October 2007
IMF Country Report No. 07/341

Portugal: 2007 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by Executive Director 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 2007 Article IV consultation with Portugal, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 26, 2007, 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 August 8, 2007. 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 statement of September 28, 2007 updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its September 28, 2007 discussion of the staff report that concluded the Article IV consultation. The staff statement updates the background section and table of the PIN.

- A statement by the Executive Director for Portugal.

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

Selected Issues Paper

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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PORTUGAL

Staff Report for the 2007 Article IV Consultation

Prepared by Staff Representatives for the 2007 Consultation with Portugal

Approved by Michael Deppler and G. Russell Kincaid

August 8, 2007

Executive Summary

Background: A modest recovery is finally underway, led by strong external demand. In response, corporate investment shows signs of strengthening, but overall domestic demand remains weak. Decisive action is being taken to address fiscal imbalances accumulated during the 1990s.

Challenges: The underlying economic situation remains difficult: productivity growth continues to lag, the loss of competitiveness has not been regained, and the income convergence process with the EU is in reverse. At root, Portugal's challenges can be traced to low levels of human capital, investment in R&D, and Information and Communication Technology (ICT) penetration, but also to shortcomings in the business environment, insufficient competition in domestic markets, and labor market rigidities.

Staff views: The current favorable economic setting should be used to further streamline the public sector and to boost productivity and competitiveness. In particular, expenditure plans should be adhered to, the revenue overperformance locked-in, the labor market made more flexible, and the contestability of the nontradable sector increased.

Authorities' views: The authorities broadly agreed with the staff's analysis, which overlapped considerably with their own. The authorities concurred with the need to lock-in the revenue overperformance, though they stressed the need for caution in setting targets and the uncertainty of the revenue strength. On competitiveness, the authorities agreed there is a problem but downplayed the significance of the standard indicators. On the labor market, the authorities intend to increase flexibility, but thought its rigidity is somewhat overstated.

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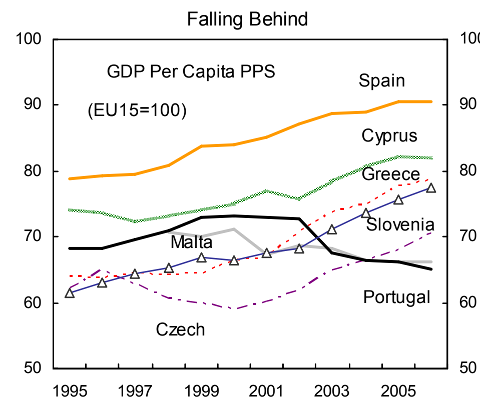
I. Overview: Boom to Bust

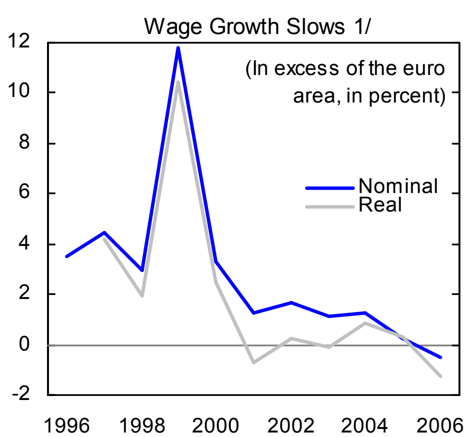
"The Portuguese economy is in serious trouble. Productivity growth is anemic. Growth is very low. The budget deficit is large. The current account deficit is very large."
Olivier Blanchard, 2006

1. **Portugal boomed at the end of the 1990s.** The prospect of adopting the euro turbocharged the convergence process as real interest rates plummeted, investment and consumption (fuelled by borrowing) boomed, and the underlying fiscal stance loosened. The result was rapid growth of GDP, employment, wages, debt, and the current account deficit.

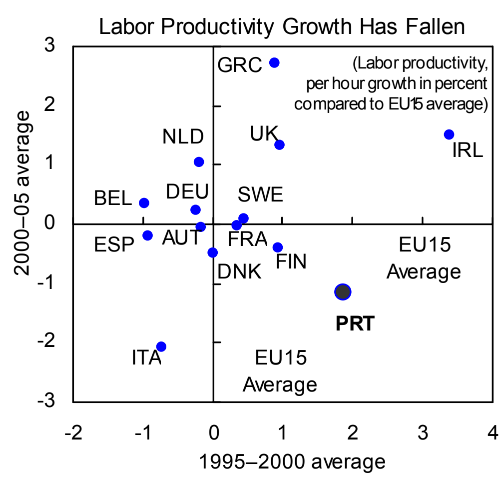


2. **Boom turned to bust in 2000.** Balance sheets became stretched and, as the expected productivity gains failed to materialize, corporates cut investment and employment, and growth slumped. Reflecting the erosion of competitiveness and negative external developments, exports flagged, and the convergence process went into reverse.

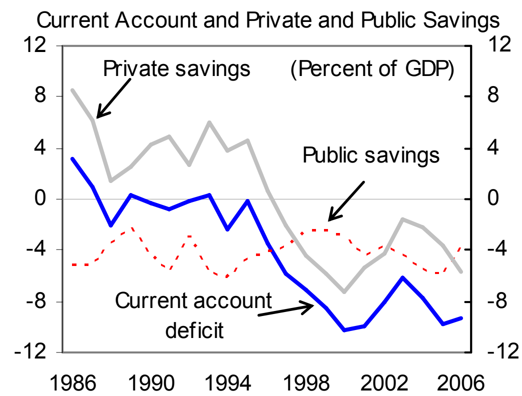
3. **Real wage increases have waned, but with anemic productivity growth, unit labor costs have remained high.** Wage growth moderated to the euro area average as the economy slowed after 2000. However, real wage increases continued to outpace labor productivity growth, further raising unit labor costs. Poor productivity growth can be traced to low levels of human capital, investment in R&D and ICT penetration, but also to shortcomings in the business environment, insufficient competition in domestic markets, and labor market rigidities.



1/ Calculated as compensation of employees divided by employees (national account data).



4. **The sustained large current account deficit (and the corresponding external indebtedness) is symptomatic of the imbalances of the economy.** In particular, it reflects weak competitiveness, sustained high private sector borrowing[1] and declining household savings, and the large fiscal deficit. As a member of the euro area with a robust financial sector, external financing is, however, readily available.



5. **Recent policies have been impressive, especially on the fiscal front.** The government that came to power in March 2005 (with, for the first time, a single-party majority) has started expenditure-based fiscal consolidation, reformed the pension system (both private and public) and improved the business environment.

II. Outlook: A Modest and Fragile Recovery

6. **A modest recovery is finally underway.** Growth rose to 1.3 percent in 2006 (still the lowest in the euro area), led by strong external demand, which is driving a notable rebound in export growth (Box 1). In response, corporate investment shows signs of strengthening, but overall domestic demand remains weak as the anticipated retrenchment of households in response to their debt burden unfolds, and construction activity continues to decline. And while employment and participation rates have risen, so too has unemployment. Inflation has remained consistently higher than the euro average despite a still-significant output gap and sluggish domestic demand, suggesting rigidities in product and labor markets.

7. **Staff's central scenario is one of continuing but modest structural adjustment and gradually strengthening growth.** With fiscal consolidation broadly as envisaged by the government's SGP commitments, modest further structural reforms are projected to prompt a gradual recovery in competitiveness and productivity. Strong external demand is expected to lead to a positive contribution from the external sector (though exports are projected to lose slightly more market share), while domestic demand will likely remain subdued. Consumption should be constrained by weak employment growth and high indebtedness, though credit growth has picked up.[2] While some corporate balance sheet restructuring has

[1] At end-2006, household debt was around 125 percent of disposable income, the second highest in the euro area.

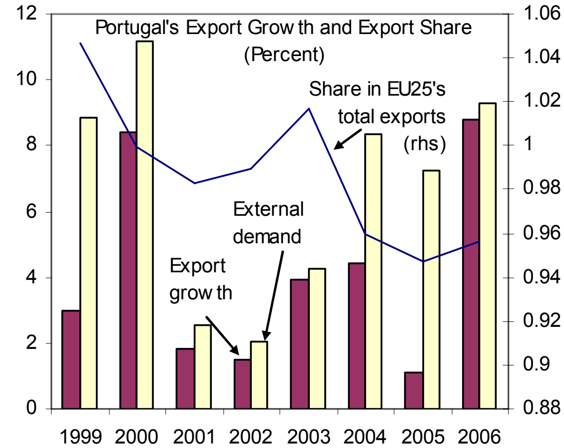
[2] The acceleration in household credit is driven mainly by non-mortgage lending, reflecting the recovery in economic activity and intensified bank competition. For corporates, survey data suggest that lending is driven by debt restructuring and M&A activity, rather than investment.

occurred, still-high enterprise debt levels may restrain any rebound in investment. Staff projects growth of around 2 percent in 2007 and 2008, in line with official and Commission estimates. Over the medium-term, staff foresees growth increasing to around 2¼ percent leading to a closing of the output gap by 2012—before settling down to potential rates of about 2 percent.

Box 1. Portugal's Exports: Blip or Recovery?

After several years of dismal performance, exports of goods and services picked up strongly in 2006, growing at almost 9 percent in real terms compared to an average of 2½ percent in the previous five years. What explains this surge, and are there signs it might be a blip or a more permanent recovery?

- Exports were led by strong demand in Portugal's main trading partners (especially Spain, Germany, and the U.S), though smaller partners (such as Angola and Singapore) contributed.
- The 2006 pick up was mainly due to faster growth in exports of machinery and transport equipment, manufactured material, as well as tourism and transport services; clothing and footwear sectors remained stagnant.
- The loss of market share in recent years appears to have stopped (though this also happened in 2002–03 before falling again).

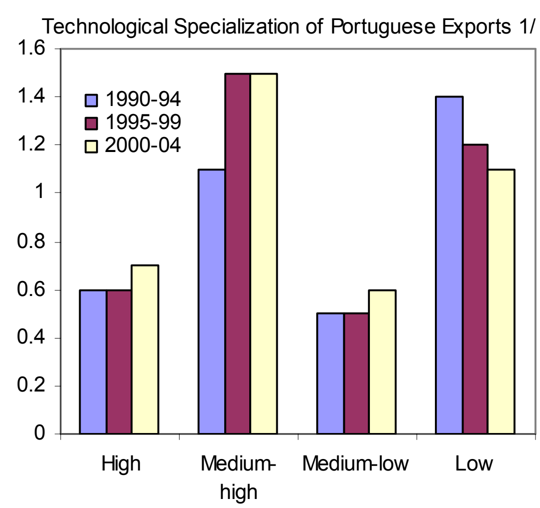


- On the other hand, a wide range of indicators still suggests Portugal has a significant competitiveness gap.

Since the beginning of this decade, two trends stand out:

- Portugal continues to move away from low-tech exports (clothing and footwear), although the process is slower than in the 1990s.
- Portugal's export share continues to slip in the EU market, its largest export destination, but has been growing outside the EU (though these markets are still comparatively small).

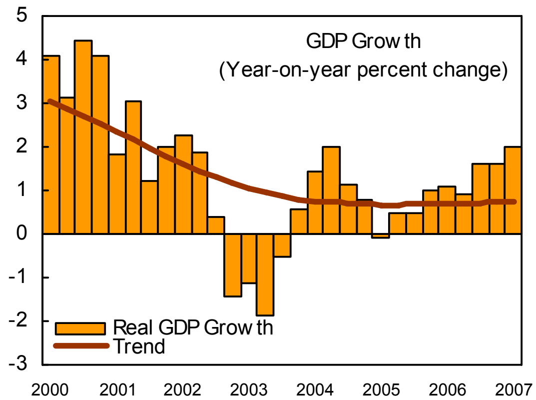
As external demand is forecast to remain robust, the strong response of Portugal's exports to world demand since 2006 bodes well for a gradual recovery. However, given the competitiveness loss of recent years, it seems premature to expect any gains in market share.



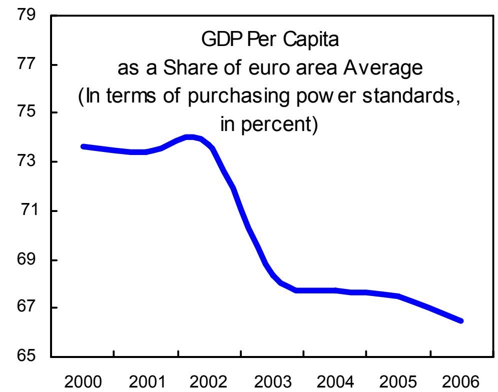
1/ As measured by share in Portuguese exports divided by share in world exports.

The Economy Has Slumped...

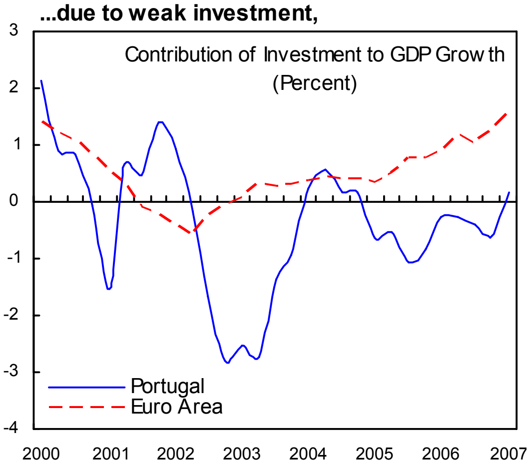
Growth has remained anemic...



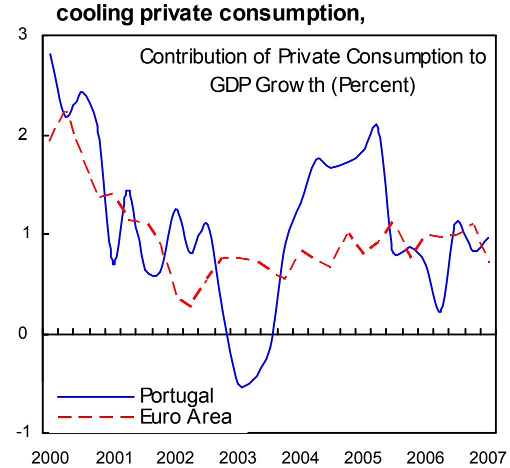
...and the convergence process reversed...



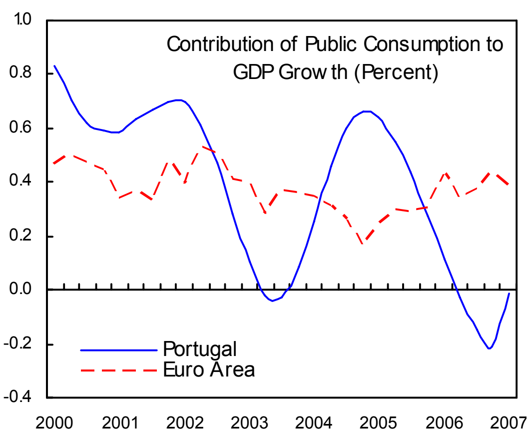
...due to weak investment,



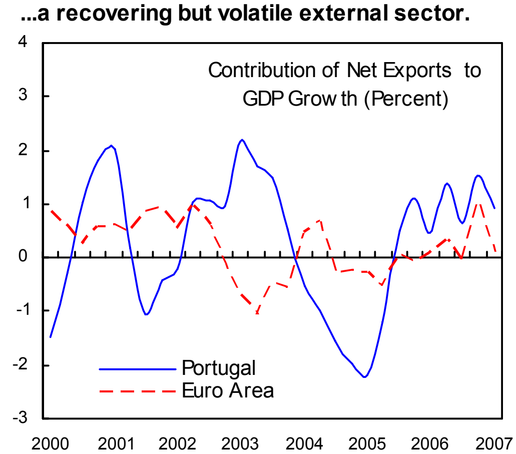
cooling private consumption,



lower public consumption and...

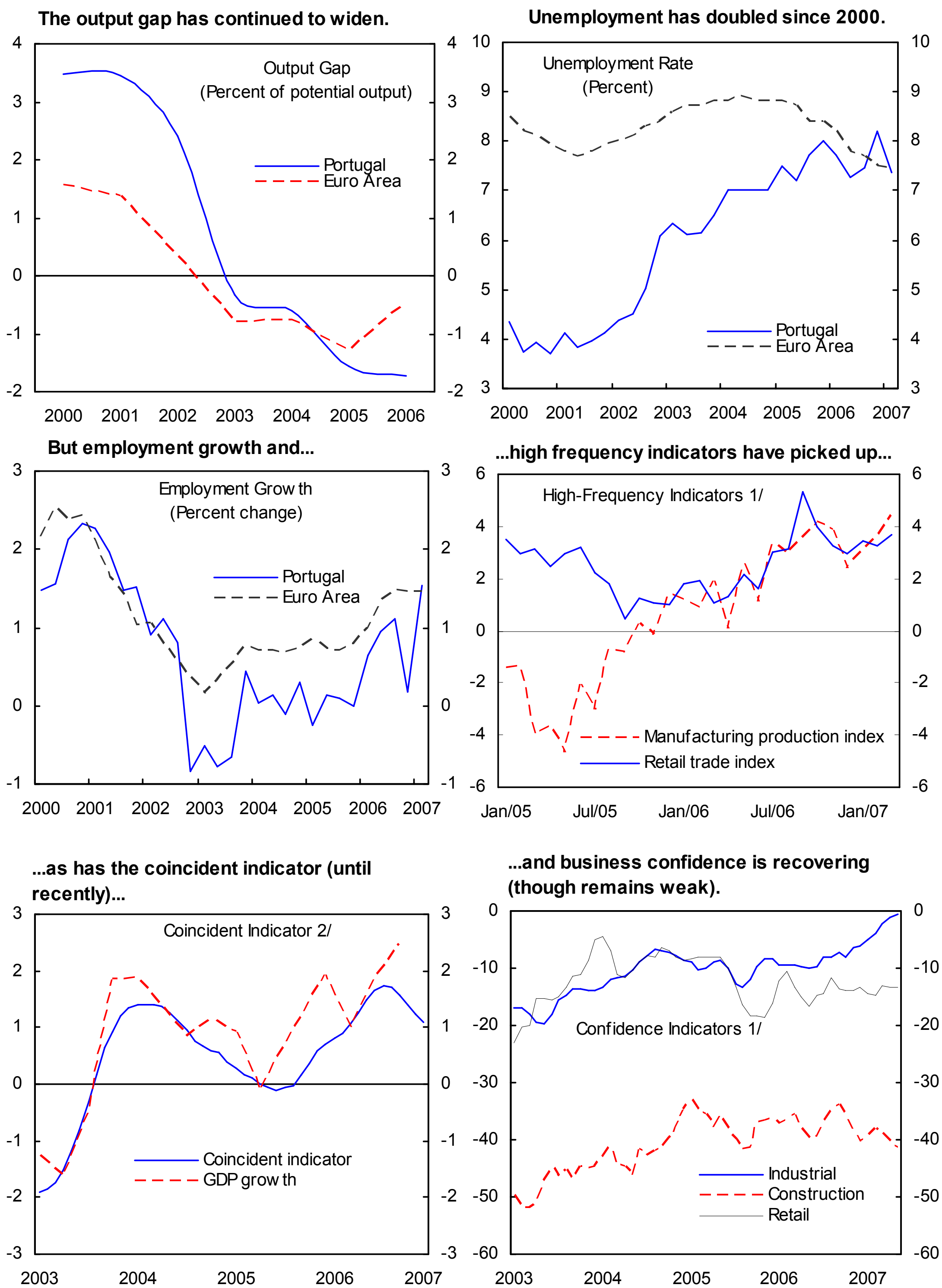


...a recovering but volatile external sector.



Sources: Bank of Portugal; National Institute of Statistics (INE); and IMF staff calculations.

...But Shows Signs of a Moderate Pick-Up

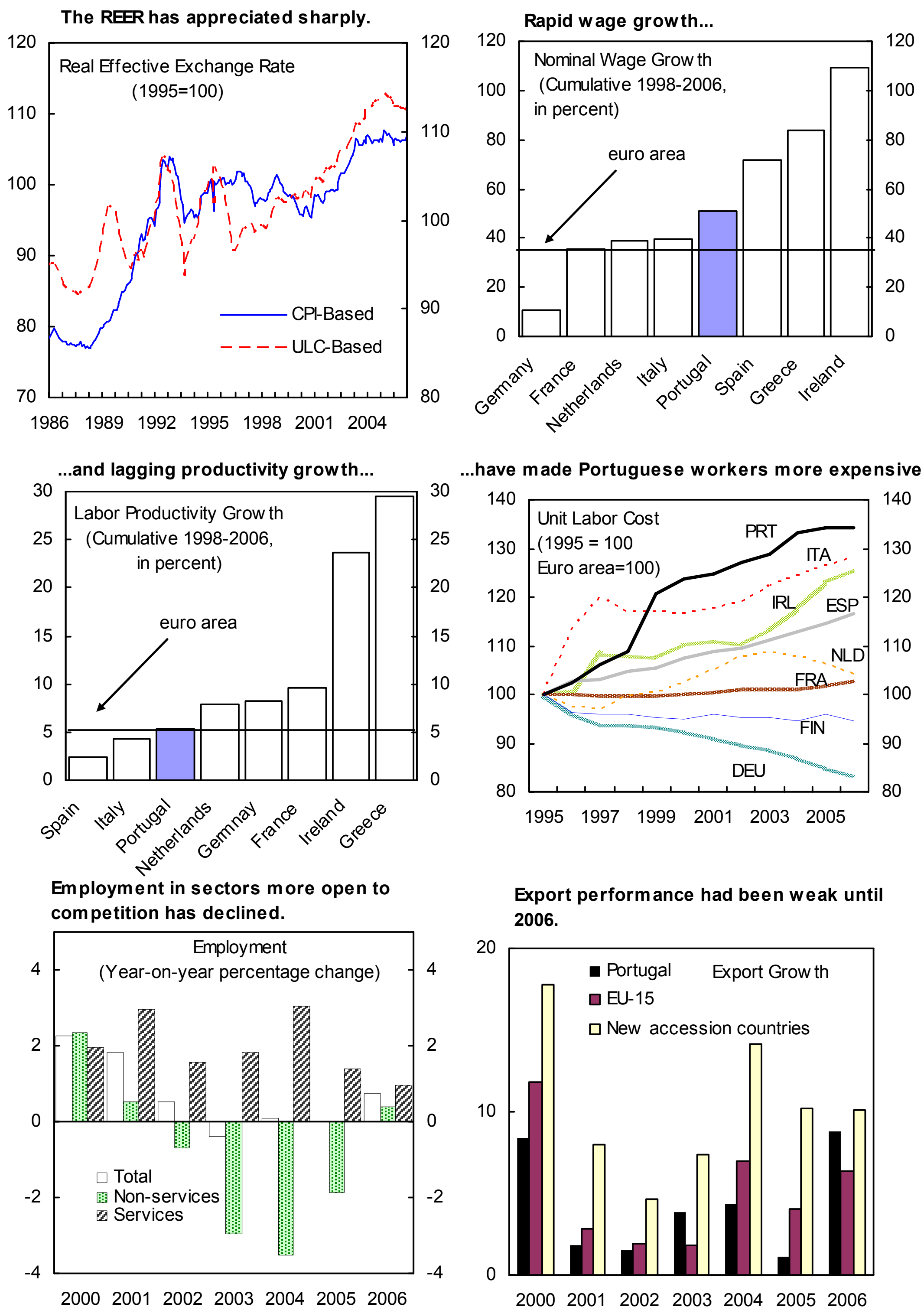


Sources: INE, Bank of Portugal; and IMF staff calculations, end of period.

1/ Three-month moving average of year-on year growth rate.

2/ Year-on year growth rate (three-month moving average, seasonally adjusted). The coincident indicator is a composite indicator for economic activity published by the Bank of Portugal. It combines indicators of retail sales, heavy commercial vehicle sales, cement sales, manufacturing production, household's financial situation, new job vacancies, and a consumer survey of Portugal's main trade partners.

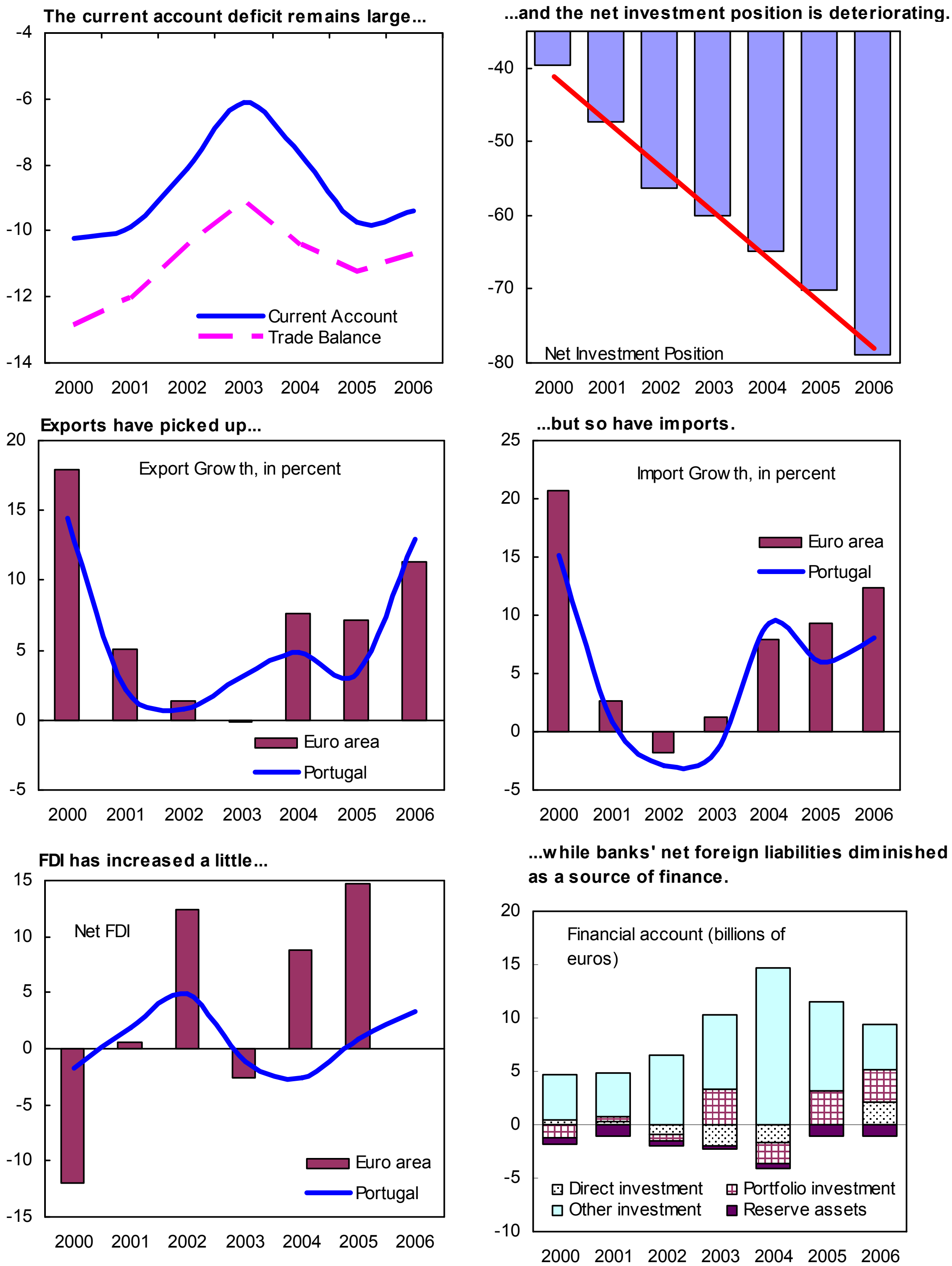
Portugal Has Lost Competitiveness...



Sources: OECD Economic Outlook; AMECO; National Institute of Statistics (INE); Eurostat; and IMF staff calculations.

...And the External Accounts Remain Weak

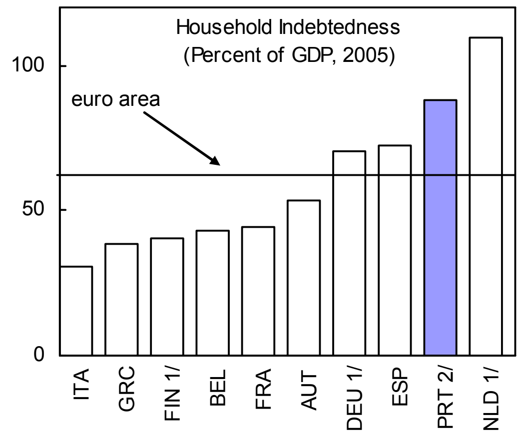
(Percent of GDP, unless otherwise indicated)



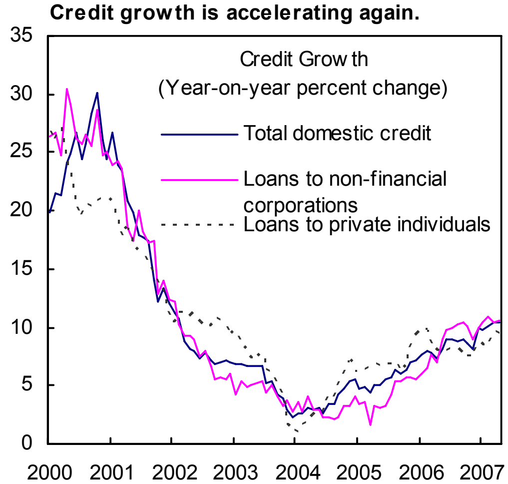
Source: Bank of Portugal.

Private Debt Is High and Growing (But No Housing Boom)

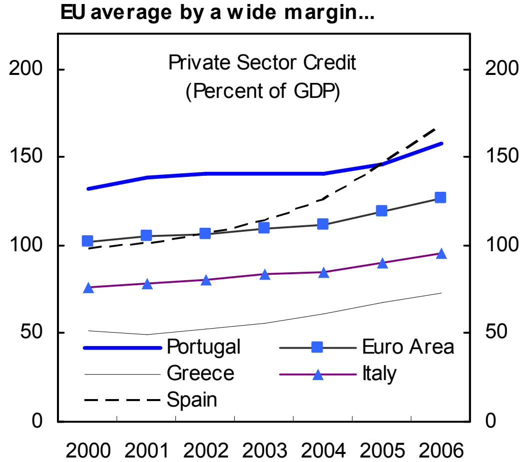
Household debt remains one of the highest in Europe.



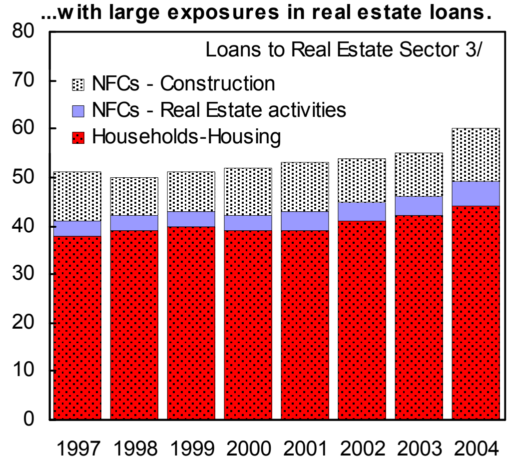
Credit growth is accelerating again.



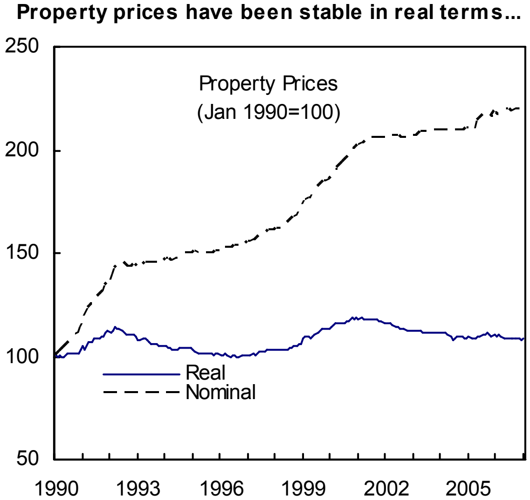
Credit to the private sector exceeds the EU average by a wide margin...



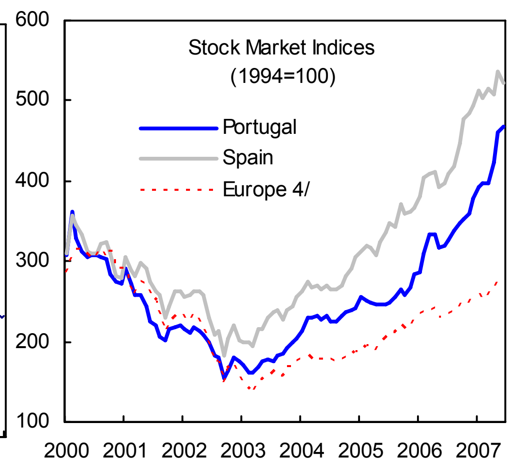
...with large exposures in real estate loans.



Property prices have been stable in real terms...



...while share prices have risen faster than the EU average.



Sources: Bank of Portugal; Ministry of Finance, Monthly Economic Indicators; Datastream; and IMF staff calculations.

1/ Data refers to 2004.
2/ Data refers to 2006.
3/ Loans to nonfinancial corporations of the construction and real estate sectors and to households for housing as a percentage of total loans extended to the nonfinancial private sector (adjusted for securitization).
4/ FTSE Eurotop 100 (in euros).

8. **Risks to near-term growth outlook appear balanced, but are skewed to the downside further forward.** In the short term, private investment may not pick up as strongly as projected, but exports could grow more strongly, benefiting from more favorable global demand. In the longer term, the main risk is that the pace of reform will slacken and balance sheet problems may depress household consumption and investment.

9. **The authorities were more optimistic, especially about the prospects for private investment, and saw stronger growth over the medium term.** The authorities emphasized that business investment excluding construction grew by 3 percent in 2006, after a long slump and that substantial foreign investment plans were in the pipeline. Overall, the authorities saw upside risks to domestic demand in the near-term and growth accelerating to 3 percent by 2010.

III. Policy Challenges

10. **Staff and officials agreed that raising the economy's long-term growth potential requires maintaining the reform momentum, building on the gains already made.** The current favorable economic setting should be used, in particular, to further streamline the public sector and to boost productivity and competitiveness. Further streamlining the public sector would help regain competitiveness by moderating wage growth (as in the Netherlands during the 1980s and 1990s) and improving the efficiency of public services. And greater competitiveness would spur growth and employment, easing fiscal adjustment. In contrast, letting the reform effort slip would increase the duration and costs of adjustment.

11. **There was broad agreement that Portugal continues to face a competitiveness problem.** Staff estimates, based on a range of indicators, indicate a real exchange rate overvaluation of some 10–20 percent.[3] While these estimates should be assessed with caution, the presence of such a gap is consistent with developments in relative unit labor costs, the current account and export market share. Going forward, fiscal consolidation, balance sheet adjustment by households, and a series of product market reforms should help narrow this gap, but at the current juncture, staff considered that, on balance, the real exchange rate was overvalued.

[3] See IMF Country Report No. 06/386.

12. **While agreeing with the challenges facing Portugal, the authorities downplayed quantitative assessments of competitiveness based on standard indicators.** In the authorities' view, standard indicators of competitiveness (such as equilibrium real exchange rates) suffered from significant methodological shortcomings and masked the fundamental restructuring underway in some sectors of the economy.

A. Streamlining the Public Sector

"Good results only mean that we are...able to reach the end of the path faster. But there is still road ahead of us."

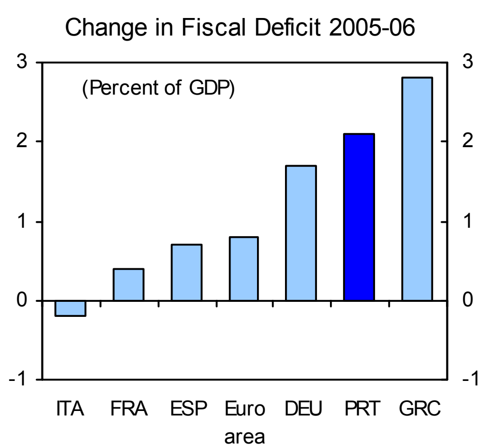
Prime Minister Sócrates, Budget address, 2007

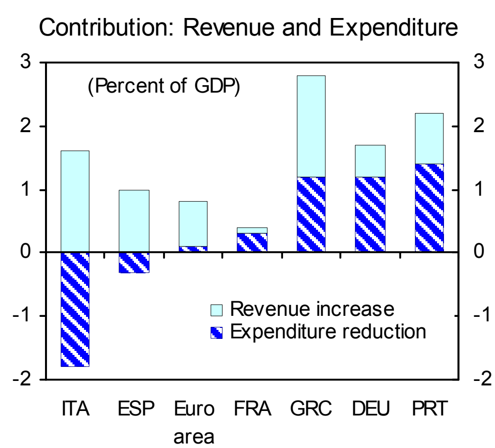
13. **Much-needed, expenditure-based fiscal consolidation is now firmly underway.** The overall balance improved sharply from a deficit of 6 percent of GDP in 2005 to 3.9 percent of GDP in 2006 (without one-off measures), compared to a budget target of 4.6 percent of GDP. The improvement was mostly due to lower spending.

Fiscal Overperformance, 2006
(Percent of GDP)

	2005	2006	Diff.
Fiscal balance			
SGP (December 2005) 1/	-6.0	-4.6	1.4
Actual	-6.1	-3.9	2.2
Revenue	41.5	42.3	0.8
Expenditure	47.5	46.2	-1.4
Structural balance			
SGP (December 2005)	-4.8	-3.3	1.5
Actual (Auth. Apr 07)	-4.9	-2.7	2.2

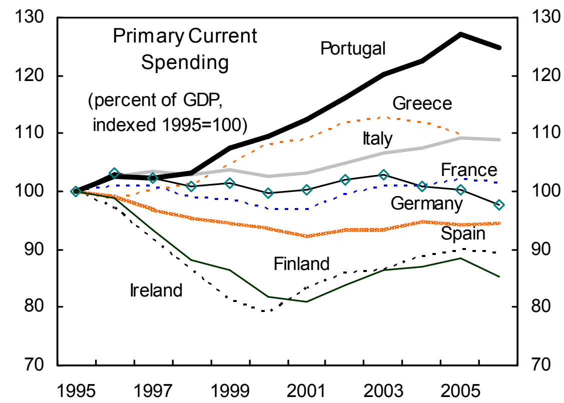
1/ Consistent with 2006 Budget.





- After a decade of almost one percentage point of GDP increases a year, primary current spending fell in 2006. Most of the reduction was due to a lower wage bill (which remains the highest in the euro area), reflecting the government's civil service reforms and wage restraint. Capital spending also came in well under budget, as local governments scaled investment back from election-related higher levels of 2005 and in response to the firm application of the local and regional government financing framework.

Spending is Falling From a High Base



- Most of the deficit overperformance relative to the budget was driven by revenue strength towards the end of the year. While such revenue strength is being seen elsewhere in the euro area, in Portugal's case, the marked improvement in tax administration is clearly a contributing factor.

14. **Reflecting stronger-than-expected fiscal outturns, the authorities have updated their deficit targets for 2007 and 2008.** In April 2007, the authorities revised the deficit targets set at the time of the SGP in December 2006. The revision implied somewhat less adjustment in structural terms, but continued to reduce the structural deficit by at least ½ percent of GDP a year until meeting the government's Medium-term Objective (MTO) of half a percentage point of GDP in 2010.

Fiscal Targets
(Percent of GDP)

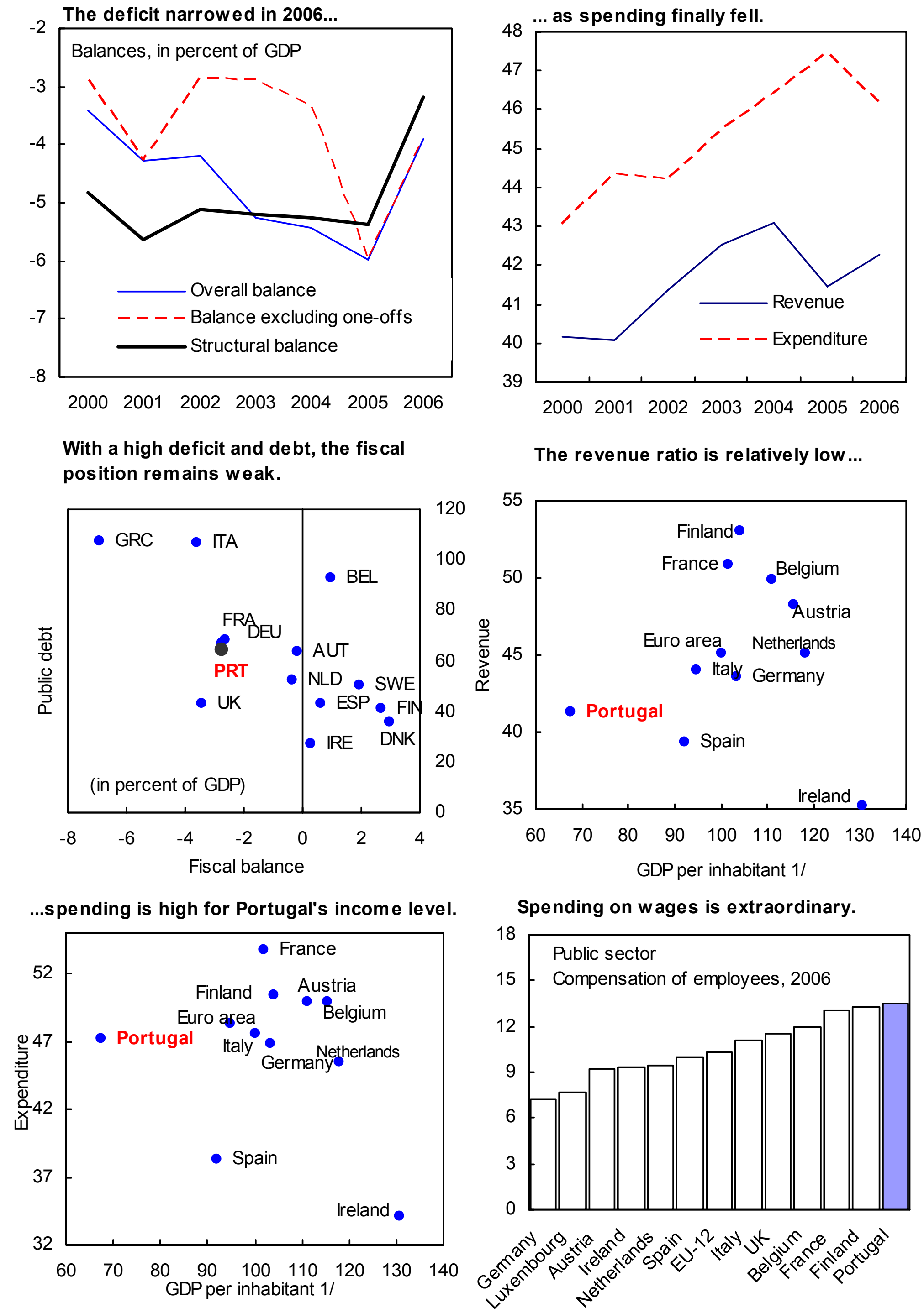
	2006	2007	2008	2009	2010
Fiscal balance					
SGP Dec. 06	-4.6	-3.7	-2.5	-1.5	-0.4
Updated targets (Apr. 07)	-3.9	-3.3	-2.4	-1.5	-0.4
Structural balance					
SGP Dec. 06	-3.4	-2.6	-1.8	-1.3	-0.5
Updated targets (Apr. 07)	-2.7	-2.2	-1.6	-1.2	-0.5

Source: Ministry of Finance.

15. **Staff welcomed the authorities' intention to accelerate the pace of consolidation, but saw a greater opportunity to further front-load the adjustment.** Data through June suggest that revenues are coming in stronger than envisaged at the time of the revision, driven primarily by buoyant corporation tax receipts. In staff's view, somewhat more ambitious deficit targets for 2007 and 2008 were warranted given the substantial uncertainties about the budgetary implications of the current fiscal reforms, the growing pressure to cut taxes, and to make the remaining adjustment in 2009 (an election year) and 2010 to achieve the MTO more credible. Specifically, staff saw a case for maintaining the envisaged pace of structural deficit reduction, which implies additional tightening by about ¼ percentage point of GDP in both 2007 and 2008. Staff also supported the new mechanism in place to better monitor budget execution of local government, but noted that any further large shortfalls of capital spending compared to budget should be carefully monitored.

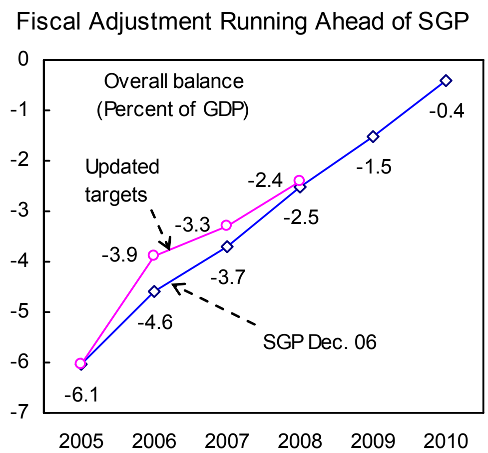
Weak Fiscal Accounts Are Starting to Improve

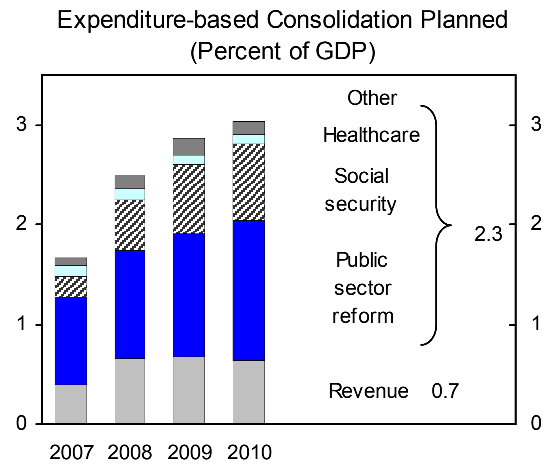
(Percent of GDP, unless otherwise indicated)



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

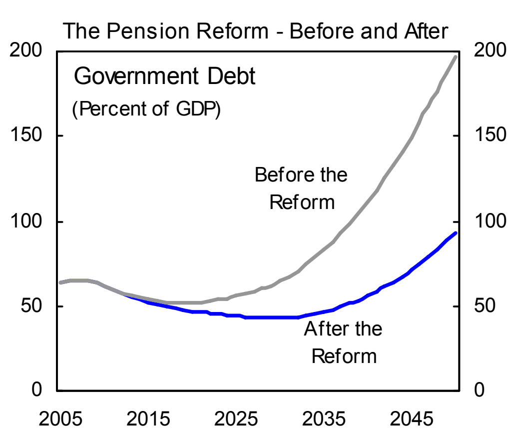
1/ euro area=100.

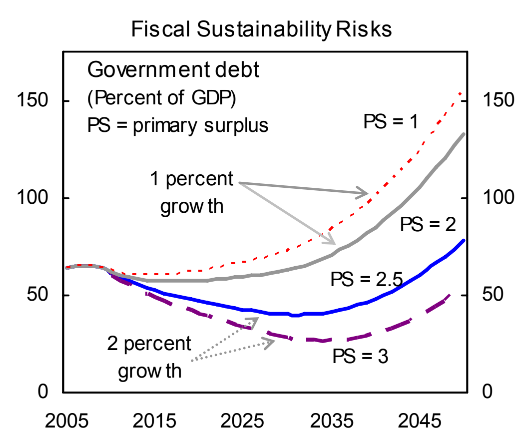




16. **While agreeing in principle, the authorities pointed to the need for caution in setting targets**. The authorities expressed their concerns about whether the current revenue buoyancy would last, partly due to high volatility in corporate tax. Nevertheless, they stated their intention to lower the deficit further to the extent that the revenue overperformance persists. On spending, officials concurred with staff's assessment that there may be overrun risks, in particular, in social transfers, health, and transfers to the public roads company, but stressed their close monitoring of monthly spending patterns and that a contingency reduction had been implemented to ensure the targets are met.

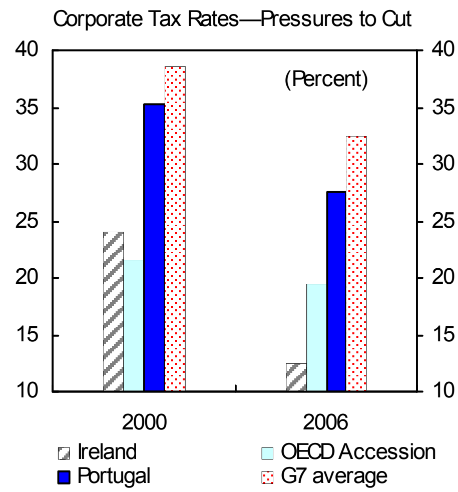
17. **Staff recognized that recent reforms had substantially improved long-term sustainability.** The recent fundamental changes to the social security system imply that if the underlying (i.e., non age-related primary balance) MTO position is achieved and maintained, public debt would remain below 60 percent of GDP through 2040. However, the debt ratio would exceed 90 percent of GDP by 2050 (compared to nearly 200 percent of GDP before the reform), and the SGP reference level for the deficit of 3 percent of GDP would also be breached in the 2030s. Assumptions in the long-term projections could also prove optimistic, especially, for example, health-care inflation.





18. **The restructuring of the central administration is making good progress and is entering a critical phase.** The number of central administration structures has been cut by a quarter, the new public employment framework has been submitted to parliament, and recruitment has been kept to less than half of departures. Staff and officials recognized that the process is now entering a critical phase of identifying significant numbers of weaker-performing civil servants and moving them into the special mobility pool (where they will receive increasingly lower pay as an encouragement to leave).

19. **With fiscal consolidation performing better than expected, the government has faced pressure to reduce the tax burden; staff and officials agreed it should be resisted (Box 2).** Given Portugal's fiscal situation and the relatively low revenue ratio, no room exists for a discretionary reduction in the tax burden in the near term. Nevertheless, some tax laws should be further simplified and procedures, which could have a significant impact on competitiveness, especially for small and medium-sized firms, streamlined.



20. **Fundamental reforms to substantially enhance the budgetary process are envisaged.** The interim report of the program budgeting committee envisages moving to performance-based, medium-term budgeting with expenditure ceilings. Staff agreed that such a reform would greatly enhance the efficiency and quality of public spending and would make government fiscal programs more transparent and credible, but suggested that the target of a full roll-out by 2010 may prove unduly demanding.

B. Boosting Productivity and Competitiveness

"The problems have been diagnosed...what the Portuguese expect...is action and more action...we need to increase our productivity and to be more competitive."
President Silva, Inaugural Address, 2006

Wage restraint and labor market flexibility

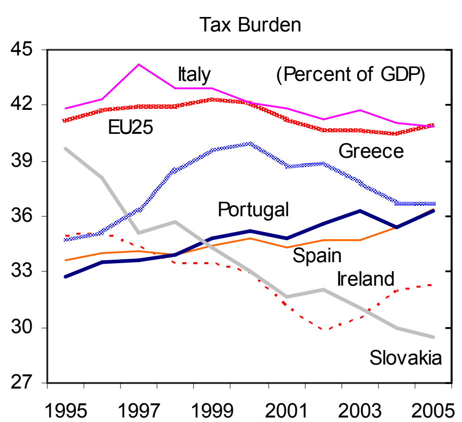
21. **Given the membership in EMU, staff noted that competitiveness needed to be restored by a combination of factors that includes sustained wage moderation.** Experiences from other economies point to the importance of wage moderation in regaining

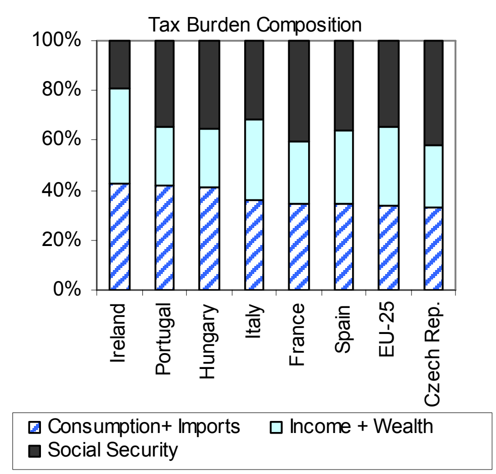
Box 2. Making the Tax System More Pro-Growth

The current tax system has its roots in the late-1980s tax reform, when the VAT and the income tax were introduced in preparation for EU accession in 1992. Since then, the tax burden has increased, but remains low compared to other industrialized countries and below the EU average. The system relies more on consumption taxes than the European average, which is typically positive for long-term growth, a result of good (although declining) VAT productivity, but also the low revenue response of income tax (mainly due to generous base reductions and noncompliance).

Tax administration has recently improved (updated registers; better use of electronic filing; improved audit results; more reliable databases; and better use of cross-checking), helping bring the administration more in line with international best practice. But there is considerable scope for the tax administration to further encourage growth by promoting a fair and less burdensome business environment.

Given the current need for fiscal consolidation, measures to make the tax system more pro-growth require a balanced approach between policy and administration, such as: strengthening the economic efficiency of the tax system (through broadening the tax base which, in turn, could create some margin for revenue-neutral rate reductions); increasing the system's simplicity and predictability; reducing administrative and compliance costs; and enhancing tax administration (through greater focus on taxpayer services and a reduction in noncompliance).





competitiveness and that this process may take considerable time, even with a highly flexible labor market (Box 3). For Portugal, however, indicators suggest significant labor market rigidities. Despite high unemployment in recent years and widespread use of temporary contracts, real wages have not fallen. This in turn may reflect substantial employment protection of permanent workers and limited movement within employment.

22. **Against this background, staff saw the recent decision to increase the minimum wage by 5.3 percent a year annually on average between 2007–11 as potentially problematic**. While the minimum wage is only binding for 5 percent of the total employment, it is substantially higher in sectors facing intensive competitive pressures, including textiles (15 percent). In staff's view, the existing high employment protection combined with a higher floor on wages could make the much-needed restructuring more challenging. The authorities, however, emphasized that the minimum wage had eroded significantly in recent years and that poverty remained a pressing issue.

23. **Staff urged the authorities to take the opportunity of the current labor code review to take steps to make the labor market more flexible.** In this context, staff stressed that it will be important to ease employment protection legislation (especially for individuals), end the automatic extension of collectively agreed contracts to firms not part of the agreement, and make procedures less cumbersome.

24. **Officials broadly agreed with the need to make the labor market more flexible, but some differences emerged.** In the authorities' view, while there is scope for increasing labor market flexibility, and action will be taken, staff overstated both the problems and the benefits. The authorities saw the labor market as more flexible than the standard indicators suggest, especially in practice. They also explained the difficult political economy aspects of labor market reform, especially in the Portuguese historical context of "solidarity." In their view, the focus of reform efforts should be on enhancing labor productivity and human capital rather than restraining wage growth, which they pointed out has been slightly below inflation recently.

25. **Progress is being made to support labor market participation and skill upgrading.** Recent changes to the unemployment benefit system to broaden the definition of "acceptable" employment and to promote more active job-seeking should encourage more rapid reintegration by the jobless into employment. The authorities indicated that the "New Opportunities" program has been successful in boosting training and skill level of the labor force. Staff welcomed the extent of the initial take-up and the outcome of the "New Opportunities" program, but cautioned that care should be taken to ensure that the quality of the training does not deteriorate as numbers increase.

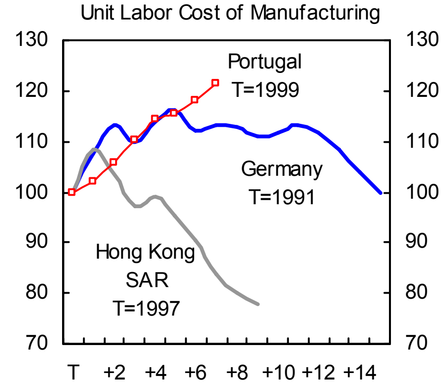
Box 3. The Importance of Labor Market Flexibility in Regaining Competitiveness

The experiences of Hong Kong SAR and Germany, both with fixed exchange rates, suggest labor market flexibility is key to regaining competitiveness, but the adjustment process can still take many years.

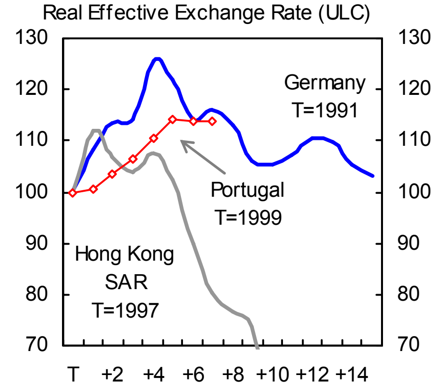
Hong Kong SAR faced a large competitive shock stemming from the 1997 Asian crisis and integration with the mainland. Similarly, Germany experienced significant cost pressures in the early 1990s with unification. In both cases, the key to adjustment was wage moderation and labor shedding from manufacturing and low-end services towards higher value-added services, which lowered unit labor costs. In Hong Kong SAR, this process took about six years, involving a sharp contraction in output upfront followed by sustained deflation. Its highly flexible labor market allowed nominal wage growth to turn negative, especially in manufacturing. As a result, the REER depreciated by about 5 percent a year. The economy rebounded strongly and the trend growth rate increased. In contrast, the adjustment process took about 12 years in Germany. With less flexible labor and product markets, the REER depreciated gradually at about 2 percent a year based on a sustained reduction in real wages.

Portugal has broadly followed Germany's path, but its unit labor cost of manufacturing continues to rise and the REER has barely moved. A 10–20 percent competitive gap implies the adjustment could still take about 5–8 years, assuming equal labor productivity growth but lower nominal wage growth in Portugal relative to the euro area by 2 percent annually.

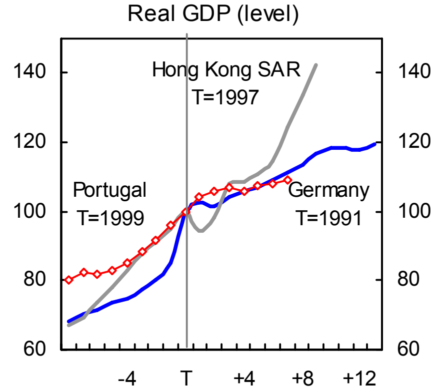
Unit Labor Cost of Manufacturing



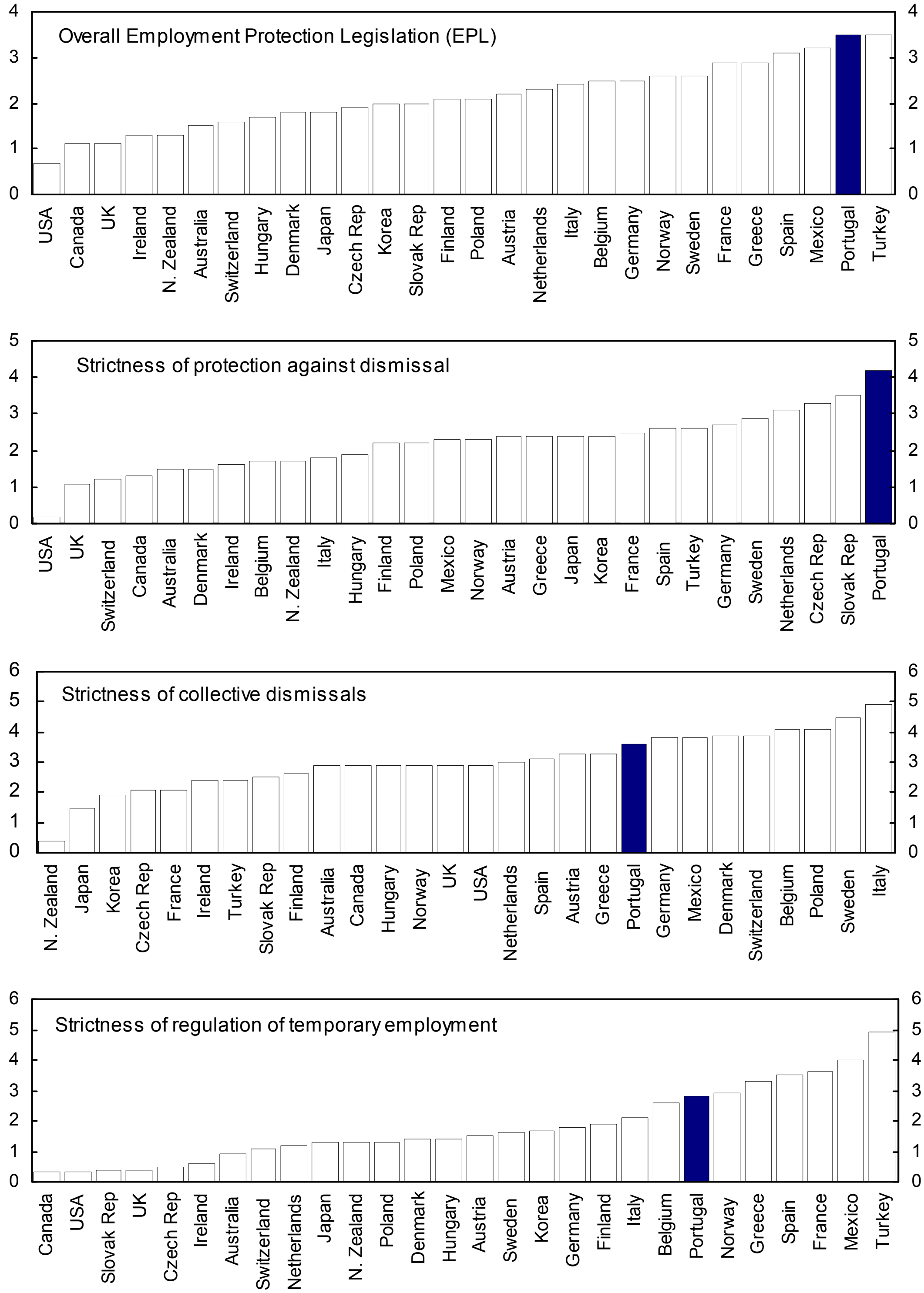
Real Effective Exchange Rate (ULC)



Real GDP (level)



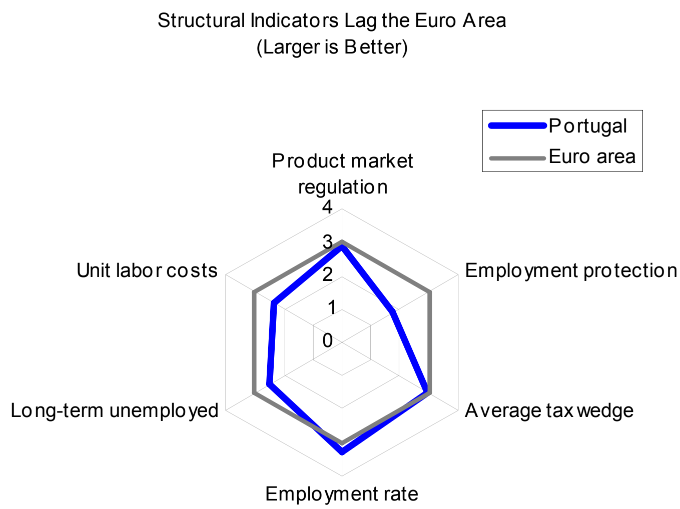
Employment Is Highly Protected
(Data refers to 2003)



Source: OECD Employment Outlook 2006.

Boosting productivity

26. **Staff and the authorities concurred that increasing domestic competition in the nontradable sector was key to improving productivity.** Increased competition in the nontradable sector was critical to ensuring that real wage moderation in the tradable sector results in lower prices rather than higher mark-ups. Lower prices could also foster support for labor market reform. Key areas to be addressed include the business environment, network sectors, and energy.

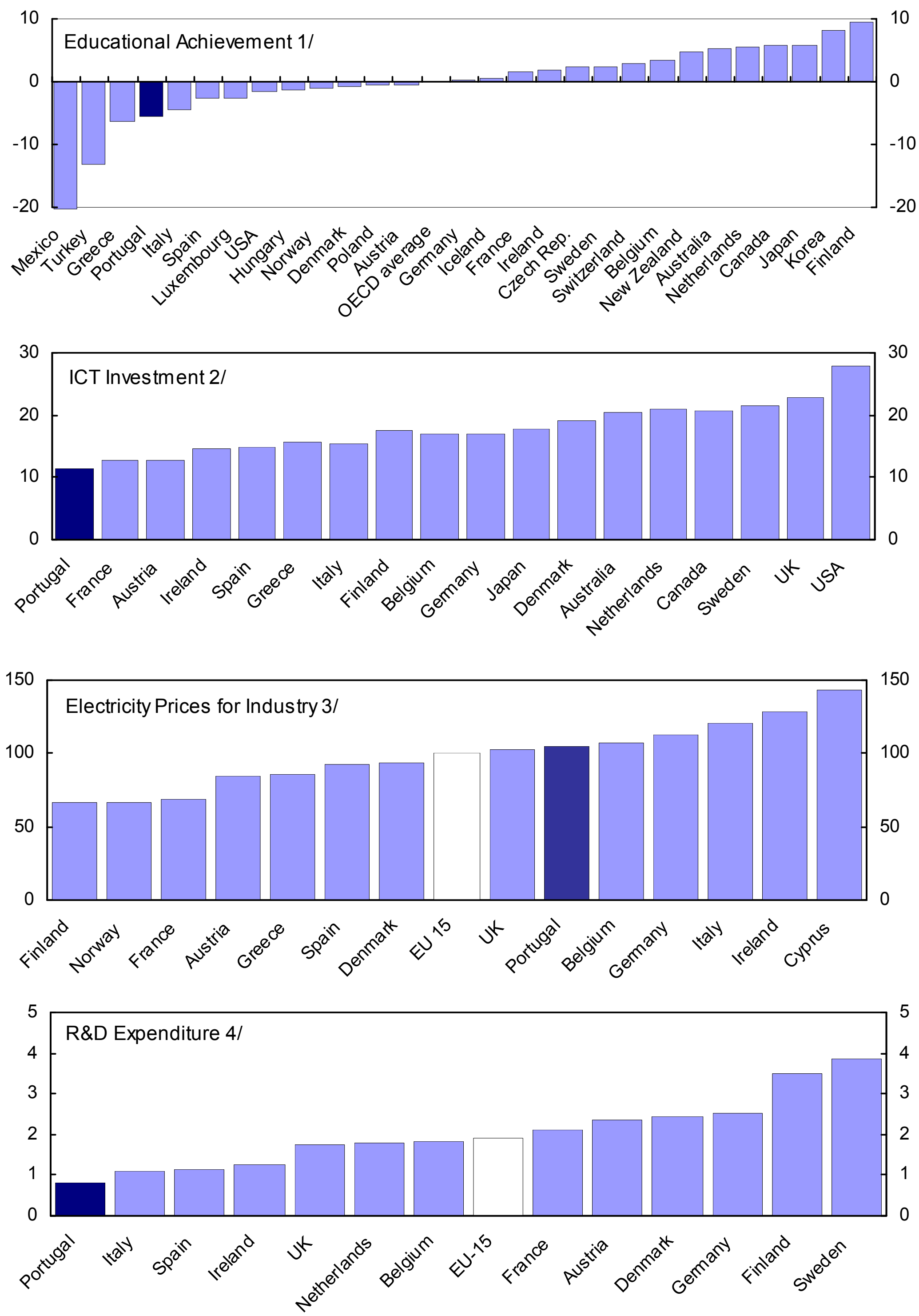


27. **Staff welcomed the emphasis and progress made on improving the business environment.** All the mission's interlocutors welcomed the substantial improvement generated by the government's "SIMPLEX" program which, for example, greatly eased procedures to create companies. Initiatives to simplify the permit system, especially at the local level, should further enhance the business environment.

28. **There was agreement that the Competition Authority should continue to advocate and enforce competition, as done recently in the pharmaceutical and telecommunication sectors.** In this context, the planned spin-off of the cable network operator from Portugal Telecom in September was welcome, though staff suggested that its effectiveness for enhancing competition may be determined by whether the two network operators share the same ownership structure going forward.

29. **Progress continues to be made on increasing competition in the energy sector and integration with Spain is accelerating.** Electricity consumers have been able to choose their suppliers since September and the electrical and gas grid company is about to be privatized. But their immediate impact on electricity prices will be muted by the decision to

Structural Indicators Are Poor



Sources: OECD; EUROSTAT; and IMF staff calculations.

1/ Average of PISA scores in reading, mathematics, and science, 2003.
2/ Percent of nonresidential gross fixed capital formation, total economy, 2001.
3/ Index EU15=100, 2006 (first half).
4/ In percentage of GDP, 2005. Italy, Netherlands, and the U.K. data are for 2004.

pass on to consumers the costs arising from existing electricity supply contracts and the policy to increase the share of renewables in generation. Promoting competition is thus critical and staff argued that actions such as the recent capping of regulated price increases should be avoided. In the gas sector, it was agreed that meeting the target of end-2008 for full liberalization will be important.

Safeguarding financial system soundness

30. **Staff and the authorities agreed that Portugal's financial system remained sound.** While intensified competition has resulted in banks granting somewhat more favorable lending terms, and in a slight deterioration in banks' liquidity ratios, average loan-to-value ratios are in line with other EU countries, nonperforming loans remain low, and the banking sector compares favorably with those of other EU countries in terms of asset quality, efficiency, and profitability (capital adequacy is about average). Recently, profitability has been helped by the economic pick-up, and banks have further rationalized operating costs and enhanced risk management procedures in adopting Basel II. While interest rates have risen and unemployment inched higher, the increases are modest and the FSAP exercise last year found that the financial system could withstand even severe macroeconomic disturbances.[4]

31. **The authorities have made progress in implementing FSAP recommendations (Table 8), and the Bank of Portugal is monitoring key risk areas closely.** The FSAP last year found that the financial system was well supervised. Since then, the Bank of Portugal has further strengthened its supervisory capacity with the adoption of a new risk rating system, completion of the Household Wealth Survey, and enhanced housing price statistics. High household and corporate debt remains the main source of risk to the financial system. In addition, bank lending concentrates on the real estate sector and on a limited number of large corporates, and banks' employee pension schemes are exposed to stock market fluctuations. While the FSAP found risks were well managed, staff stressed the need to update the results regularly. Therefore staff welcomed the Bank of Portugal's plan to conduct bottom-up stress tests every other year, with the next round due early 2008. The forthcoming results of the wealth survey will also help risk management by identifying key vulnerable subgroups of households.

IV. Staff Appraisal

32. **Decisive action is being taken to correct the fiscal imbalances accumulated during the 1990s, and the results are beginning to be seen.** In particular, substantial,

[4] See IMF Country Report No. 06/378.

expenditure-based fiscal consolidation is now firmly underway, the pension system has been reformed, and the business environment has been enhanced.

33. **But the economic situation remains challenging and a significant external competitiveness gap persists.** The income convergence process with the EU has reversed, and labor market rigidities, coupled with anemic productivity growth, cast doubt about the ability to substantially lower unit labor costs. To regain competitiveness and increase the economy's long-term growth potential, further reforms are needed. This means making the most of the current favorable economic setting and building on gains already made to further streamline the public sector and to boost productivity and competitiveness.

34. **The ambitious fiscal deficit reduction target for 2006 was surpassed.** This improvement was mainly driven by expenditure reduction, especially of the wage bill, and to a lesser extent by unexpected revenue strength in the latter part of the year. This strong performance reflects the authorities' determination to stick to tight expenditure targets and to strictly enforce the new local and regional government financing framework, as well as recent improvements in tax administration.

35. **The revenue overperformance is continuing and should be saved.** The government's intention to do so is welcome, but somewhat more ambitious deficit targets for 2007 and 2008 (by about ¼ percent of GDP), front-loading the adjustment, seem warranted given the continuing revenue boom, the uncertainties about the budgetary implications of the current fiscal reforms, and the need to make the remaining adjustment in 2009 and 2010 to achieve the MTO more credible.

36. **Following through on central administration restructuring will be important for achieving fiscal consolidation goals and improving productivity.** Encouraging progress has been made, and it will be important to follow through in the forthcoming critical phase of moving significant numbers of civil servants to the special mobility pool.

37. **Pressure to reduce the tax burden in the near term should be resisted.** Given Portugal's fiscal situation, there is no room for a discretionary reduction in the tax burden in the near term. But there is scope for further simplifying some tax laws and procedures and the recent improvement in the efficiency of the tax administration should be built upon.

38. **The plan to move to performance-based budgeting is welcome.** Such a move could greatly improve the efficiency and quality of public spending, though care should be taken to ensure the timetable is not unduly demanding.

39. **A comprehensive strategy is needed to substantially enhance the economy's potential growth.** Fiscal adjustment, while necessary, is not sufficient to regain competitiveness and boost productivity and a comprehensive strategy is needed to avoid prolonging the recent slump. Strengthening productivity, including by enhancing

contestability in the nontradable sector, is a key element in this strategy, but the effect of policies on productivity is uncertain in both impact and timing. It is thus also essential to address the cost side of competitiveness through policies that might foster wage moderation.

40. **In this regard, the government's reform strategy would be strengthened by addressing labor market rigidities more fully.** The government's intention to consider reforming the labor market in setting up a commission to study the issue is thus encouraging, and should be quickly followed by concrete measures. In particular, it will be important to ease employment protection legislation (especially for individual dismissals), end the automatic extension of collectively agreed contracts to firms not part of the agreement, and make procedures less cumbersome. In this context, the impact on labor market functioning of the recent decision to sharply increase the minimum wage in coming years should be carefully monitored.

41. **Strengthening ongoing product and service market reform could also appreciably boost competitiveness and consumer welfare, lending support for reform in general.** Important progress has been made with the SIMPLEX program, and initiatives to simplify the permit system, especially at the local level, should further enhance the business environment. Continued progress on increasing competition in domestic markets, especially in network industries and some service sectors, will also be important. Among other areas, improving the working of the judicial system should be a priority.

42. **Progress continues to be made on increasing competition in the energy sector.** However, the immediate impact on consumers is likely to be limited and actions, such as the recent capping of regulated price increases, should be avoided.

43. **The financial system remains sound and well supervised.** Some risks have increased slightly, though the system's capacity to absorb even severe macroeconomic disturbances is strong. Close monitoring of key risk areas, as being exercised by the Bank of Portugal, should help ensure the financial system's continued health, and in this context, the progress made on following up on last year's FSAP is welcome.

44. Portugal is encouraged to increase its **ODA** to 0.7 percent of GNI. **Statistical data** provision is adequate for surveillance. Nevertheless, improvements in timeliness and quality of employment and wage compensation data and sectoral balance sheet data should be a priority (Appendix II).

45. It is recommended that the next consultation occur on the standard 12-month cycle.

Table 1. Portugal: Selected Economic Indicators, 2002–08
(Changes in percent, except as otherwise indicated)

	2002	2003	2004	2005	2006	Proj. 2007	Proj. 2008	Latest	
Domestic economy									
Real GDP	0.8	-0.7	1.3	0.5	1.3	1.8	2.0	2.0	Q1 07
Real domestic demand	0.0	-2.0	2.4	0.8	0.3	1.0	1.3	0.1	Q1 07
Private consumption	1.3	-0.1	2.5	2.2	1.2	1.3	1.4	1.2	Q1 07
Public consumption	2.6	0.2	2.5	2.2	-0.5	0.0	0.4	-0.8	Q1 07
Gross fixed investment	-3.5	-7.4	1.2	-3.2	-1.6	1.0	1.9	-1.1	Q1 07
Foreign sector contribution	0.7	1.5	-1.3	-0.5	1.0	0.8	0.6	1.9	Q1 07
Savings-investment balance (percent of GDP)									
Gross national savings	17.1	16.8	15.3	12.7	12.6	12.5	12.5	...	...
Private	17.4	18.1	17.8	15.9	14.1	13.4	12.5	...	...
Government	-0.3	-1.4	-2.4	-3.2	-1.5	-0.9	0.0	...	...
Gross domestic investment	25.2	22.9	23.0	22.5	22.0	21.7	21.6	...	...
Private	21.7	19.8	19.9	19.5	19.7	19.4	19.3	...	...
Government	3.5	3.1	3.1	2.9	2.3	2.3	2.2	...	...
Resource utilization									
Employment	0.5	-0.4	0.1	0.0	0.7	0.9	0.9	0.2	Q1 07
Unemployment rate	5.0	6.3	6.7	7.6	7.7	7.4	7.1	8.4	Q1 07
Real potential GDP	1.9	1.7	1.6	1.6	1.6	1.6	1.7	...	...
Output gap	2.3	-0.2	-0.4	-1.5	-1.8	-1.6	-1.4	...	...
Labor productivity	0.3	-0.4	1.2	0.5	0.6	0.9	1.1	...	...
Compensation per worker (whole economy)	3.9	2.6	2.6	2.8	2.6	2.6	2.5	...	...
Unit labor costs (whole economy)	3.6	3.0	1.3	2.3	2.0	1.7	1.4	...	...
Prices									
Consumer prices (harmonized index)	3.7	3.3	2.5	2.1	3.0	2.5	2.4	2.6	Jun07
GDP deflator	3.9	3.1	2.7	2.8	2.9	3.0	2.4	3.3	Q1 07
External accounts									
Export volume (goods)	1.5	5.8	4.4	1.1	8.2	5.7	5.8	6.4	Q1 07
Import volume (goods)	-0.4	-0.2	6.9	4.7	4.3	2.8	3.5	1.8	Q1 07
Export unit value (goods and services)	-0.1	-1.4	1.3	2.5	4.5	2.5	0.9	3.8	Q1 07
Import unit value (goods and services)	-1.7	-1.8	2.2	4.1	4.6	1.0	0.6	-0.2	Q1 07
Current account (percent of GDP)	-8.1	-6.1	-7.7	-9.7	-9.4	-9.2	-9.1	...	...
Nominal effective exchange rate	0.9	3.2	0.8	0.1	0.2	...	...	1.1	May07
Real effective exchange rate (CPI based)	2.4	4.5	1.0	-0.3	0.6	...	...	2.3	May07
General government finances (percent of GDP)									
Revenues	41.4	42.5	43.1	41.5	42.3	41.8	41.6	...	...
Expenditures	44.2	45.4	46.4	47.5	46.2	45.1	44.0	...	...
Overall balance	-2.9	-2.9	-3.3	-6.1	-3.9	-3.3	-2.4	...	...
Excluding one-off measures	-4.2	-5.2	-5.4	-6.1	-3.9	-3.3	-2.4		
Government debt, Maastricht definition	55.5	56.8	58.2	63.6	64.8	65.0	64.7	...	...
Financial variables 1/									
National contribution to euro area M3 2/	-1.1	4.3	5.7	5.8	3.4	...	...	4.2	May07
Credit to the private sector 3/	10.2	6.4	6.1	7.7	8.7	...	...	9.2	May07
Interest rates (percent)									
Overnight rate	3.1	2.2	2.1	2.4	3.6	...	...	4.1	Jun07
Deposit rate, up to 2 years	2.9	2.0	2.0	2.1	2.7	...	...	3.0	May07
Loans granted to nonfinancial corporations	4.6	4.4	4.3	4.4	5.4	...	...	5.7	May07
Government benchmark bond	4.5	4.4	3.6	3.5	4.0	...	...	4.7	Jun07

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

1/ End-of-period data.
2/ Excludes currency in circulation held by nonbank private sector.
3/ Includes securitized loans. Also corrected for loan write-offs and reclassifications.

Table 2. Portugal: Balance of Payments, 2001–12

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
							Proj.					
							(Billions of euros)					
Current account	**-12.8**	**-11.0**	**-8.5**	**-11.1**	**-14.5**	**-14.6**	**-15.0**	**-15.4**	**-15.6**	**-15.7**	**-15.9**	**-16.2**
Trade balance	-15.5	-14.1	-12.6	-15.0	-16.8	-16.6	-16.2	-16.2	-16.2	-15.8	-15.4	-15.1
Exports fob	27.3	27.5	28.4	29.7	30.7	34.7	37.6	40.0	42.2	44.7	47.7	50.7
Imports fob	42.9	41.6	41.0	44.8	47.5	51.3	53.8	56.2	58.4	60.6	63.2	65.8
Services, net	2.9	3.3	3.6	4.0	3.8	4.9	5.5	5.9	6.2	6.5	6.9	7.3
Exports	10.5	10.9	10.9	11.9	12.3	14.1	15.2	16.0	16.7	17.5	18.3	19.2
Imports	7.6	7.6	7.3	7.8	8.4	9.2	9.7	10.1	10.5	10.9	11.4	11.9
Of which:												
Tourism	3.8	3.8	3.7	4.0	3.7	4.0	4.3	4.6	4.9	5.1	5.3	5.6
Exports	6.1	6.1	5.8	6.2	6.2	6.6	7.1	7.5	7.8	8.2	8.6	9.0
Imports	2.4	2.2	2.1	2.2	2.5	2.6	2.7	2.9	3.0	3.1	3.2	3.4
Income	-3.9	-3.2	-2.3	-2.9	-3.8	-5.4	-6.9	-7.8	-8.4	-9.2	-10.2	-11.3
Current transfers, net	3.7	2.9	2.9	2.8	2.3	2.5	2.6	2.7	2.9	2.9	2.9	2.9
Private remittances, net	3.6	2.6	2.2	2.2	1.9	2.2	2.3	2.4	2.6	2.6	2.6	2.6
Official transfers, net	0.2	0.3	0.7	0.6	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Capital account	**1.2**	**2.0**	**2.7**	**2.2**	**1.7**	**1.3**	**1.6**	**2.0**	**2.5**	**3.0**	**3.1**	**3.0**
Current account (including capital transfers)	-11.6	-9.0	-5.8	-8.9	-12.7	-13.3	-13.3	-13.4	-13.1	-12.7	-12.8	-13.2
Financial account	**10.8**	**8.3**	**5.1**	**9.6**	**13.6**	**12.0**	**13.3**	**13.4**	**13.1**	**12.7**	**12.8**	**13.2**
Direct investment	0.0	2.1	0.5	-4.4	1.5	3.1	2.7	3.0	3.2	3.4	3.4	3.6
Portuguese investment abroad	-7.0	0.2	-7.1	-6.3	-1.7	-2.8	-2.0	-2.0	-2.0	-2.1	-2.2	-2.3
Foreign investment in Portugal	7.0	1.9	7.6	1.9	3.2	5.9	4.8	5.0	5.2	5.4	5.6	5.9
Portfolio investment, net	3.1	3.1	-6.5	0.0	-1.2	2.6	1.3	1.2	1.3	1.3	1.4	1.4
Equity securities	1.6	2.5	8.0	4.3	3.1	-1.9	4.9	4.6	4.1	4.3	3.8	3.2
Long-term debt securities	-2.5	-0.2	-11.4	-11.2	-5.8	5.8	-4.6	-4.6	-5.0	-4.2	-3.5	-2.6
Money market instruments	4.1	0.8	-3.1	7.0	1.5	-1.3	1.0	1.2	2.1	1.1	1.0	0.8
Financial derivatives	0.4	0.0	0.1	-0.1	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Other investment, net	8.3	4.3	5.2	12.5	12.0	4.6	9.6	9.4	9.0	8.4	8.3	8.5
Of which:												
Monetary financial institutions	14.8	8.8	9.4	1.7	6.7	14.9	...	...	...	...	...	...
Of which:												
Short-term	6.0	-1.2	-2.8	-1.8	-5.0	5.7	...	...	...	...	...	...
Long-term	8.8	10.0	12.2	3.6	11.7	9.2	...	...	...	...	...	...
Reserve assets	-1.0	-1.1	5.8	1.5	1.4	1.9	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	0.8	0.6	0.7	-0.7	-0.8	1.3	0.0	0.0	0.0	0.0	0.0	0.0
							(Percent of GDP)					
Memorandum items:												
Current account	**-9.9**	**-8.1**	**-6.1**	**-7.7**	**-9.7**	**-9.4**	**-9.2**	**-9.1**	**-8.8**	**-8.5**	**-8.2**	**-8.0**
Current account (including capital transfers)	-9.0	-6.6	-4.2	-6.2	-8.6	-8.6	-8.2	-7.9	-7.4	-6.9	-6.6	-6.5
Net international investment position 1/	-47.4	-56.3	-60.0	-64.9	-70.4	-79.4	-84.4	-89.0	-92.9	-96.3	-99.1	-101.7
Direct investment, net	-12.1	-16.4	-14.9	-11.7	-12.3	-15.1	-16.0	-17.1	-18.1	-19.2	-20.1	-21.0
Portfolio investment, net	-16.3	-18.4	-15.2	-14.2	-12.7	-16.8	-16.7	-16.7	-16.7	-16.7	-16.7	-16.7
Financial derivatives	0.7	0.4	0.0	-0.4	0.0	0.0	-0.8	-0.9	-1.1	-1.2	-1.3	-1.4
Other investment, net	-32.9	-34.3	-37.2	-44.5	-51.2	-52.4	-55.6	-58.7	-61.3	-63.3	-64.8	-66.3
Reserve assets	13.2	12.5	7.3	6.0	5.9	4.9	4.6	4.4	4.2	4.1	3.9	3.7

Sources: Bank of Portugal; and IMF staff calculations.

1/ End-of-period data.

Table 3. Portugal: General Government Accounts, 2001–50 1/

	2001	2002	2003	2004	2005	2006	Auth. Updated SGP Apr.07 2/ 2007	2008	2009	2010	2011	2012	2020	2030	2040	2050
								(Percent of GDP)								
Total revenues	40.1	41.4	42.5	43.1	41.5	42.3	41.8	41.6	41.4	41.4	41.4	41.4	41.4	41.4	41.4	41.4
Current receipts	38.4	39.6	39.8	39.5	40.2	41.3	41.0	40.8	40.7	40.7	40.7	40.7	40.8	40.8	40.8	40.8
Tax revenue	22.9	23.5	23.4	22.7	23.5	24.2	24.4	24.5	24.5	24.3	24.3	24.3	24.4	24.4	24.4	24.4
On goods and services	13.5	14.2	14.8	14.1	14.9	15.4	15.4	15.5	15.6	15.5	15.5	15.5	15.5	15.5	15.5	15.5
Direct taxes	9.4	9.3	8.6	8.5	8.6	8.9	9.0	9.0	8.9	8.8	8.8	8.8	8.8	8.8	8.8	8.8
Social security contributions	11.4	11.7	12.2	12.2	12.5	12.5	12.3	12.3	12.2	12.2	12.2	12.2	12.2	12.2	12.2	12.2
Other current revenues	4.1	4.4	4.2	4.7	4.1	4.6	4.2	4.1	4.0	4.2	4.2	4.2	4.2	4.2	4.2	4.2
Capital revenues	1.7	1.7	2.7	3.6	1.3	1.0	0.8	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Total expenditures	44.4	44.2	45.4	46.4	47.5	46.2	45.1	44.0	42.9	41.8	41.9	41.9	42.4	42.9	45.4	49.0
Primary current expenditures	36.0	37.1	38.5	39.3	40.6	39.9	41.9	40.8	39.7	38.6	36.0	36.2	37.2	37.8	39.8	41.9
Compensation of employees	14.3	14.7	14.1	14.1	14.4	13.5	13.1	12.4	11.8	11.3	11.3	11.3	11.3	11.3	11.3	11.3
Intermediate consumption	4.3	4.2	3.8	4.0	4.0	4.0	4.0	3.9	3.8	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Subsidies	1.4	1.5	1.8	1.5	1.6	1.4	1.0	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Social transfers	13.9	14.6	17.0	17.6	18.3	18.7	18.8	18.5	18.2	17.8	18.0	18.1	19.1	19.7	21.7	23.8
Other	2.1	2.0	1.8	2.1	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Interest payments	3.0	2.9	2.7	2.6	2.7	2.8	2.9	2.9	2.8	2.6	2.6	2.5	2.0	1.9	2.3	3.8
Capital expenditures	5.4	4.3	4.3	4.5	4.2	3.4	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2
Overall balance	**-4.3**	**-2.9**	**-2.9**	**-3.3**	**-6.1**	**-3.9**	**-3.3**	**-2.4**	**-1.5**	**-0.4**	**-0.4**	**-0.5**	**-1.0**	**-1.4**	**-3.9**	**-7.5**
Excluding one-off measures 3/	**-4.3**	**-4.2**	**-5.2**	**-5.4**	**-6.1**	**-3.9**	**-3.3**	**-2.4**	**-1.5**	**-0.4**	**-0.4**	**-0.5**	**-1.0**	**-1.4**	**-3.9**	**-7.5**
Memorandum items:																
One-off measures	0.0	1.3	2.4	2.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Structural balance (excluding one-off measures) 4/	-5.6	-5.1	-5.2	-5.3	-5.5	-3.2	-2.6	-1.9	-1.1	-0.1	-0.3	-0.5	-1.0	-1.4	-3.9	-7.5
Primary balance (excluding one-off measures) 4/	-1.3	-1.3	-2.5	-2.8	-3.4	-1.1	-0.4	0.4	1.3	2.3	2.2	2.0	1.1	0.4	-1.6	-3.7
Primary structural balance	-2.7	-2.3	-2.4	-2.6	-2.8	-0.4	0.2	1.0	1.7	2.5	2.3	2.0	1.1	0.4	-1.6	-3.7
Public debt (Maastricht definition)	**52.9**	**55.5**	**56.8**	**58.2**	**63.6**	**64.8**	**65.0**	**64.7**	**63.4**	**61.1**	**59.0**	**56.9**	**46.9**	**43.2**	**56.5**	**93.7**
Real increase in primary current spending	4.5	3.8	2.9	3.5	3.9	-0.5	-0.5	-0.7	-0.6	-0.7	2.7	2.7	1.5	1.4	1.4	1.4
Nominal GDP (in millions of euros)	129,309	135,434	138,582	144,223	148,928	155,216	162,740	170,019	177,570	185,234	193,491	202,165	276,576	389,727	525,298	708,029
Output gap (percent of potential output)	3.4	2.3	-0.2	-0.4	-1.5	-1.8	-1.6	-1.4	-0.9	-0.6	-0.3	0.0	0.0	0.0	0.0	0.0
Real GDP growth (in percent)	2.0	0.8	-0.7	1.3	0.5	1.3	1.8	2.0	2.2	2.2	2.3	2.3	1.5	1.0	1.0	1.0

Sources: Ministry of Finance; and IMF staff estimates.

1/ Staff projections based on the latest available EDP figures and the authorities' updated SGP figures.
2/ Structural balance calculated using staff's estimate of the output gap.
3/ One-off measures consist of the transfer of the postal pension fund in 2003, the state enterprises pension funds in 2004, securitization and asset sales.
4/ Calculated using the staff's estimates of potential output. Asset sales, including UMTS receipts, the transfer of pension funds and securitization are netted.

Table 4. Portugal: Medium-Term Scenario
(Changes in percent, unless otherwise indicated)

					Proj.					
	1996–2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Real GDP	2.8	1.3	0.5	1.3	1.8	2.0	2.2	2.2	2.3	2.3
Real domestic demand	3.1	2.4	0.8	0.3	1.0	1.3	1.4	1.4	1.4	1.4
Private consumption	3.0	2.5	2.2	1.2	1.3	1.4	1.4	1.4	1.4	1.4
Public consumption	3.1	2.5	2.2	-0.5	0.0	0.4	0.5	0.5	0.5	0.5
Gross fixed investment	3.5	2.1	-3.8	-1.6	0.8	2.0	2.0	2.0	2.3	2.3
Public	4.2	1.9	-5.5	-19.9	1.3	1.0	2.5	3.6	2.1	1.9
Private	3.9	1.1	-2.8	1.3	1.0	2.0	2.0	2.0	2.5	2.5
Structure	3.0	-1.3	-4.7	-6.3	-1.2	0.6	0.9	1.2	1.8	1.7
Equipment and machinery	5.0	3.8	-1.7	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Foreign balance (contribution to growth)	-0.5	-1.3	-0.5	1.0	0.8	0.6	0.7	0.8	0.8	0.8
Exports of goods and services	4.9	4.4	1.1	8.7	5.7	5.8	5.3	5.5	5.7	5.1
Imports of goods and services	5.3	6.6	1.9	4.3	2.8	3.5	2.8	3.1	3.3	2.9
Real imports of partner countries (WEO)	6.9	8.4	7.3	9.3	6.3	6.8	6.2	6.0	5.7	5.4
Export market share (2000=100)	104.0	94.7	89.3	88.8	88.3	87.5	86.8	86.4	86.4	86.2
Savings-investment balance (percent of GD	-7.4	-7.7	-9.7	-9.4	-9.2	-9.1	-8.8	-8.5	-8.2	-8.0
Gross national savings	18.5	15.3	12.7	12.6	12.5	12.5	12.6	12.9	13.2	13.4
Private	18.4	17.8	15.9	14.1	13.4	12.5	11.6	10.7	11.1	11.4
Government	0.1	-2.4	-3.2	-1.5	-0.9	0.0	1.0	2.2	2.1	2.1
Gross domestic investment	25.9	23.0	22.5	22.0	21.7	21.6	21.4	21.3	21.4	21.5
Private	22.2	19.9	19.5	19.7	19.4	19.3	19.2	19.1	19.1	19.2
Government	3.7	3.1	2.9	2.3	2.3	2.2	2.2	2.3	2.3	2.3
Resource utilization										
Population (15-64)	0.2	0.6	0.4	0.0	0.3	0.1	0.0	-0.1	-0.2	-0.1
Labor force	2.3	0.5	1.0	0.8	0.6	0.6	0.6	0.6	0.6	0.6
Employment	2.5	0.1	0.0	0.7	0.9	0.9	0.8	0.8	0.7	0.7
Labor force participation rate	73.8	77.5	77.9	78.5	78.8	79.2	79.7	80.2	80.9	81.5
Unemployment rate	5.3	6.7	7.6	7.7	7.4	7.1	6.9	6.7	6.6	6.6
Potential output	2.4	1.6	1.6	1.6	1.6	1.7	1.8	1.8	2.0	2.0
Output gap	1.0	-0.4	-1.5	-1.8	-1.6	-1.4	-0.9	-0.6	-0.3	0.0
Labor productivity	1.4	1.2	0.5	0.6	0.9	1.1	1.4	1.4	1.6	1.6
Nominal wage (whole economy)	7.5	2.6	2.8	2.6	2.6	2.5	2.3	2.3	2.3	2.3
Real wage (whole economy)	4.6	0.2	0.7	-0.5	0.1	0.1	0.2	0.2	0.2	0.2
Unit labor costs (whole economy)	6.7	1.3	2.3	2.0	1.7	1.4	0.9	0.9	0.7	0.7
Consumer prices (harmonized index)	3.0	2.5	2.1	3.0	2.5	2.4	2.1	2.1	2.1	2.1
Memorandum items:										
Real GDP growth in the euro area 1/	2.2	2.0	1.4	2.6	2.3	2.3	2.2	2.1	2.0	2.0
Potential output growth in the euro area 1/	2.1	2.0	1.9	1.9	2.1	2.0	2.1	2.1	2.1	2.1

Sources: National Statistics Office (INE); and IMF staff estimates and projections.

1/ As projected in the World Economic Outlook, April 2007.

Table 5. Portugal: Indicators of External and Financial Vulnerability, 2001–06
(Percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006
External indicators						
Exports (goods, annual percent change in euro)	2.1	0.8	3.1	4.8	3.3	13.0
Imports (goods, annual percent change in euro)	0.9	-2.9	-1.6	9.3	6.0	8.0
Terms of trade (goods and services, annual percent change)	0.5	1.6	0.4	-0.8	-1.5	-0.1
Current account balance	-9.9	-8.1	-6.1	-7.7	-9.7	-9.4
Current account balance (including capital transfers)	-9.0	-6.6	-4.2	-6.2	-8.6	-8.6
Capital and financial account balance	9.3	7.6	5.6	7.7	9.7	9.4
Of which : inward portfolio investment (debt securities, etc.)	9.2	7.9	9.0	7.6	9.9	6.0
Inward foreign direct investment	5.4	1.4	5.5	1.3	2.1	3.8
Other investment liabilities (net)	6.4	3.1	3.8	8.2	7.5	3.3
Central Bank foreign liabilities (billions of euro) 1/	8.3	8.7	2.7	8.6	12.8	14.3
Foreign assets of the financial sector (billions of euro) 2/	60.3	59.0	69.6	73.9	80.4	83.1
Foreign liabilities of the financial sector (billions of euro) 2/	95.7	102.0	116.2	118.1	128.2	142.0
Exchange rate (per U.S. dollars, period average)	1.12	1.06	0.88	0.80	0.80	0.80
Financial market indicators						
Public sector debt (Maastricht definition)	52.9	55.5	56.8	58.2	63.6	64.8
Money market rate - 3 month Euribor (period average in percent)	4.3	3.3	2.3	2.1	2.2	3.1
Money market rate (real, in percent)	-0.1	-0.3	-0.9	-0.3	0.1	0.0
Stock market index (PSI 20, 1992=3000)	7,831	5,825	6,747	7,600	8,619	11,198
Share prices of financial institutions (2005=1000)	977	735	764	856	1065	1435
Spread of 10-year benchmark bond with euro yield (percentage points)	0.35	0.23	0.09	0.08	0.06	0.12
Financial sector risk indicators						
Foreign exchange assets (billions of euro) 3/	7.0	5.9	4.9	4.6	4.8	5.2
Deposits in foreign exchange (billions of euro) 4/	5.5	3.7	4.9	5.4	5.1	6.2
Share of foreign deposits in total deposits (percent) 4/	4.1	2.8	3.5	3.7	3.1	3.6
Share of real estate sector in private credit 5/	53.7	55.7	57.9	60.1	63.0	63.7
Share of nonperforming loans in total loans 2/ 6/	2.1	2.1	2.1	1.8	1.7	1.5
Risk-based capital asset ratio 7/	9.5	9.8	10.0	10.4	…	...
(IAS accounting - sample of institutions)	..	...	...	10.2	11.3	10.9
Return on equity for the banking system	14.9	11.7	13.9	12.8	…	...
(IAS accounting - sample of institutions)	..	...	...	10.8	14.5	15.6
Household debt						
Percent of disposable income	90	97	104	110	117	125
Percent of GDP	64	68	73	78	83	88
Nonfinancial corporate debt (percent of GDP)	96	96	99	99	103	105

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

1/ Reserves and foreign liabilities refer to the Bank of Portugal.
2/ Banks only.
3/ Non-euro area currencies assets vis-à-vis the resident and nonresident nonmonetary sector.
4/ Deposits in non-euro area currencies by the resident nonmonetary sector and liabilities in non-euro area currencies by the nonresident nonmonetary sector.
5/ Real estate defined as the sum of total credit by monetary financial institutions to individuals for housing and to nonfinancial corporations for construction and real-estate activities; private credit defined as total domestic credit excluding the general government. Stocks adjusted for securitization operations.
6/ NPL concern households and nonfinancial corporations.
7/ Capital over risk-weighted assets. Consolidated data for the banking system.

Table 6. Portugal: Selected Financial Indicators of the Banking System, 2000–06
(Percent)

	2000	2001	2002	2003	2004	2004 1/	2005 1/	2006 1/
Capital adequacy								
Regulatory capital to risk-weighted assets (*)	9.2	9.5	9.8	10.0	10.4	10.2	11.3	10.9
Regulatory tier I capital to risk-weighted assets (*)	7.6	7.3	7.1	7.1	7.3	7.0	7.1	7.7
Capital (net worth) to assets 2/	5.8	5.5	5.6	5.8	6.2	5.1	5.8	6.4
Asset composition and quality								
Sectoral distribution of loans to total loans (*)								
Households	48.2	47.7	48.4	48.3	49.3	49.3	50.7	52.8
of which : Housing	36.3	36.8	38.4	38.6	39.4	39.4	41.2	42.9
Construction	8.1	8.6	8.4	8.8	8.7	8.7	8.9	8.4
Manufacturing	8.0	7.8	7.6	7.6	6.8	6.8	6.2	5.5
Agriculture	0.6	0.6	0.6	0.7	0.7	0.7	0.7	0.6
Services	24.8	26.7	27.5	28.7	27.9	27.9	27.0	26.6
NPLs to gross loans (*) 3/	2.2	2.2	2.3	2.4	2.0	1.5	1.5	1.3
Specific provision to NPLs 3/	67.7	66.8	62.8	73.0	83.4	72.2	79.0	80.0
NPLs net of provisions to capital (*) 3/	7.3	7.5	9.1	6.7	3.3	4.8	3.3	2.8
Large exposure to capital (*) 3/	...	...	119.9	94.1	91.4	97.5	75.8	88.2
Earnings and profitability								
ROA (post-tax) (*)	0.9	0.9	0.7	0.8	0.8	0.6	0.8	1.0
ROE (post-tax) (*)	15.1	14.9	11.7	13.9	12.8	10.8	14.5	15.6
Interest margin to gross income (*)	62.9	65.8	65.0	60.0	58.1	60.0	54.8	54.7
Noninterest expenses to gross income (*)	58.2	57.6	59.1	57.4	57.2	71.7	58.3	53.3
Personnel expenses to noninterest expenses	61.8	59.5	59.3	59.3	58.6	59.9	57.7	57.5
Trading and fee income to total income	29.5	25.5	26.1	27.7	29.1	33.0	40.9	39.5
Spread between reference loan and deposit rates 4/	4.1	4.3	3.6	3.4	3.1	3.1	3.1	3.5
Stock price index of bank shares 5/	107.9	92.9	69.3	72.1	80.7	80.7	100.5	135.4
Liquidity								
Liquid assets to total assets (*) 6/	...	15.3	12.5	17.1	15.4	15.2	14.8	13.5
Liquid assets to total short-term liabilities (*) 6/	...	89.0	85.6	108.6	115.2	108.6	95.1	91.7
Loans as percent of deposits (*)	116.0	122.7	129.5	129.1	128.3	130.9	137.5	145.6
FX liabilities to total liabilities 7/	10.7	9.9	9.0	9.0	7.9	7.9	8.3	8.9
Sensitivity to market risk								
Net open position in FX to capital (*)	...	...	7.1	4.7	3.9	4.0	4.5	6.1
Net open position in equities to capital	...	...	1.8	0.2	1.8	1.8	1.3	2.6

Sources: Bank of Portugal; and IMF staff estimates.
(*) Core Financial Sector Indicators.

1/ For 2005 and 2006 the figures are for the sample of institutions that are already complying with IAS, accounting as of December 2004 for about 87 percent of the usual aggregate considered. To ensure comparability, the figures for 2004 for this sub-sample are also presented.

2/ On accounting basis; consolidated.

3/ On a consolidated basis. NPLs are defined as credit to customer overdue. For comparable 2004 and 2005 figures. The concept of NPL is only applicable at an individual level and for prudential purposes. The following definition of NPL's will be used: principal and interest past due for more than 90 days (amount overdue only) + future instalments of loans fallen due and classified as doubtful, according to criteria that include initial maturity, the time elapsed since the first instalment fallen due, and the relative importance of fallen due instalments in each loan.

4/ Based on weighted averages of lending rates to households and to nonfinancial corporations and of deposit interest rates for the two sectors.

5/ PSI Financial Services (Euronext Lisbon); 01/01/2000 =100.

6/ Three-month residual maturity horizon.

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

Table 7. Portugal: External Debt Sustainability Framework, 2002–12
(Percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	**Debt-stabilizing noninterest current account** 6/
1	**Baseline: external debt** 1/	149.2	155.0	160.8	172.5	179.8	**181.1**	**182.4**	**183.6**	**184.2**	**184.9**	**185.9**	**-3.0**
2	Change in external debt	7.8	5.8	5.8	11.7	7.2	1.3	1.3	1.2	0.6	0.7	1.0	
3	Identified external debt-creating flows (4+8+9)	-1.7	-8.3	-5.3	-2.5	-3.7	-5.0	-4.0	-4.1	-4.5	-4.6	-4.4	
4	Current account deficit, including capital transfers and excluding interest payments	1.9	0.3	2.1	4.4	2.8	1.0	0.6	-0.3	-0.9	-1.5	-2.0	
5	Deficit in balance of goods and services	7.9	6.5	7.6	8.7	7.5	6.6	6.1	5.6	5.0	4.4	3.8	
6	Exports	28.4	28.3	28.8	28.9	31.5	32.4	32.9	33.2	33.6	34.2	34.6	
7	Imports	36.3	34.9	36.5	37.5	39.0	39.0	39.0	38.8	38.6	38.5	38.4	
8	Net nondebt creating capital inflows (negative)	-1.2	-7.0	-4.2	-6.0	-5.1	-4.3	-4.0	-3.6	-3.7	-3.3	-2.9	
9	Automatic debt dynamics 2/	-2.4	-1.6	-3.2	-1.0	-1.3	-1.7	-0.6	-0.2	0.1	0.2	0.5	
10	Contribution from nominal interest rate	4.8	3.9	4.0	4.1	5.7	7.2	7.3	7.6	7.7	8.1	8.5	
11	Contribution from real GDP growth	-1.0	0.9	-1.8	-0.7	-2.2	-2.9	-3.4	-3.8	-3.8	-4.0	-4.0	
12	Contribution from price and exchange rate changes 3/	-6.2	-6.4	-5.4	-4.4	-4.9	-6.0	-4.4	-4.0	-3.8	-3.9	-4.0	
13	Residual, incl. change in gross foreign assets (2-3)	9.5	14.1	11.1	14.2	10.9	6.3	5.3	5.2	5.1	5.3	5.3	
	External debt-to-exports ratio (percent)	525.7	547.0	557.6	597.9	571.3	558.4	554.1	553.7	549.0	541.5	537.6	
	Gross external financing need (billions of euros) 4/	53.6	47.8	51.7	59.7	64.0	66.2	68.9	71.6	74.0	76.3	79.8	
	in percent of GDP	39.6	34.5	35.9	40.1	41.2	40.7	40.5	40.3	39.9	39.4	39.5	
	Scenario with key variables at their historical averages 5/						**193.0**	**196.1**	**198.3**	**200.7**	**203.7**	**206.7**	**-5.0**
	Key macroeconomic assumptions												
	Real GDP growth (percent)	0.8	-0.7	1.3	0.5	1.3	1.8	2.0	2.2	2.2	2.3	2.3	
	GDP deflator (change in domestic currency)	3.9	3.1	2.7	2.8	2.9	3.0	2.4	2.2	2.1	2.1	2.1	
	Nominal external interest rate (percent)	3.7	3.2	3.0	2.6	3.5	4.5	4.2	4.4	4.4	4.7	4.9	
	Growth of exports (euro terms, in percent)	1.6	2.2	5.9	3.3	13.7	8.1	6.1	5.2	5.6	6.3	5.8	
	Growth of imports (euro terms, in percent)	-2.6	-1.8	8.9	6.2	8.3	4.8	4.5	3.9	3.7	4.3	4.1	
	Current account balance, excluding interest payments	-1.9	-0.3	-2.1	-4.4	-2.8	-1.0	-0.6	0.3	0.9	1.5	2.0	
	Net nondebt creating capital inflows	1.2	7.0	4.2	6.0	5.1	4.3	4.0	3.6	3.7	3.3	2.9	

1/ Refers to gross external debt.

2/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

3/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

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

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and nondebt inflows in percent of GDP. Averages are for the period 1997–2006.

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.

Table 8. Portugal: Status of Implementation of FSAP Main Recommendations

Recommendation	Status
Short-term stability issues	
? Continue to carefully monitor key risk areas:	
- household debt, especially toward more vulnerable sub-groups of household borrowers;	Results of the new round of the wealth survey will become available in the second half 2007.
- corporate debt developments;	Refinement of existing statistics for cohorts of corporate sector and development of credit risk analytical tools were introduced.
- banks' lending concentrations;	Supervisory and macro-prudential attention continues to be dedicated to bank lending concentration issues, including the development of analytical tools and enhanced requirements for the measurement and management of concentration risk, as well as for the public disclosure of banks' policies.
- and banks' external borrowing and the associated pricing and liquidity risks.	Liquidity risk monitoring and assessment continues to be central in the banking system financial stability analysis, with an assessment based on both quantitative and qualitative information.
? Continue to ensure bank capital levels are consistent with the evolving risk outlook and if necessary impose additional capital requirements using the discretion available under Basel II.	Banco de Portugal aims at ensuring the alignment between capital levels and banks' risk profile on an ongoing basis. The possibility to impose additional capital requirements was not made available by Basel II as it was already foreseen in Portuguese regulation.
? Improve statistics on housing market, in particular, as regards property prices.	Private sources resumed the production of house price indexes in October 2006 with improved raw data and methodology.
? Continue to foster banks' systems to accurately measure, monitor, and adequately control risks, and further strengthen the BdP's supervisory capacity in this area.	Banks' risk management systems have been enhanced recently following the adoption of Basel II. BdP's capacity in this area is also being strengthened namely in the context of the adoption of a risk rating system (MAR).
? Perform further stress testing on the financial system at appropriate intervals, taking into account banks' linkages with the insurance sector and their employee pension funds.	A new run of stress-tests encompassing the whole range of materially relevant risks to the banking system is programmed to take place in early 2008.
Structural and longer-term issues	
? Improve the judicial framework for debt recovery by speeding up court processes in particular.	...
? Enhance the financial independence of the securities and insurance supervisors, Comissão do Mercado de Valores Mobiliários (CMVM) and the Instituto de Seguros de Portugal (ISP).	The possibility of the Government to appropriate CMVM surplus was eliminated for 2006, through the inclusion of a provision in the 2006 Budget Act. This new provision reinforces the financial independence of the CMVM as it makes it clear that (i) the budget lines of the CMVM will no longer be subject to freezing (as happened in the 2003–05 period and which is still the rule applicable to public bodies in general) and (ii) the CMVM is allowed to spend its surpluses without prior authorization of the Ministery of Finance. There is a commitment of the Ministery of Finance to include a permanent provision on the subject of the surplus and a proposal for a revision of the Ministerial Order setting CMVM supervisory fees. The ISP is preparing a proposal to ammend its charter, enhancing the financial independence rules. The proposal will be submitted to the government in July 2007.
? Transfer the management of the guarantee fund for Motor Third Party and workers compensation from the ISP to other organizations.	There is already a public commitment of the government about this transfer. A decision about the new operational structure is expected by the end of 2007.
Refinements to supervisory and safety net arrangements	
? fully implement the new system for risk profile assessment of credit institutions and other financial intermediaries, as planned; and	The implementation of MAR is currently taking place. Banco de Portugal has already applied the new system to a few institutions and a detailed programme to fully implement the methodology has already been devised and will be made effective in two stages (end-2007 and end-2008).
? in insurance supervision, set appropriate fit and proper criteria for members of governing bodies of insurance undertakings and intermediaries, strengthen corporate governance requirements, and establish rules or guidelines on market conduct regarding the problem of fraud.	The ISP is finalizing a proposal to amend the law that lays down the conditions governing the carrying out of the insurance business on this specific matters. It is expected that this ammendment will be approved till the end of 2007.

Table 9. Portugal: Fund Policy Recommendations and Implementation

Policy Area	Fund Recommendations	Implementation
Fiscal policy		
Fiscal consolidation	Reduce fiscal deficit to 0.4 percent of GDP by 2010 through structural expenditure measures without one-off measures, including civil service reform.	Deficit reduction target for 2006 was surpassed without one-off measures. The improvement was driven by expenditure reduction reflecting the civil service reforms and wage restraint, improvement in tax administration, and firm application of the new local and regional government financing framework.
Population aging	Curtail long-term spending pressure from population aging by additional fiscal adjustment and reforms.	The reform of the social security system for the private and public sectors has significantly improved long-term fiscal sustainability.
Budget planning	Strengthen budget planning and control and move toward comprehensive multiyear budget targets.	Fundamental reforms to substantially enhance the budgetary process are envisaged. The plan is to move to performance-based, medium-term, budgeting with expenditure ceilings.
Structural reforms		
Labor market	Increase flexibility by relaxing employment protection legislation and collective bargaining arrangements.	The 2003 Labor Code enhanced flexibility by increasing the duration of fixed-term contracts and easing collective dismissal but did not address the fundamental difficulty of restrictive employment protection legislation. The government has set up a commission to study options for labor market reform.
Product market	Pursue comprehensive range of product market reforms to strengthen the business environment and increase domestic competition.	Significant progress with the SIMPLEX program to cut red tape and enhance the business environment. Good progress increasing competition in the energy sector.
Financial sector	Ensure adequate bank capital under Basel II, improve statistics on housing market, further strengthen banks' systems to measure and control risks, and perform further stress testing.	In line with the recommendations of the 2006 FSAP, bottom-up stress tests are now conducted every two years with the next one due early 2008, banks' risk management systems have been enhanced, the wealth survey has been conducted to monitor key risk areas, and house price index has been improved.

INTERNATIONAL MONETARY FUND

PORTUGAL

Staff Report for the 2007 Article IV Consultation—Informational Annex

Prepared by the European Department

August 8, 2007

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Appendix I. Portugal: Fund Relations
(As of June 30, 2007)

The 2007 Article IV discussions were held in Lisbon during June 14–26, 2007. The staff team comprised Messrs. Daniel (head) and Xiao, Ms. Honjo (all EUR), and Ms. Lemgruber (FAD). It met with the Ministers of Finance and Economy, the Governor of the Bank of Portugal, senior staff of several government ministries and agencies, representatives of regulatory agencies, the Competition Authority, representatives of labor unions, employer organizations, banks and private exporters. Mr. Cardoso (OED) attended most meetings. The authorities released the mission's concluding statement, available at (http://www.imf.org/external/np/ms/2007/062807.htm).

Portugal maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, except for restrictions that are maintained for security reasons and that have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51)

It subscribes to the SDDS, and economic data are adequate to conduct effective surveillance (Appendix II).

I. **Membership Status**: Joined March 29, 1961; 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 of Quota
Quota	867.40	100.00
Fund holdings of currency	797.10	91.89
Reserve position in Fund	70.32	8.11

III. **SDR Department**:	SDR Million	Percent of Allocation
Net cumulative allocation	53.32	100.00
Holdings	76.67	143.80

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

V. **Latest Financial Arrangements**:

Type	Approval Date	Expiration Date	Amt Approved (SDR Million)	Amt Drawn (SDR Million)
Stand-by	Oct. 7, 1983	Feb. 28, 1985	445.00	259.30

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

VII. **Exchange Rate Arrangements**:

Portugal's currency is the euro, which floats freely and independently against other currencies.

VIII. **Exchange Restrictions**:

Portugal maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, except for restrictions that are maintained for security reasons and that have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

IX. **Article IV Consultation**: Portugal is on a standard 12-month consultation cycle. The last Article IV consultation discussions were concluded on October 18, 2006.

X. **Technical Assistance**:

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

XI. **ROSCs**:

Standard Code Assessment	Date of Issuance	Country Report No.
Fiscal Transparency	December 1, 2003	03/373

XII. **Resident Representative**: None

Appendix II. Portugal: Statistical Issues

1. Data provision to the Fund is adequate for surveillance purposes. Notwithstanding some recent improvements, statistical weaknesses continue to hamper the assessment of economic developments. Portugal subscribes to the Special Data Dissemination Standard (SDDS), and the relevant metadata have been posted on the Dissemination Standards Bulletin Board. Portugal's publication policy is characterized by a high degree of openness and 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. **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. 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.

3. **Fiscal sector** data have undergone a number of revisions during the transition to *ESA95*, sizably altering revenue and expenditure and hampering comparisons across years. From 2001 onward, budgets have been presented in a manner consistent with recent changes in national and fiscal accounting methodology. Intra-year budget data are available only on a cash basis. In 2002, INE started to publish data for the Social Security Fund on a monthly basis with a 45 days delay, and in 2003 for the Autonomous Funds on a quarterly basis with a 75 days delay. Except for the local and general government, data broadly meet the SDDS timeliness standards. Quarterly general government statistics on an accrual basis are available as derived from the national accounts statistics.

4. **Trade and balance of payments** data are provided according to the IMF's fifth edition of the *Balance of Payments Manual*. The external trade data meet the timeliness standards, although revisions are frequent and sizeable. 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 1.5 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 believe 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: Table of Common Indicators Required for Surveillance
(As of June 29, 2007)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	07/06/29	06/29	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	05/07	06/07	M	M	M
Reserve/Base Money	05/07	05/07	M	M	M
Broad Money	05/07	05/07	M	M	M
Central Bank Balance Sheet	05/07	05/07	M	M	M
Consolidated Balance Sheet of the Banking System	05/07	05/07	M	M	M
Interest Rates[2]	06/07	06/07	W	W	W
Consumer Price Index	05/07	05/07	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	05/07	05/07	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	05/07	05/07	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	05/07	05/07	M	M	M
External Current Account Balance	04/07	06/07	M	M	M
Exports and Imports of Goods and Services	04/07	06/07	M	M	M
GDP/GNP	2007 Q1	06/07	Q	Q	Q
Gross External Debt[6]	2007 Q1	06/07	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I); and not available (NA).

Statement by the IMF Staff Representative
September 28, 2007

1. **This statement provides information that has become available since the staff report was issued.** The thrust of the staff appraisal remains unaltered.

2. **The economy continues to show signs of modest recovery.** Output growth slowed slightly to 1.6 percent year-on-year in the second quarter (1.9 percent quarter-on-quarter annualized). Domestic demand strengthened as investment rebounded after nine consecutive quarters of decline, and private consumption firmed. As expected, export growth, while remaining robust, slowed somewhat. Unemployment declined to 7.9 percent and labor costs edged up to 3.7 percent year-on-year in the second quarter. The current account deficit continued to narrow. Short-term indicators remained broadly stable; the coincident indicator of economic activity was robust in August, though industrial production slowed. Inflation (harmonized) declined to 1.9 percent year-on-year in August.

3. **As envisaged by staff, the fiscal accounts continue to be buoyed by strong revenues.** Preliminary data through August indicate that revenue collection remained strong, boosted primarily by corporate tax receipts. Spending remained subdued, in part due to timing issues, but is likely to pick up in the remainder of the year in line with the budget. Further progress has been made with identifying civil servants to be moved to the special mobility pool.

4. **Portugal appears to have weathered the recent tensions in financial markets relatively well, though risks remain.** Financial markets followed similar trends in Germany, the US and the UK; interbank rates and bank credit default spreads increased and bank equity prices fell. While the recent decline in Portuguese bank equity prices has been somewhat more pronounced, they remain above their end-2006 levels due to the sharp gains made earlier in the year. The Bank of Portugal recently surveyed banks' liquidity and their exposure to US sub-prime mortgage markets and to asset-backed commercial paper conduits, and found their liquidity position to be comfortable and their exposure negligible. Several banks have also issued new bonds since mid-August. However, as Portuguese banks rely on significant foreign borrowing, protracted tensions in international capital markets, especially in the euro area, constitute a risk.

5. **Although real sector indicators are yet to be affected, the recent market tensions have worsened the growth outlook.** While the full implications of the market tensions are still being played out, current indications are that the impact on real economic activity in Portugal is likely to be modest—staff have revised down the 2008 forecast from 2 percent to 1¾ percent (with no change for 2007). In line with the greater downside risks highlighted in the current World Economic Outlook, the global growth implications could slow export growth and protracted tensions in financial markets could tighten credit conditions.

Statement by Arrigo Sadun, Executive Director for Portugal and José Cardoso, Advisor to Executive Director September 28, 2007

1. Introduction

We want to start by thanking the Article IV staff team for their thorough, constructive, and insightful approach to this consultation. The staff's report is balanced and broadly corresponds to the authorities' own analysis and interpretation of the evidence. The staff's recommendations are welcome and also agree with the main guidelines of the Portuguese authorities, namely in what concerns streamlining the public sector and enhancing overall productivity growth. The staff's evaluation of the soundness of the financial system, as well as the favorable assessment concerning the implementation of FSAP recommendations, is also to be underlined. As for the *Selected Issues Paper*, it includes several insightful contributions on very important topics concerning the Portuguese economy. As always there are caveats in these exercises which we stress below.

The **Portuguese economy is gradually recovering** from the protracted period of low growth observed in the first half of this decade, and converging to the average rates of growth observed in the EU. The implementation of measures aiming to enhance trend productivity growth continues to be vital. At the human capital level, potential policy measures tend to produce visible effects only in the medium to long-term. At the institutional level, reforms aimed at the correction of the structural imbalance of public accounts and conducive to improvements in the functioning of goods and labor markets may have significant effects on productivity over a shorter horizon.

There are several important features of the recent behavior of the Portuguese economy that deserve being highlighted. Economic activity accelerated, **boosted by exports of goods and services and**, more recently, **by a recovery of corporate investment**. Labor market conditions remained broadly unchanged, with high rates of unemployment and of long-term unemployment. The general government deficit declined considerably, more than projected in the Stability Program, reflecting significant improvements in the structural balance. In tandem, a number of major reforms were launched, notably the social security reform, which is likely to bring a notable improvement in the sustainability of public accounts. In turn, the banking system continued to confirm its capacity of adjustment to the low growth of the Portuguese economy and strengthened its capacity to absorb adverse shocks in its balance sheet and profit and loss account.

2. Macroeconomic Overview

The Portuguese economy grew 1.3 percent in 2006 (after 0.5 percent in 2005) and **projections point to a gradual acceleration in 2007 and 2008**. The projected outcome in 2007 and 2008 is based, on the one hand, on a significant recovery of total factor productivity growth and, on the other, on an acceleration of corporate investment, in a context of robust growth of total exports of goods and services. It should be underlined that the projected acceleration of activity in Portugal is bound to be insufficient to resume the real catching-up process with the country's European partners in 2007 and 2008, even though GDP growth is expected to converge to the level of the euro area in 2009. Moreover, the average economic growth over the current business cycle has been considerably lower than in previous cycles, reflecting to a large extent the low level of trend productivity growth.

It should be stressed that the series for GDP per capita corrected for PPP as a percentage of the EU average presented in the report (pgs. 3 and 6) has a break in 2003. The series break is referred to in the Eurostat metadata and is due to a change in the methodology used for the computation of rents, affecting the Portuguese PPP exchange rate series. This methodological break amplifies the fall observed in GDP per capita corrected for PPP as a percentage of the EU average. In light of this fact, the sentence in the executive summary mentioning that the "convergence process with the EU is in reverse" should be qualified.

Exports of goods and services were buoyant in 2006 and, albeit to a lesser extent, in the first half of 2007. This is in clear contrast with the disappointing performance in the two previous years, where the Portuguese economy is estimated to have lost 10 p.p. in real export market shares. The behavior of Portuguese exports must be interpreted in the light of the gradual process of adaptation to a changing pattern of comparative advantages at a global level. Among the key features of this process are the geographical diversification of export markets, the decline in the share of exports in goods from traditional low-tech sectors and with a poorly qualified labor force, and the higher share of services in total exports. The available information in nominal terms shows overall positive developments both by groups of products and by geographic markets. In the export structure by products, it is important to highlight sales of machinery and appliances and, albeit to a lesser extent, vehicles. In contrast, exports of clothing and footwear continued to fall. The greatest contributions to export growth came from some traditional geographic markets, although stress should be laid on the substantial growth of sales to other markets.

According to the recent trade statistics, nominal exports of goods and services decelerated from around 14 percent in the fourth quarter of 2006 to around 9 percent in the second quarter of 2007. This deceleration was concentrated on the exports of goods, from 12.7 percent in the fourth quarter of 2006 to 7.0 percent in the second quarter of 2007. In turn, exports of services recorded a year-on-year rate of growth of 15.0 percent in the second quarter of 2007, broadly unchanged relative to the fourth quarter of 2006. Even though a deceleration of the exports of goods was fully expected, in line with the deceleration in activity and in the volume of trade of the main Portuguese trading partners, it is difficult to assess whether exports will continue in the future to broadly follow global demand growth. First, exports have been quite volatile in 2006 and in the first half of 2007. Second, the dynamics of exports have been significantly influenced by the behavior of some specific sectors, the impact of which cannot be immediately extrapolated into the future. Finally, relative unit labor costs have continued to rise in Portugal, even though the globalization process and the productive restructuring enhance the difficulties in interpreting these price-competitiveness indicators. We thus agree with the conclusion of the Selected Issues Paper I on "***Portugal's Export Rebound in 2006: Recovery or Blip?***", that there is a high degree of uncertainty concerning the near-term evolution of exports of goods and services.

Regarding the **recent recovery in corporate investment**, it is important beforehand to place its evolution in light of the Portuguese economy's adjustment to a new regime characterized by structurally lower and less volatile financing costs in the second half of the 90s. This regime change implied a rise in the ratio of corporate investment to GDP from around 14 percent in 1996 to around 18 percent in 2000. Following this sharp dynamic, one would expect a gradual slowdown once the transition to the new steady state was complete. The reduction in growth expectations in the early 00s tended to amplify this adjustment against a background of growing macroeconomic imbalances, of uncertainty concerning the implementation of the necessary structural reforms deemed necessary to reinforce economic competitiveness, and of structural weaknesses in terms of human capital. Corporate investment thus declined considerably between 2001 and 2005, and the ratio of corporate investment to GDP declined to around 15 percent in 2005.

The forecasts for 2007 and 2008 point to a significant recovery in corporate investment. This dynamic is to be supported by an expected robust behavior of global demand, by the gradual restructuring of the Portuguese productive structure, and by the significant productivity gains in industry observed since 2000. Moreover, and in contrast to a message reiterated in the staff's report, high enterprise debt levels should not constitute by themselves a restraint on the investment outlook. This conclusion is clearly supported by the Investment Survey conducted by Instituto Nacional de Estatística (INE), the Portuguese national institute of statistics, where financing conditions are reported by firms not to be a relevant limiting factor to their investment decisions. Furthermore, data on profitability and solvency, as well as the low number of recorded default situations, also corroborate that conclusion. This notwithstanding, the recent turmoil in financial markets has tilted the balance of risks concerning the projections of investment clearly to the downside. The impact of these developments will depend on the persistence of the current instability in money and credit markets, on the degree of repricing of credit risk, and on the degree of tightening of credit availability. These elements are, however, still surrounded by a high degree of uncertainty.

3. Fiscal Policy

3.1 Recent Developments

We fully agree with the staff's report when it states that decisive action is being taken to address fiscal imbalances accumulated during the 1990s. When the current government assumed its functions **in March 2005, the government stated that fiscal policy would abstain from one-off fiscal measures and that the structural causes of fiscal imbalances would be addressed**. A reform program was implemented with ambitious results for the long run and visible results in the short run that surpassed targets.

The **background prior to these reforms** was characterized by an expansionary fiscal policy with a clearly pro-cyclical stance until 2000. The continued deterioration of the structural primary balance resulted mainly from the expansion of primary current expenditure, only partially offset by an increase in the tax burden. In 2002, the need to correct the budgetary imbalance led to the implementation of a slightly restrictive and pro-cyclical fiscal policy. Nevertheless, given that the measures implemented had a one-off and essentially short-term impact, they were not enough to reverse the upward trend of primary current expenditure, in particular, pensions expenditure. In the following years until 2005, the fiscal position deteriorated. These developments were not in line with the guidelines of the Stability and Growth Pact, according to which until a Member State reaches its medium-term budgetary objective, a positive change in the structural primary balance is required. In 2005, Portugal recorded again an excessive deficit situation and the structural primary balance reached its lowest value since Portugal's participation in the euro area. In this context, a strong structural adjustment was necessary. Therefore, in 2006 the budget policy was remarkably more restrictive than the policy pursued in the euro area countries as a whole and the structural balance has converged towards the euro area average.

The **restrictive stance of the fiscal policy** is apparent in the significant reduction in the structural primary deficit in 2006 (2.4 p.p. of GDP, from 2.8 percent to 0.4 percent of GDP), reached due to a rise in revenue (in particular tax revenue) and a reduction in primary expenditure. In this context, it should be noted that, **for the first time since 1997, primary current expenditure as a percentage of GDP decreased** (0.7 p.p. of GDP).

The implemented reforms decisively stamped the impressive evolution of the Portuguese fiscal position in 2006. **The general government deficit recorded an expressive reduction of 2.2 p.p. of GDP** (reflecting an increase in revenue of 0.8 p.p. of GDP and a reduction of expenditure of 1.4 p.p. of GDP), **from 6.1 percent to 3.9 percent of GDP, which was much more favorable than the objective of a deficit of 4.6 percent of GDP laid down in the Stability Program**. This result reflected the reduction of the structural deficit in 2.2 p.p. of GDP. Therefore, the recommendation of the Council of the EU, setting out an **adjustment of the structural balance** by 1.5 percentage points of GDP, **was also clearly exceeded**, reflecting the successful fiscal consolidation efforts.

Regarding the fiscal consolidation, some highlights are essential to mention in the field of current revenue and current expenditure. **Current revenue** increased significantly in 2006 (7.1 percent), chiefly due to the strong expansion of tax revenue (6.1 percent), which translated into an increase in this item by 0.7 p.p. of GDP. These developments resulted from the discontinuing of tax incentives in the 2005 State Budget, the adoption in the personal income tax of a new marginal rate of 42 percent in the 2006 State Budget, and the increase of the standard VAT rate from 19 to 21 percent in July 2005. The continued improvements in the collection procedures by the tax administration also contributed to the revenue increase.

The **reversal in the trend of primary current expenditure as a percentage of GDP** in 2006 resulted mainly from the impact of the fiscal consolidation measures implemented since mid-2005, in particular those relating to the containment in the government wage bill and current transfers in kind to households (chiefly due to the enforcement of the new rules regarding medicine and diagnostic co-payments, and regarding conventions with health service providers), as pensions expenditure continued to increase at a strong pace.

Following last years' trend, the strong increase in **pensions expenditure** resulted both from the increase in the number of pensioners and in the average pension. Three factors can be highlighted in 2006 regarding the social security sub-system: **(i)** the annual increase in pensions (approximately 2.3 percent in the general contributive system); **(ii)** the convergence process of minimum pensions in the general system towards values indexed to the national minimum wage (a process ended in 2006); and **(iii)** the composition effect resulting from the fact that the new pensions are, on average, far higher than pensions ceased to be paid.

The **government wage bill** decreased by 0.7 p.p. of GDP, due to the net fall in the number of civil servants, the impact on the average wage resulting from ingoings/outgoings of this sector, and the freeze of automatic progressions in public administration careers, which were only very slightly offset by the moderate increase (1.5 percent) in the civil servants wage scale.

To conclude the analysis of current expenditure, it should be noted that in 2006 the composition of current expenditure was influenced by the fact that, at the end of 2005, five hospitals of the National Health Service were converted into or were included in public corporate entities. Therefore, in 2006 they are already classified in the non-financial corporate sector, i.e. outside the general government sector. The conversion of these hospitals led, on the one hand, to a decline in the government wage bill and intermediate consumption and, on the other, to an increase in transfers in kind from the general government to households, which include payments for the services rendered by corporate hospitals.

Regarding **public debt**, notwithstanding the significant reduction in the primary deficit (from 3.4 percent to 1.1 percent of GDP), the persistence of a deficit has kept the still rising trend of public debt recorded in last years. In 2006, the public debt rose 1.2 p.p. of GDP to 64.8 percent of GDP. In spite of the continued growth of the stock of government debt in the past few years, expenditure on government debt interest increased only slightly as a percentage of GDP, due to the fact that the implicit interest rate has remained virtually unchanged. In fact, due to the high share of government debt issued at a fixed rate and the redemption of Treasury bonds at rates even higher than those currently prevailing, the rise in euro area interest rates did not fuel an increase in the implicit interest rate of government debt.

The **2007 State Budget** was adopted on November 2006. It targeted a general government deficit of 3.7% of GDP, confirmed in the December 2006 Stability Program update. However, in March 2007 the government announced a downward revision in the deficit target of 0.4 p.p. of GDP to 3.3 percent of GDP. The adjustment in the structural budget was 0.4 p.p. of GDP to 2.2 percent of GDP. Given the better-than-expected fiscal outturns, the government has faced strong pressure to reduce taxes. **The Portuguese government agreed with staff that in the near-term there is no room for a discretionary reduction in the tax burden**, and reaffirmed its best efforts to adopt the necessary structural reforms and to avoid one-off measures, in a credible and sustainable process of fiscal consolidation, towards the medium-term objective of a structural balance of -0.5 percent of GDP in 2010 set down in the Stability Program. As the staff's report quotes, "good results only mean that we are … able to reach the end of the path faster. But there is still road ahead of us".

3.2 Tax System

With respect to the section in the report on "Streamlining the Public Sector" and the *Selected Issues Paper II* on ***"Making Portugal's Tax System More Pro-Growth"***, there are a few clarifying issues that deserve mention, namely related to the outturn of investment expenditure, the new local and regional government financing framework, and the references to VAT productivity.

Regarding the reference to under budget developments in local government capital expenditure (pg. 13 of the report), the outturn of investment expenditure in Portugal is usually below budget. In this context, the 2006 developments do not constitute an exception. This notwithstanding, the decline in investment expenditure as a percentage of GDP had a significant contribution to the improvement in the fiscal position in 2006 and this should continue to be highlighted.

Several charts (pgs. 14, 15 and 17 of the report) miss the reference to the year the data depicted and/or the source they are based on. In addition, the chart on pg. 13 of the report could be changed in order to better illustrate the relative position of Portugal as far as primary current spending is concerned. Indeed, as the chart presents primary current expenditure as a percentage of GDP indexed to 1995=100 and given that Portugal had a fast growth in this item since then, it appears to be significantly above the other countries in the chart, while actually, in spite of the growing trend, the respective level still lies below some of them.

The reference to the VAT productivity (pg. 17 of the report and pg. 12 of the Selected Issues) states that VAT productivity in Portugal in the last few years has been high, although declining. Concerning the absolute value of this indicator, and given the definition used, it should be noted that a country with a higher share of VAT receipts stemming from reduced rates is placed in a worse position in this type of comparison. To avoid this problem, and if there is information available, only VAT receipts stemming from the standard rate should be used in the indicator. In addition, the measure is not adequate to assess the evolution of VAT productivity when there are changes in the rates. Indeed, in Portugal, there was an increase in the standard rate of VAT from 17 to 19 percent in the middle of 2002 and from 19 to 21 percent in the middle of 2005, but the reduced rates were kept unchanged. As such, and mechanically, the value of the indicator declined, which might lead to the misleading interpretation of a decline in VAT productivity.

Regarding to the percentage of arrears recovered which were securitized (pg. 17 of the Selected Issues), the text states that "the value of arrears recovered reached 1 percent of GDP in 2006. While about 70 percent of the arrears are securitized (…)". However, the available information points to a figure close to 0.2 percent of GDP for the value of recovered arrears which were securitized in 2006.

Finally, with regard to the reference to the municipal surcharge in the corporate income tax (pg. 19 of the Selected Issues) from 2007 onwards, the municipal surcharge may go up to 1.5 percent of the annual taxable profit and not to 10 percent of the corporate income tax generated in each municipality as before.

4. Labor Market and Competitiveness

Regarding to the recent developments in the labor market, the unemployment rate stood at 7.9 percent in the second quarter of 2007 (7.3 percent in the same quarter a year earlier and 7.7 percent in 2006 as a whole). Long-term unemployment continued to record very high levels, accounting for over 49 percent of total unemployment in the second quarter of 2007 (51.7 percent in 2006). The pattern of unemployment may reflect a fault line between the professional skills of the unemployed and the new job offers within the gradual productive restructuring which is under way. The high financial coverage of the unemployment benefit scheme and the significant potential duration of payments may also be contributing to the increase in long-term unemployment. In this vein, the changes in unemployment benefit policy introduced in early 2007 should contribute to increase the incentives to job search by the unemployed with shorter contribution careers. Another measure that should be highlighted is the **"New Opportunities" initiative**, which aims to make the upper secondary level the minimum standard for the qualification of youth and adults. In this regard, two major targets up to 2010 for the education and training systems were set: **(i)** to enroll the youth in vocational education and training courses and **(ii)** to qualify adults, giving a new opportunity to those that, due to a sub-investment in education for decades, did not have the opportunity to carry on longer and qualifying training pathways when younger.

In spite of the continuing increase in the unemployment rate and the proportion of long-term unemployed in recent years, there has not been a significant adjustment in the private sector's aggregate wages. The cyclical behavior of aggregate wages, besides reflecting significant changes in the sectoral composition of the labor force, have also been affected by the degree of wage rigidity in Portugal, one of the highest in the EU. In a context of low inflation and low productivity growth, nominal wage rigidity hinders the ability of firms to adjust to negative shocks in demand, leading them to adjust the level of employment rather than wages. In addition, curbs on the capacity to change the number of workers in the light of market conditions are conducive to the closure of firms that could otherwise redeploy successfully.

In this context, fostering a framework of labor market policies that are compatible with an increase in corporate efficiency and in the incentives to labor supply are important elements in enhancing the ability of the economy to adapt to domestic and external shocks. These elements are particularly relevant at a time when the change in the pattern of comparative advantages, associated with the globalization process, requires a significant reallocation of resources in the economy. We therefore concur with the *Selected Issues Paper III* on "***The Importance of Labor Market Flexibility in Regaining Competitiveness***", regarding the importance of some labor market reforms. We also highly commend the quality of the analysis, undertaken in a state-of-the-art multi-country DSGE model. However, in our view, the attempt in the paper to bridge the issue of improving Portugal's competitiveness with the model experiment of changing steady-state mark-ups in the labor and goods markets is not convincing. In fact, the various model simulations basically imply that a fall in mark-ups is associated with significant rises in GDP, consumption and hours worked, with some reallocation of factors between the tradable and non-tradable sectors. However, labor productivity stays basically unaltered in the steady-state. The exercise and the conclusions in the paper thus overlook that an increase in competitiveness of the Portuguese economy will require a gradual change in the specialization pattern of the productive structure and increases in productivity of the goods and services tradable sector. These ideas should be the main focus of any study concerning the competitiveness of the Portuguese economy, and are actually reflected in several sections of the staff's report. Finally, the paper also presents several estimates of real exchange rate overvaluation of the Portuguese economy based on last year's Selected Issues Paper. In the context of a monetary union, the concept of a real exchange rate can be an indicator of competitiveness issues and could help highlight the possible need and scope of policies other than exchange rate policies to improve competitiveness. Additionally, the report should recognize more fully the methodological caveats of all these measures and the large uncertainty surrounding them. In particular, this uncertainty is enhanced in the Portuguese case, given the current context of sectoral structural change, of financial and monetary integration within the euro area, and of enhanced global economic integration. Actually, an analogous criticism can be pointed out to the "Scenario with key variables at their historical averages" presented on Table 7 "External debt sustainability framework" (pg. 32). In fact, the 10-year historical averages presented in the exercise include a period prior to the beginning of the euro area, when the macroeconomic regime was rather different. The results from these exercises must therefore be interpreted with due caution.

5. Social Security Reform

Among the several reforms that have been implemented in the recent past, the social security reform deserves being highlighted, given its strong implications in terms of the sustainability of public finances and of the expectations of the private sector. The four most representative measures of the 2006 social security reform are: **(i)** earlier transition to the pension formula, which considers the whole contributive career and increases the accrual rate for lower wages; **(ii)** a new rule for updating pensions as a function of consumer inflation, the real growth of GDP, and the pension amount; **(iii)** a bigger financial penalty for early retirement, i.e. retirement prior to the legal retirement age; and **(iv)** the introduction of a "sustainability factor" that will relate the calculation of new pensions to the evolution of life expectancy at age 65. According to estimates by Banco de Portugal, the reform makes a significant contribution to improving the sustainability of Portuguese public finances and should allow the reclassification of Portugal from a "high-risk" country" to a "medium-risk" country, according to the methodology followed by the European Commission. However, it is important to underline that for Portugal to move into this latter group, it will have to proceed with the ambitious but necessary budgetary consolidation objectives set out in Portugal's Stability Program.

6. Financial System

Due to its importance in the intermediation of funds in the economy, the banking system is a key element in the assessment of financial stability in Portugal. Developments in the banking system in the past few years confirmed its capacity for adjustments to the low trend growth of the Portuguese economy and strengthened its capacity to absorb adverse shocks in its balance sheet and profit and loss account. According to the stress tests conducted in 2006 under the IMF's FSAP, the Portuguese banking system has a high level of resilience, meaning that the level of its own funds is adequate to absorb extreme, but plausible, shocks. In the course of 2006 and the first half of 2007, the banking system's profitability remained high and, in general terms, solvency stood at comfortable levels. In turn, default indicators remained at low levels, although the flow of non-performing loans increased in the household sector.

In the Financial Stability Report 2006 published by Banco de Portugal in the beginning of June 2007, several risks and vulnerabilities for financial stability on a global scale were identified, namely the persistence of macroeconomic imbalances on a global scale, the cooling of the real estate market in several countries, the increase in the degree of financial leveraging of non-financial corporations, the sensitivity of financial markets to abrupt increases in volatility, and, finally, the growing transfer of credit risk to several participants in the financial system. During the most recent months, some of these risk factors materialized, in the context of the financial markets turmoil observed since August.

Since the beginning of August a high level of volatility in the international financial markets was observed, associated with negative developments in the US sub-prime mortgage and leveraged loan markets, as well as in other related credit markets. These developments may have an unfavorable impact on banking activity in the second half of the year, in particular with respect to the asset portfolio valuation and to possible constraints on the financing of banks in medium to long run debt markets. In fact, the strong indebtedness of Portuguese banks in the international financial markets is a risk factor that is particularly relevant in the current context of strong instability on a global scale. Even though the available evidence suggests that the direct exposure of Portuguese banks to the US sub-prime mortgage segment is rather limited, the reduction in the available market liquidity and the strong rise in spreads in the private debt market, if prolonged, it may affect the activity of Portuguese banks. In fact, despite the relatively comfortable liquidity position of Portuguese banks in shorter horizons, the continuation of the current instability in international debt markets is likely to be reflected in a slowdown of credit to the private sector and, conceivably, in a restructuring of the term structure of granted loans, with a rise in the proportion of short-term loans.

7. Expected Impact of the Current Financial Turmoil on Economic Activity

Projections point to a gradual acceleration of GDP in 2007 and 2008 based, on the one hand, on a significant recovery of total factor productivity growth and, on the other, on an acceleration of corporate investment, in the context of robust growth of total exports of goods and services. The recent turmoil in financial markets has tilted the balance of **risks concerning the projections of investment to the downside**. Naturally, the impact of these developments will depend, on the one hand, on how quickly normalcy returns to money and credit markets and, on the other hand, on the degree of repricing of credit risk and on the degree of tightening of credit availability. In particular, a prolonged period of heightened uncertainty concerning the global demand outlook and of less supportive financial conditions could materialize in a downward revision of the investment outlook for the Portuguese economy. Furthermore, **the current downside risks to global demand also translate directly into downside risks for Portuguese exports of goods and services**.

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Washington, D. C. 20431 USA

IMF Executive Board Concludes 2007 Article IV Consultation with Portugal

On September 28, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Portugal.[1]

Background

A modest recovery is finally underway. Growth rose to 1.3 percent in 2006, led by strong external demand, which is driving a notable rebound in export growth. In response, corporate investment shows signs of strengthening, but overall domestic demand remains relatively weak. While employment and participation rates have risen, unemployment has edged up to 7.9 percent in the second quarter of 2007. Inflation has remained consistently higher than the euro area average despite a still-significant output gap and sluggish demand. The current account deficit (including capital transfers) remained around 8½ percent of GDP last year.

Real GDP growth is projected to strengthen to about 1.8 percent in 2007 and 2008, though the tensions in financial markets have increased the downside risks. Robust external demand is forecast to lead to a positive contribution from the external sector, while domestic demand is expected to remain subdued. Private consumption is forecast to remain constrained by weak employment growth and high indebtedness. While some corporate balance sheet restructuring has occurred, still-high enterprise debt levels and tighter credit conditions may restrain any

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[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.

rebound in investment. With the envisaged fiscal consolidation, modest further structural reforms are projected to prompt a gradual recovery in competitiveness and productivity.

The overall fiscal balance improved sharply from a deficit of 6.1 percent of GDP in 2005 to 3.9 percent of GDP in 2006, outperforming the original deficit target of 4.6 percent of GDP. The improvement was mostly driven by much-needed reduction in primary spending. Reflecting stronger-than-expected fiscal outturns in 2006, the authorities have lowered their deficit targets for 2007 and 2008. The restructuring of the central administration will play a central role in achieving fiscal consolidation goals and improving productivity. Recent reforms to the social security system have significantly improved the long-term sustainability. Important steps to move to performance-based budgeting are underway.

Portugal's financial system remains sound and well supervised and appears to have weathered the recent tensions in financial markets relatively well, though risks remain. While intensified competition has resulted in a slight deterioration in banks' liquidity ratios, average loan-to-value ratios are in line with other EU countries, and nonperforming loans remain low. High household and corporate debt remains the main source of risk to the financial system, but the Financial Sector Assessment Program (FSAP) exercise last year found that the financial system could withstand even severe macroeconomic disturbances. In accordance with the Bank of Portugal's plans, and also in line with the FSAP recommendations, the Bank of Portugal has further strengthened its supervisory capacity with the adoption of a new risk rating system, a Household Wealth Survey has been finished, and housing price statistics have been enhanced.

Executive Board Assessment

Executive Directors welcomed Portugal's modest economic recovery in 2006 after several years of sluggish growth. Directors commended the decisive action taken by the government to correct fiscal imbalances, reform the social security system, and improve the business environment.

Nevertheless, Directors recognized that the underlying economic situation remains challenging and that external competitiveness remains weak. Much remains to be done to achieve higher trend growth and income convergence with the European Union. Moreover, Directors noted that downside risks to the near-term outlook have risen recently as a result of the disturbances in international financial markets and the projected slowdown of growth in the United States. They emphasized that overcoming Portugal's imbalances will require that the authorities build on the reform momentum to further consolidate the public finances, streamline the public sector, and boost productivity and competitiveness.

Directors commended the authorities for a fiscal deficit reduction that went beyond their already ambitious target for 2006, without recourse to one-off measures. They particularly welcomed the expenditure-based nature of the consolidation and the buoyant revenue growth. This strong performance owes much to the authorities' commitment to strictly adhere to expenditure targets, enhance local government finances, and improve tax administration.

Directors welcomed the authorities' intention to accelerate the pace of fiscal consolidation in 2007 and 2008, and to save any revenue overperformance and take contingency measures in case of spending overruns. A number of Directors considered that somewhat more ambitious deficit targets for 2007 and 2008 seem warranted given the continuing revenue boom, and would enhance the credibility of achieving the government's medium-term objective of reducing the structural deficit to half a percent of GDP in 2010.

Directors welcomed progress in restructuring the central administration. They noted that the process is entering a critical and challenging phase of moving significant numbers of civil servants to the special mobility pool, and emphasized the importance of following through to achieve the envisaged fiscal consolidation and to boost productivity.

Directors stressed that there is no room for a discretionary reduction in the tax burden in the near term. But they saw scope for building on the recent improvement in the efficiency of tax administration by further simplifying some tax laws and procedures. Directors also welcomed the plan to move to performance-based budgeting and a medium-term budgeting framework, which could substantially improve the efficiency of public spending, and recommended that the timetable not be unduly demanding.

Directors stressed the need for a comprehensive structural reform strategy to significantly enhance Portugal's competitiveness and growth. They stressed that key components of this strategy involve strengthening productivity, including by enhancing contestability in the nontradable sector, and addressing the cost side of competitiveness through policies that foster wage moderation.

Directors encouraged the authorities to address labor market rigidities more fully. They welcomed the "New Opportunities" program to upgrade skills and the establishment of a commission to consider labor market reform, noting that the latter should be quickly followed up by concrete measures. In particular, most Directors stressed the need to ease employment protection legislation, end the automatic extension of collective contracts, and make procedures less cumbersome. Concern was expressed about the authorities' recent decision to sharply increase the minimum wage.

Directors noted that strengthening ongoing product and service market reform could help support reform in general by boosting competitiveness and consumer welfare. They welcomed the important progress in enhancing the business environment and increasing competition in the energy sector, while noting that much more remains to be done. In particular, Directors emphasized the need to enhance competition in network industries and some service sectors, and to strengthen the judicial system.

Directors welcomed the finding that the financial system is sound and well supervised, and that bank liquidity remains adequate despite recent financial market disturbances. They noted, however, that some risks have risen in light of these disturbances, and advised continued vigilance by the supervisory authorities given the large foreign borrowing by banks and the high indebtedness of the corporate and household sectors. Directors welcomed the progress made with implementing last year's FSAP recommendations.

Portugal: Selected Economic Indicators, 2001–2008

	2002	2003	2004	2005	2006 /1	2007 /1	2008 /1
Real economy (change in percent)							
Real GDP	0.8	-0.7	1.3	0.5	1.3	1.8	1.8
Domestic demand	0.0	-2.0	2.4	0.8	0.3	1.0	1.3
CPI (year average, harmonized index)	3.7	3.3	2.5	2.1	3.0	2.5	2.4
Unemployment rate (percent)	5.0	6.3	6.7	7.6	7.7	7.4	7.1
Gross national saving (percent of GDP)	17.1	16.8	15.3	12.7	12.6	12.7	12.6
Gross domestic investment (percent of GDP)	25.2	22.9	23.0	22.5	22.0	21.9	21.7
Public Finance (percent of GDP)							
General government balance 2/	-4.2	-5.2	-5.4	-6.1	-3.9	-3.3	-2.4
Primary balance 2/	-1.3	-2.5	-2.8	-3.4	-1.1	-0.4	0.4
Public debt	55.5	56.8	58.2	63.6	64.8	65.1	64.9
Money and credit (end-of-period, percent change)							
Total domestic credit 3/	6.5	6.6	7.3	7.4	10.6	...	...
National contribution to euro area M3 4/	-1.1	4.3	5.7	5.8	3.4	...	...
Interest rates (end-period)							
Deposit rate, up to two years 5/	2.9	2.0	2.0	2.1	2.7	...	...
Government benchmark bond yield	4.5	4.4	3.6	3.5	4.0	...	...
Balance of payment (percent of GDP)							
Trade balance	-10.4	-9.1	-10.4	-11.3	-10.7	-10.0	-9.6
Current account (including capital transfers)	-6.6	-4.2	-6.2	-8.5	-8.6	-8.4	-8.4
Net official reserves (in U.S.$ billions, end of period)	15.9	11.5	10.7	10.9	9.4	...	...
Exchange rate							
Exchange rate regime -- euro-area member							
Present rate (September 28, 2007) U.S.$1.42 per euro							
Nominal effective rate (2000=100)	101.3	104.6	105.4	105.6	105.8	...	...
Real effective rate (2000=100)	104.9	109.6	110.6	110.7	111.4	...	...

Sources: Bank of Portugal; Ministry of Finance; and IMF staff estimates and projections.
1/ 2006 is estimate, and figures for 2007 and 2008 are projections.
2/ Excludes one-off measures.
3/ The annual growth rates are obtained from the relation between the outstanding amounts and the monthly transactions, which are calculated from the outstanding amounts corrected for reclassifications, write-offs/write-downs, exchange rate changes, and price revaluations.
4/ Excludes currency in circulation held by nonbank private sector.
5/ Data refer to new deposits for 2002 and to the stock of outstanding deposits thereafter. Before 2003 deposit rate with 91–180 day maturity is reported.