2	41.0	41.4	41.0
Commercial real estate loans to total loans	11.8	13.3	15.0	15.2	15.6	16.0	16.2

Sources: Bank for International Settlements; Bank of Portugal; Institute of Insurance and Pensions; and IMF calculations.

1/ Data are for consolidated accounts of financial groups comprising at least one deposit taking institutions (excluding those with head offices in the Madeira off-shore center and carrying out activities predominantly with nonresidents).

2/ Included in the "core set" of FSIs.

3/ Loans to resident nonfinancial sector.

4/ Loans to resident nonmonetary sector in FX as a share of total loans.

5/ NPLs are defined as interest and principal overdue more than 30 days.

6/ 2003 returns are annualized.

7/ Net income is before deduction of minority interest.

8/ Noninterest expense including depreciation.

9/ Rates on outstanding amounts (12-month average). Rates before 2002 estimated from new loans.

10/ Liquid assets defined as cash, interbank assets (including in central banks), and government securities.

11/ Interbank liabilities include liabilities with central banks.

12/ Of resident nonmonetary sector. Excludes shares.

13/ The fall in the solvency ratio during 2000-2001 was due to a change in the calculation of required capital.

14/ Estimates for 2003.

15/ Average annual rate of change.

PORTUGAL: FUND RELATIONS
(As of December 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	506.62	58.41
	Reserve position in Fund	360.82	41.60

III.	SDR Department:	SDR Million	Percent Allocation
	Net cumulative allocation	53.32	100.00
	Holdings	61.13	114.65

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

V. **Latest Financial Arrangements:** None

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

VII. **Exchange Rate Arrangements:**

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

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

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

IX. **Technical Assistance**

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

X. **ROSCs**

Standard Code Assessment	Date of Issuance	Document Number
Fiscal Transparency	November 18, 2003	SM/03/374

XI. **Resident Representative:** None.

PORTUGAL: STATISTICAL ISSUES

1. Portugal subscribes to the Special Data Dissemination Standards (SDDS), and the relevant metadata have been posted on the Dissemination Standards Bulletin Board. Portugal has taken a flexibility option regarding the timeliness of reporting wages. Portugal's publication policy is characterized by a high degree of openness and with extensive use of the Internet. The Bank of Portugal, Ministry of Finance, and National Statistics Office (INE) have several websites with long- and short-term economic indicators and data.
2. Notwithstanding some recent improvements, considerable statistical weaknesses continue to hamper an assessment of economic developments.
3. **Real sector** statistics were improved in the fall of 2000, when INE published a full set of national accounts based on ESA95 methodology, including quarterly GDP estimates. However, statistical weaknesses remain and the Bank of Portugal continues to produce separate, and at times considerably different, estimates of the annual national accounts. Shortcomings in timely and high quality monthly and quarterly data on output, employment, and total wage compensation hamper the monitoring of within-year developments in the labor market. Unemployment data also suffer from statistical problems caused, inter alia, by frequent revisions to the measurement of unemployment and sampling rotations.
4. **Fiscal sector** data have undergone a number of revisions during the transition to ESA95, sizably altering revenues and expenditures and hampering comparisons across years. Some progress was made and the 2001–04 budgets were presented fully consistent with recent changes in national and fiscal accounting methodology. Intra-year budget data is available only on a cash basis. In 2002 INE started to publish data for the Social Security Fund on a monthly basis with 45 days delay and in 2003 for Autonomous Funds on a quarterly basis with 75 days delay. Except for the local and general government, the data broadly meet the SDDS timeliness standards. A project is underway concerning quarterly general government statistics on an accrual basis, but no firm timetable is in place for publication of the data.
5. **Trade and balance of payments** data are provided according to the IMF's Fifth Edition of the *Balance of Payments Manual*. Although the external trade data meet the timeliness standards, frequent and sizeable revisions hamper their usefulness. The portfolio investment collection system has a simplified threshold of €500 million, which is relatively high in comparison with many EU countries. The authorities estimate however, that only about 2 percent of transactions are not captured on a monthly basis by this threshold, and that this reporting simplification does not significantly hamper the quality of the monthly balance of payments. Moreover, they indicated that all transactions below this threshold are included in the first release of the annual balance of payments data, and the monthly numbers are revised accordingly.

Portugal: Core Statistical Indicators
as of January 27, 2003

	Exchange Rates	International 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	External Debt
Date of Latest Observation	12/31/03	Dec. 2003	11/30/03	11/30/03	11/30/03	11/30/03	Dec. 2003	Nov. 2003	Nov. 2003	Dec. 2003	2003 Q3	Sep. 2003
Date Received	12/31/03	3rd week of January	3rd week of January	3rd week of January	3rd week of January	3rd week of January	3rd week of January	3rd week of January	3rd week of January	3rd week of January	December 9 2003	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 2/	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/ BoP = Bank of Portugal; MoF = Ministry of Finance; INE = National Statistics Office.

PORTUGAL: GENERAL GOVERNMENT AND EXTERNAL DEBT SUSTAINABILITY

1. This Appendix reports standardized stress tests for general government and external debt sustainability. The baseline scenario builds on the assumptions provided in the World Economic Outlook database.
2. For general government as well as external debt, the standardized tests fail to capture important issues concerning debt sustainability. In the case of general government debt, this relates foremost to the impact of population aging on the fiscal accounts. As elaborated in the main text (for example, in Box 1), these effects would be large without further policy adjustments—but they arise, for the most part, only beyond the horizon captured in the standardized tests. Concerning external sustainability, the relevance of several reported stress tests is questionable as the tests are based on historical experiences pre-dating monetary union.

General government debt sustainability

3. **The baseline scenario envisages a substantial increase in the public debt ratio in 2004 and a fairly stable ratio thereafter.** Under the baseline projection—which assumes that the structural primary deficit in 2004–09 remains at its projected 2004 level—the public debt ratio would increase to 65 percent of GDP in 2006, and decline only slightly thereafter (Table 1). The increase reflects a sizable (1¾ percent of GDP) worsening in the primary balance in 2004, although the balance improves subsequently as the output gap closes over the medium term. The baseline projection envisages a lower real interest rate than experienced over the past decade, the result of euro area entry, and somewhat higher growth, both of which improve the debt dynamics.
4. **Shocks to the baseline illustrate potential risks, especially for the case of weaker-than-projected economic growth.** Were historical averages to repeat for real GDP growth, real interest rate and the primary balance, the debt ratio would be almost identical to the baseline projection, reflecting offsetting effects of a worsened primary balance against higher growth and lower real interest rates in the baseline scenario (compared with the historical average). Other single variable shocks affect more adversely the debt ratio, although the ratio returns to a declining path in most cases. The exception is the negative GDP growth shock, but even here the increase in the debt ratio tails off. Exchange rate shocks have almost no impact on the debt ratio, as the stock of foreign currency denominated debt is very small; moreover, associated currency risks are largely hedged.
5. **While these stress tests provide some indication of short- to medium-term risks to public finances, they fail to capture the sizable longer-term pressures arising from aging-relating spending pressures.** Similar to most advanced economies, aging-related spending is projected to increase significantly in the coming decades. As discussed in the main text, without reforms the public debt dynamics would be severely affected, but foremost beyond the horizon captured in this exercise.

External debt sustainability

6. **The baseline scenario projects broadly stable gross external indebtedness in relation to GDP** (Table 2). The projections envisage persistent external current account deficits, oscillating around the estimated 2003 level. These deficits would be considerably smaller than those observed in the wake of Portugal's entry into monetary union, which pushed the estimated net international investment liabilities to above 50 percent of GDP in 2003. Gross external assets rose also sharply in the context of increased financial integration and euro-area membership, and are assumed to remain stable in relation to GDP over the projection horizon.

7. **Several of the standardized stress tests would result in considerably higher external debt ratios than the baseline scenario, but the likelihood of some of the scenarios has become remote in the context of monetary union.** As discussed in the main text, balance sheet constraints of the private sector make a return to the high current account deficits of years 1998–2002 quite unlikely (see test B4). Standardized stress test for interest rate results in an about 6½ percentage point increase in the debt ratio by 2009 (see test B1). Reflecting in part the relatively large volatility of GDP in Portugal, standardized stress tests for real GDP growth would raise the external debt-to-GDP significantly (see test B2). The effect of a nominal depreciation on the debt ratio is limited as only about 12 percent of external debt is estimated to be denominated in non-euro currencies (see test B6).

Table 1. Portugal: Public Sector Debt Sustainability Framework, 1999-2009
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing primary balance 11/ -0.6		
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009			
1 Public sector debt 1/	54.3	53.3	55.5	57.9	59.8	63.3	64.7	65.0	64.9	64.5	63.6			
<i>a/w</i> foreign-currency denominated	17.9	3.9	3.5	4.2	2.1	1.0	1.0	1.0	1.0	1.0	1.0			
2 Change in public sector debt	-0.7	-1.0	2.2	2.5	1.9	3.5	1.3	0.3	-0.1	-0.4	-0.8			
3 Identified debt-creating flows (4+7+12)	-1.3	-2.6	0.7	-0.2	1.8	3.5	1.3	0.3	-0.1	-0.4	-0.8			
4 Primary deficit	-0.4	-0.4	1.1	-0.3	0.0	1.7	1.5	1.1	0.6	0.2	-0.2			
5 Revenue and grants	42.4	42.4	42.0	43.2	44.9	42.8	42.0	42.0	42.0	42.0	42.0			
6 Primary (noninterest) expenditure	42.0	42.0	43.1	42.9	45.0	44.5	43.5	43.1	42.6	42.2	41.8			
7 Automatic debt dynamics 2/	0.5	0.3	-0.1	0.1	1.8	1.2	-0.2	-0.7	-0.7	-0.6	-0.6			
8 Contribution from interest rate/growth differential 3/	-0.4	-0.3	-0.2	0.3	2.1	1.2	-0.2	-0.7	-0.7	-0.6	-0.6			
Of which contribution from real interest rate	1.6	1.4	0.6	0.5	1.5	1.8	1.4	1.3	1.4	1.4	1.4			
Of which contribution from real GDP growth	-2.0	-1.7	-0.9	-0.2	0.6	-0.6	-1.6	-2.0	-2.0	-2.0	-1.9			
11 Contribution from exchange rate depreciation 4/	0.9	0.6	0.1	-0.2	-0.4	...	...	...	...	...	...
12 Other identified debt-creating flows	-1.5	-2.5	-0.3	0.0	0.0	0.6	0.0	0.0	0.0	0.0	0.0			
13 Privatization receipts (negative)	-1.5	-2.5	-0.3	0.0	0.0	-0.4	0.0	0.0	0.0	0.0	0.0			
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0			
15 Other (acquisition of financial assets)	0.0	0.0	0.0	0.0	0.0	0.9	0.0	0.0	0.0	0.0	0.0			
16 Residual, including asset changes (2-3) 5/	0.7	1.6	1.5	2.7	0.1	0.0	0.0	0.0	0.0	0.0	0.0			
Public sector debt-to-revenue ratio 1/	128.0	125.6	132.0	134.0	133.1	148.1	154.0	154.7	154.5	153.5	151.5			
Gross financing need 6/	19.2	17.6	18.9	20.1	22.6	25.1	25.4	25.2	24.8	24.3	23.7			
in billions of U.S. dollars	22,108.1	18,813.3	20,859.4	24,640.0	33,553.1	42,863.7	45,894.0	48,210.3	50,224.4	52,095.7	53,784.7			
Key macroeconomic and fiscal assumptions						10-Year Historical Average	10-Year Standard Deviation					Projected Average		
Real GDP growth (in percent)	3.8	3.4	1.7	0.4	-1.1	2.4	1.8	1.0	2.7	3.3	3.3	3.2	3.2	2.8
Average nominal interest rate on public debt (in percent) 7/	6.3	6.4	6.2	5.7	5.1	7.4	2.1	5.1	4.9	4.8	4.8	4.8	4.8	4.9
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.2	2.9	1.4	1.0	2.6	3.8	2.8	3.1	2.5	2.2	2.3	2.3	2.3	2.5
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-4.7	-13.4	-3.0	5.4	19.8	0.1	9.6
Inflation rate (GDP deflator, in percent)	3.1	3.5	4.8	4.7	2.4	3.5	1.6	1.9	2.4	2.6	2.5	2.5	2.5	2.4
Growth of real primary spending (deflated by GDP deflator, in percent)	7.3	3.3	4.4	0.0	3.5	4.3	3.4	0.0	0.4	2.2	2.1	2.2	2.2	1.5
Primary deficit	-0.4	-0.4	1.1	-0.3	0.0	-0.5	0.8	1.7	1.5	1.1	0.6	0.2	-0.2	0.8
								II. Stress Tests for Public Debt Ratio						Debt-stabilizing primary balance 10/
A. Alternative scenarios								63.3	63.6	63.9	64.2	64.5	64.8	0.9
A1. Key variables are at their historical averages in 2005-09 8/														
B. Bound tests														
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006								63.3	68.9	74.0	73.8	73.3	72.4	-0.7
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								63.3	68.9	75.9	79.4	82.5	85.1	-0.8
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006								63.3	64.3	64.7	64.6	64.1	63.3	-0.6
B4. Combination of 2-4 using one standard deviation shocks								63.3	67.4	71.6	71.4	70.9	70.1	-0.6
B5. One time 30 percent real depreciation in 2005 10/								63.3	65.1	65.5	65.4	64.9	64.1	-0.6
B6. 10 percent of GDP increase in other debt-creating flows in 2005								63.3	74.7	74.9	74.7	74.1	73.2	-0.7

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as $[(r - \pi(1+g) - g + \alpha s(1+\pi)) / (1+g+\pi+g\pi)]$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and s = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as $-g$.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha s(1+\pi)$.

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ Derived as nominal interest expenditure divided by previous period debt stock.

8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

9/ The implied change in other key variables under this scenario is discussed in the text.

10/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

11/ Assumes that key variables (real GDP growth, real interest rate, and primary balance) remain at the level in percent of GDP/growth rate of the last projection year.

Table 2. Portugal: External Debt Sustainability Framework, 1999-2009
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing noninterest current account 6/ -3.9		
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009			
1 External debt	104.4	124.3	138.9	142.6	157.6	I. Baseline Projections								
2 Change in external debt	5.3	19.9	14.5	3.7	15.0	157.6	156.9	155.9	155.5	155.5	155.5			
3 Identified external debt-creating flows (4+8+9)	4.7	6.2	4.0	-4.7	-1.6	0.0	-0.7	-1.0	-0.4	0.0	0.0			
4 Current account deficit, including capital transfers and excluding interest payments	2.9	4.4	3.3	0.9	-1.5	-4.4	-6.2	-7.4	-6.6	-6.2	-6.1			
5 Deficit in balance of goods and services	10.3	11.2	9.8	7.3	5.6	-2.2	-2.6	-2.9	-2.5	-2.3	-2.2			
6 Exports	29.7	31.7	30.9	30.4	30.5	4.9	4.6	4.5	4.6	4.7	4.9			
7 Imports	40.0	42.9	40.7	37.6	36.0	29.6	30.0	30.1	30.4	30.6	30.8			
8 Net nondebt creating capital inflows (negative)	3.4	1.6	2.7	-2.7	-0.7	34.5	34.6	34.6	35.0	35.3	35.7			
9 Automatic debt dynamics 1/	-1.5	0.2	-2.1	-2.9	0.6	-1.2	-1.0	-0.9	-0.9	-0.9	-0.9			
10 Contribution from nominal interest rate	3.5	4.5	5.1	4.7	4.6	-1.0	-2.6	-3.6	-3.1	-3.0	-3.0			
11 Contribution from real GDP growth	-3.7	-3.8	-2.1	-0.5	1.3	5.0	5.2	5.4	5.5	5.5	5.5			
12 Contribution from price and exchange rate changes 2/	-1.3	-0.5	-5.2	-7.1	-5.3	-1.4	-4.0	-4.9	-4.9	-4.7	-4.7			
13 Residual, incl. change in gross foreign assets (2-3)	0.6	13.7	10.6	8.5	16.6	-4.7	-3.8	-4.1	-3.8	-3.8	-3.8			
External debt-to-exports ratio (in percent)	351.8	392.4	449.0	469.7	517.3	533.2	523.1	517.1	511.9	508.0	504.1			
Gross external financing need (in billions of U.S. dollars) 3/ in percent of GDP	37.6	42.1	42.5	44.9	48.5	52.7	55.1	57.9	62.4	66.6	70.7			
						30.8	30.5	30.2	30.8	31.0	31.1			
Key macroeconomic assumptions						10-Year Historical Average	10-Year Standard Deviation					Projected Average		
Real GDP growth (in percent)	3.8	3.4	1.7	0.4	-1.1	2.4	1.8	1.0	2.7	3.3	3.2	3.2	2.8	
GDP deflator in U.S. dollars (change in percent)	-1.8	-10.4	1.7	10.4	22.7	3.6	9.4	14.1	2.7	2.7	2.6	2.5	2.5	
Nominal external interest rate (in percent)	3.6	4.0	4.3	3.8	3.9	4.3	0.8	3.7	3.5	3.6	3.8	3.8	3.8	
Growth of exports (U.S. dollar terms, in percent)	-1.2	-1.2	0.9	8.8	21.8	7.5	10.1	11.9	7.0	6.7	6.8	6.6	6.6	
Growth of imports (U.S. dollar terms, in percent)	2.6	-0.7	-1.8	2.4	16.2	6.4	8.0	10.3	6.0	6.1	7.0	6.9	6.9	
Current account balance, excluding interest payments	-2.9	-4.4	-3.3	-0.9	1.5	-1.0	2.4	2.2	2.6	2.9	2.5	2.3	2.2	
Net nondebt creating capital inflows	-3.4	-1.6	-2.7	2.7	0.7	-0.3	1.8	1.2	1.0	0.9	0.9	0.9	0.9	
													1.0	
								II. Stress Tests for External Debt Ratio						
A. Alternative scenarios													Debt-stabilizing noninterest current account 6/ -3.9	
A1. Key variables are at their historical averages in 2005-08 4/						157.6	162.2	167.4	172.2	176.9	181.4			
B. Bound tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006						157.6	160.5	162.9	162.4	162.2	162.1		-4.0	
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006						157.6	163.2	169.7	169.5	169.7	169.9		-4.3	
B3. Change in U.S. dollar GDP deflator is at historical average minus two standard deviations in 2006 and 2006						157.6	162.0	167.7	169.6	171.8	173.9		-4.7	
B4. Noninterest current account is at historical average minus two standard deviations in 2005 and 2006						157.6	165.3	172.7	172.0	171.7	171.4		-4.2	
B5. Combination of 2-5 using one standard deviation shocks						157.6	183.8	214.4	213.5	213.1	212.8		-5.2	
B6. One time 30 percent nominal depreciation in 2005 7/						157.6	165.3	164.1	163.6	163.4	163.3		-4.1	

1/ Derived as $(r - g - \rho(1+g) + \epsilon\alpha(1+r))/(1+g+\rho+gp)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, ϵ = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \epsilon\alpha(1+r)]/(1+g+\rho+gp)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\epsilon > 0$) and rising inflation (based on GDP deflator).

3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

4/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

5/ The implied change in other key variables under this scenario is discussed in the text.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and both noninterest current account and nondebt inflows in percent of GDP) remain at their levels of the last projection year.

INTERNATIONAL MONETARY FUND

PORTUGAL

**Staff Report for the 2003 Article IV Consultation
Supplementary Information**

Prepared by the European Department

(In consultation with the Policy Development and Review Department)

Approved by Ajai Chopra and G. Russell Kincaid

March 10, 2004

1. This supplement to the staff report for the 2003 Article IV consultation with Portugal (2/19/04) provides an update on recent developments. The new information does not change the report's staff appraisal.
2. **Real GDP is estimated to have declined by 1.3 percent in 2003.** The National Institute of Statistics (INE) raised its estimates of GDP growth for both 2001 and 2002 by 0.1 percentage point, to 1.8 percent and 0.5 percent, respectively. For 2003, INE estimates that real GDP declined by 1.3 percent—about $\frac{1}{4}$ percentage points below the estimate provided in the staff report, reflecting somewhat larger-than-expected declines in capital spending and public consumption. Confidence and high-frequency activity indicators have shown little upward momentum in early 2004, pointing to additional downside risks to the staff's 1 percent GDP growth forecast for 2004.
3. **Preliminary estimates indicate an external current account deficit (including capital transfers) of 3 percent of GDP in 2003, after 5.1 percent in 2002.** Estimates for 2003 and 2002 are $\frac{1}{4}$ and $\frac{1}{2}$ percentage points, respectively, below those reported in the staff report. Considerably smaller income account deficits, which were only partly offset by lower-than-expected private sector remittances, were the main reason for the revisions.
4. **The authorities' revised estimate of the general government deficit is 2.8 percent of GDP in 2003 (versus the staff report estimate of 2.9 percent).** Relative to the staff's previous estimate, the deficit revisions reflect partly offsetting effects of several factors: (i) higher tax and social security revenues; (ii) lower capital revenues; and (iii) lower expenditures, including on public sector wages and capital. INE has also provided fiscal accounts revisions for some earlier years, most significantly raising the 2001 deficit estimate from 4.2 percent to 4.4 percent of GDP. In the staff's view, the revisions of the 2003 estimates—especially higher-than-expected tax revenues, but also lower expenditures—will have positive carry-over effects into 2004. In all, staff expects now a general government deficit of 4.1 percent of GDP for 2004 (versus the staff report estimate of 4.7 percent); absent further measures, this would still be well above the budget target of 2.8 percent of GDP.

5. **Public sector wage moderation will continue in 2004, and the government has also announced ambitious revenue targets for privatization.** Public administration wages above about €1,000 per month will be frozen, as in 2003, while lower wages will rise by 2 percent in 2004. The government has also announced plans to raise privatization revenues of about €2.5 billion over the coming year.



INTERNATIONAL MONETARY FUND

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March 22, 2004

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IMF Concludes 2003 Article IV Consultation with Portugal

On March 15, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Portugal.¹

Background

A prolonged, euro-entry-related expansion ended in a recession in mid-2002, and real GDP declined significantly in 2003. Private consumption contracted as households adjusted to high indebtedness levels and rising unemployment, and these factors also reined-in a housing boom. Investment demand was also negatively affected by relatively high corporate leverage ratios and by weakening demand prospects. Moreover, fiscal policies needed to be tightened at this juncture as the opportunity to advance fiscal consolidation was missed during the previous economic expansion. The decline in domestic demand led to a sharp fall in imports, while exports held up relatively well. As a result, the external current account deficit, while still sizable, narrowed markedly over the past two years.

Persistent inflation differentials vis-à-vis the euro area have contributed to considerable losses in competitiveness, but inflation differentials have recently fallen significantly in the wake of the recession. Large wage differentials (not compensated for by higher productivity growth) contributed to inflation rates above the euro-area average in recent years. The recent appreciation of the euro has added to losses in price and cost competitiveness. However, with

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.

economic activity and labor market conditions remaining weak, consumer price inflation fell to close to the euro-area level by end-2003.

While private sector credit growth continued to decline significantly in 2003, it remained above growth in nominal incomes. As a result, private sector credit ratios increased further and are well above the euro-area average. The rise in loans continued to exceed the growth in core deposits, and banks financed the gap largely with medium- and long-term debt securities.

Notwithstanding very weak economic conditions, the fiscal deficit was limited to 2.8 percent of GDP in 2003. The outturn benefited from substantial revenues from one-off measures (amounting to 2.5 percent of GDP), including asset sales, the takeover of the postal pension fund as well as the securitization of tax and social security arrears. It also reflected some progress in containing public expenditures, including on wages, but the structural deficit (excluding one-off measures) improved at best marginally in 2003. The 2004 budget targets a fiscal deficit of 2.8 percent of GDP, but staff estimates point to significant slippages, absent further measures.

The authorities and staff expect real GDP to grow by around 1 percent in 2004, well below the euro-area average. The projected recovery remains subject to sizable risks, including those related to stronger domestic balance sheet adjustments in view of high indebtedness levels, and to a further appreciation of the euro.

Executive Board Assessment

Executive Directors commended the Portuguese authorities for the progress achieved in containing the fiscal deficit, strengthening financial sector resilience, and moving forward with structural reforms. This has contributed to ongoing adjustments of large imbalances, including a deceleration in the rise in household indebtedness and a narrowing of the external current account deficit. Directors observed, however, that the task of correcting the imbalances and associated vulnerabilities and laying the foundation for a durable investment rebound and sustained real income convergence is far from complete. Accordingly, the authorities face the difficult challenge of pursuing their fiscal and structural reform agenda with determination in a context of continuing weak domestic demand.

Directors underscored that a robust and sustainable economic recovery hinges on strengthening competitiveness, including to cope with the effects of euro appreciation and the challenges arising from EU enlargement. Along with structural reforms, this will require sufficient wage moderation. Directors welcomed, in this context, the policy of continued wage moderation for the public sector, which they expected to provide an important signal for private sector wages, and encouraged continued close cooperation with the social partners in this area.

Directors commended the authorities' efforts to contain the fiscal deficit in line with the requirements of the Stability and Growth Pact, despite sharply deteriorating economic conditions. The adjustment had rightly focused on expenditure measures, with some of them, including the reduction in public sector employment, expected to yield further savings in coming years. Nevertheless, fiscal consolidation has continued to rely extensively on one-off measures,

and, as a result, the underlying fiscal deficit remains large, even when accounting for the impact of the recession. While welcoming the consolidation target for 2004, Directors pointed out that additional measures should be considered—and would likely be needed—to ensure that the budget targets are fully secured.

Concerning the medium term, Directors supported the government's objective of an evenly-paced fiscal consolidation by about ½ percentage point of GDP per annum until 2007, to be achieved through high-quality adjustment measures. A sustained effort toward this objective will be needed to strengthen public sector saving and help achieve further reductions of the external current account deficit. To strengthen the credibility of the consolidation path, Directors called on the authorities to establish a clear timetable for the elimination of one-off measures over the next few years, by replacing them with durable expenditure reductions.

Directors, accordingly, welcomed the focus of the fiscal adjustment program on expenditure restraint, including through efficiency improvements in public services and health care. They urged the authorities to press ahead with the vigorous implementation of the civil service reform, and to extend hiring limits to all parts of the public sector. Directors emphasized the need to proceed with further reforms of aging-related spending, and viewed early progress in this area as indispensable for securing fiscal solvency. They encouraged the authorities to fully implement the recommendations of the fiscal Report on the Observance of Standards and Codes (ROSC), and to give priority, in this context, to strengthening budget planning and control and moving toward comprehensive multi-year budget targets.

Directors recognized that reductions of the tax burden could enhance economic growth prospects. At the same time, however, they stressed that the growth benefits of tax cuts will depend on corresponding expenditure reductions, which—along with improved tax administration—will help safeguard the fiscal consolidation objectives. In this regard, they noted that expenditure cuts to offset the revenue losses arising from the corporate tax reductions in 2004 still need to be put in place.

Directors noted that financial sector performance had generally held up well during the recession, supported by earlier supervisory and regulatory initiatives. Nevertheless, against the backdrop of historically high private sector indebtedness and risk concentrations, especially to the real estate sector, potential vulnerabilities remain. These require continued supervisory vigilance. In particular, Directors underscored the need for careful monitoring of capital and provisioning levels and for assessing financial institutions' resilience on the basis of regular stress tests. They also considered that market-based discipline could be enhanced by further strengthening disclosure requirements. Directors strongly welcomed the intention to request a more in-depth financial sector review under the Financial Sector Assessment Program (FSAP) in 2005. They commended the authorities' ongoing efforts to combat money laundering and terrorism financing.

Directors underscored that raising the productivity of the Portuguese economy from its below-EU average level remains key to securing a durable convergence in living standards. Progress in this area will depend on sustaining ongoing reform efforts in a range of areas. Steps will be needed to improve general education and vocational training, and to encourage research and

development. While the establishment of a fully independent competition authority is welcome, the authorities should make further efforts to strengthen competition, including through implementing the government's privatization program and facilitating market entry and exit. Directors welcomed recent reforms to add flexibility to labor market arrangements, and saw scope for further steps to address Portugal's restrictive employment dismissal restrictions.

While progress has been made in improving the timeliness and coverage for some fiscal data, Directors encouraged the authorities to address remaining statistical shortcomings expeditiously, including in the area of real sector data.

Directors urged the authorities to continue to actively support further trade liberalization in the context of the Doha Round. They also encouraged efforts toward raising Portugal's official development assistance.

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 2003 Article IV Consultation with Portugal is also available.

Portugal: Selected Economic Indicators, 2000–04

	2000	2001	2002	2003 1/	2004 1/
Real economy (change in percent)					
Real GDP	3.4	1.8	0.5	-1.3	1.0
Domestic demand	2.9	1.4	-0.5	-2.9	0.8
CPI (year average, harmonized index)	2.8	4.4	3.7	3.3	2.1
Unemployment rate (in percent)	3.9	4.1	5.1	6.4	7.0
Gross national saving (percent of GDP)	18.4	18.2	18.8	17.8	18.0
Gross domestic investment (percent of GDP)	28.8	27.7	25.4	22.8	22.8
Public finance (percent of GDP)					
General government balance	-2.9	-4.4	-2.7	-2.8	-4.1
Primary balance	0.4	-1.2	0.3	0.1	-1.1
Public debt	53.3	55.6	58.1	60.1	63.3
Money and credit (end-period, percent change)					
Total domestic credit	23.9	13.9	9.8	6.4	...
National contribution to euro area M3 2/	6.5	6.9	-1.6	2.9	...
Interest rates (end-period)					
Deposit rate, up to 2 years 3/	4.4	3.3	3.0	2.0	...
Ten-year government bond yield	5.2	5.1	4.5	4.4	...
Balance of payments (percent of GDP)					
Trade balance	-13.0	-12.1	-9.7	-8.5	-7.6
Current account (including capital transfers)	-8.9	-8.5	-5.1	-3.0	-2.8
Net official reserves (in US\$ billions, end of period)	14.1	15.3	15.9	11.5	...
Exchange rate					
Exchange rate regime		Euro-area member			
Present rate (March 15, 2004)		US\$1.23 per €1			
Nominal effective rate (1995 = 100)	92.9	93.4	94.2	96.8	...
Real effective rate (1995 = 100)	95.9	98.3	100.6	104.7	...

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

1/ 2003 is estimate and 2004 is staff projections.

2/ Excludes currency in circulation held by non-bank private sector.

3/ Data refer to new deposits for 1997-2002 and to the stock of outstanding deposits thereafter. Before 2003 deposit rate with 91-180 day maturity is reported.