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Portugal: Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Portugal

The following documents have been released and are included in this package:

- The staff report, prepared by a staff team of the IMF, following discussions that ended on **December 1, 2009**, 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 **December 18, 2009**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN).

- A statement by the Executive Director for Portugal.

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

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PORTUGAL

Staff Report for the 2009 Article IV Consultation

Prepared by Staff Representatives for the 2009 Consultation with Portugal

Approved by Ajai Chopra and Martin Mühleisen

December 18, 2009

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I. Staff Appraisal and Executive Summary

1. **The global economic crisis is severely buffeting the Portuguese economy.** Output will likely contract by almost 3 percent in 2009, driven by sharp falls in exports and investment. Signs of adjustment are emerging, as prices have fallen faster than in the euro area, households are saving more, and the large current account deficit has narrowed. The policy response has been rapid and supportive.

2. **Economic growth seems set for a weak and fragile recovery of about ½ a percent in 2010.** The outlook is little brighter for the longer term, with Portugal likely to continue with sub-euro area growth and high levels of unemployment. While the most likely scenario is one of gradual adjustment of Portugal's imbalances, the longer they persist, the greater the risk that the adjustment could become disruptive. This calls for an ambitious policy response, requiring broad-based support and determined leadership over many years, with the benefits taking similarly long to materialize.

3. **Fiscal consolidation is critical to prevent further deterioration and preserve hard-won credibility.** Despite impressive recent consolidation, the fiscal deficit is projected at around 8 percent of GDP in 2009. Without new measures, the deficit will likely increase in 2010 before declining to around 5–6 percent of GDP by 2013, with the debt ratio approaching 100 percent of GDP. While achieving even this consolidation requires considerable spending restraint, it would still leave public finances weak. Achieving the government's deficit target of 3 percent of GDP in 2013 is thus critical. Given the economy's continued weakness in 2010, some back-loading would be appropriate, but a start should still be made. Specifically, it would seem important that the deficit should at least not widen in 2010, which would require at least ½ a percent of GDP tightening compared to unchanged policies. The 2010 public administration wage adjustment will be key, both in terms of credibility and supporting consolidation. An overarching need is to adopt a credible medium-term strategy based on realistic projections and concrete measures.

4. **The consolidation should focus on reducing primary current spending, especially the public wage bill and social transfers.** But the consolidation need is large enough that revenue enhancement should also be considered, which should focus on base-broadening. Raising the VAT rate should be an option if other measures fall short. It will also be critical that existing policies that support medium-term consolidation be fully implemented. In this regard, it is important that the deviation from the pension formula for 2010 be a one-off and the costs recouped in future adjustments. Improving fiscal frameworks, for example, by introducing a medium-term expenditure ceiling and an independent fiscal agency, could also support high-quality and durable consolidation.

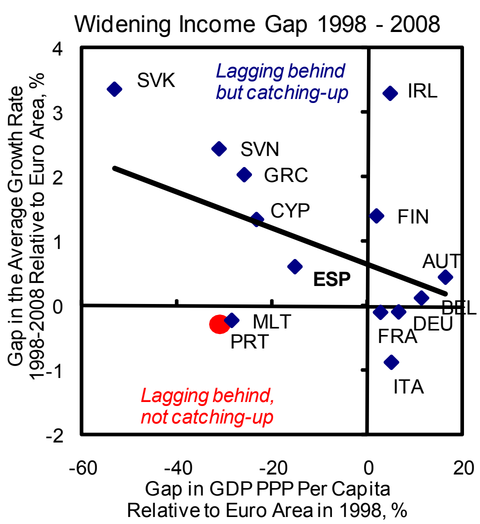
5. **The banking system has weathered the global financial crisis relatively well, reflecting pre-existing strengths, but some vulnerabilities increased.** Decisive steps have been taken by the Bank of Portugal (BdP) to address these vulnerabilities, including recommending that banks bring their Tier I capital ratios to 8 percent by September 2009. Further pro-active measures to address underlying vulnerabilities should be considered, many of which are already on the authorities' agenda and will need to be implemented in the context of the evolving international financial architecture. In particular, regulations on the quality of capital could be gradually tightened, liquidity ratios introduced, a special resolution framework for financial institutions considered, and inter-agency coordination enhanced. The implications of the envisaged switch to the "twin peaks" model should also be carefully assessed and cautiously implemented.

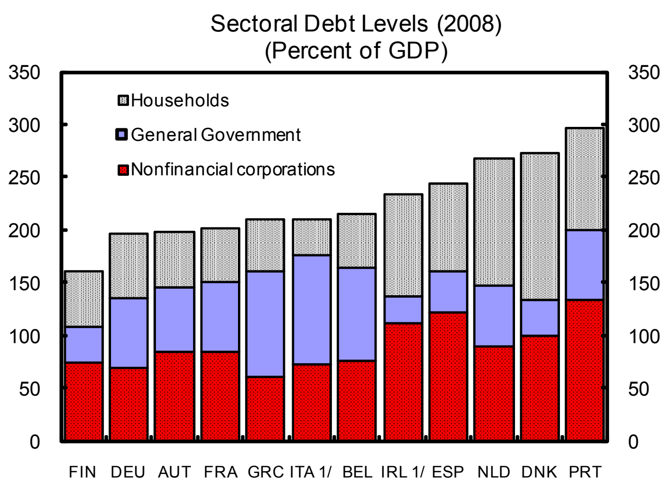
6. **Comprehensive structural reform remains vital to improve competitiveness and boost growth.** The EU Services Directive should be grasped as an opportunity to make a clean sweep of legislation, licensing should be streamlined, and the competition agency should be further enhanced. The recent labor code revision should be assessed for effectiveness, the unemployment benefit system examined to see if it can be better-targeted, and the planned large increases in the minimum wage reconsidered.

7. It is proposed to hold the next Article IV consultation on the regular 12-month cycle.

II. The Problems: Low Productivity, Weak Competitiveness and High Debt

8. **Portugal's economy continues to suffer from low productivity, weak competitiveness and high debt.** Multi-faceted structural problems have depressed productivity growth and undermined the economy's ability to adjust. Combined with brisk wage and price growth, competitiveness suffered and the income convergence process





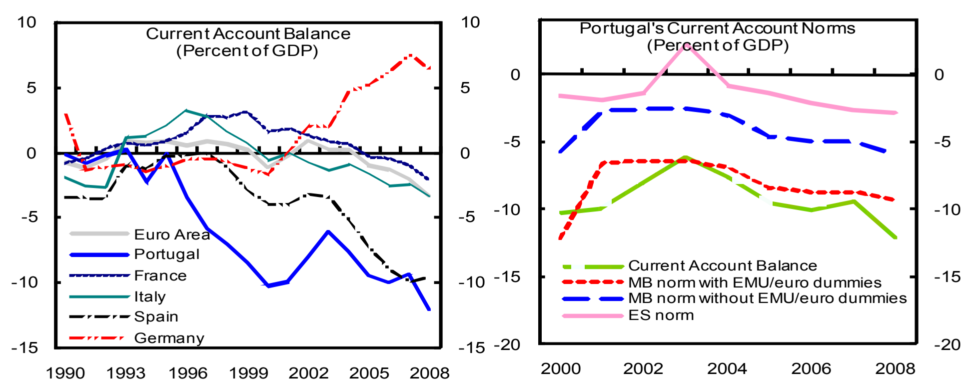
Source: Eurostat
1/ Data as of 2007.

reversed. The large fiscal and external imbalances that arose from the boom in the run-up to adoption of the euro have not been unwound, resulting in the economy becoming heavily indebted and growing banking system vulnerabilities. The global financial crisis has exacerbated these pre-existing, home-grown, problems.

A. Low Productivity and Weak Competitiveness

9. **Portugal's growth performance has been sluggish since the early 2000s, as the pre-euro adoption boom turned into a post-euro bust** (Figure 1). Portugal stands out during this period for the anemic contribution from total factor productivity. A range of structural factors have been linked to the productivity slowdown. Rigidities in the labor market and strict regulation discourage investment and growth, while nontradable sectors also suffer from a lack of competition. Though progress has been made recently, the business environment remains weak, FDI low, and specialization based on traditional low-skill products. Human capital also remains relatively poor.

10. **Weak productivity, robust wage growth and above euro average inflation have led to a substantial competitiveness gap** (Figure 2). Both priced-based and cost-based real effective exchange rate measures have appreciated substantially from the early 1990s. Exports have lost market share and the sharp widening of the competitiveness gap has also contributed to Portugal running one of the largest current account deficits among advanced countries. On the basis of estimations of current account norms, staff estimates the competitiveness gap at some 10–40 percent.



Source: IFS statistics, IMF Staff Calculations

Estimates of Real Exchange Rate Gap

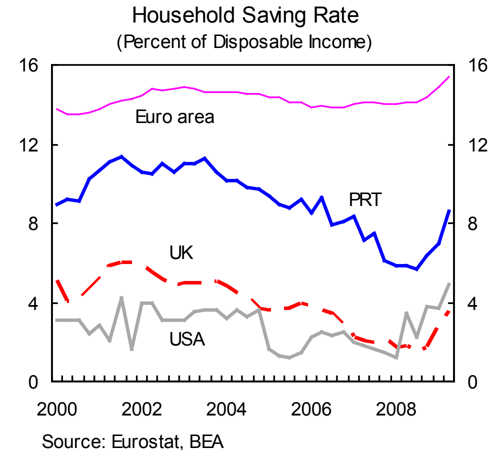
	Current Account (Percent of GDP)	Estimated Real Exchange Rate Gap (Percent)
Underlying current account 1/	-11.5	
Macroeconomic balance (MB) norm with EMU/euro dummies	-9.4	10
Macroeconomic balance (MB) norm without EMU/euro dummies	-5.9	26
External sustainability (ES) norm 2/	-3.1	39

Source: IMF Staff Calculations
1/ The current account balance that w ould emerge at zero output gap both domestically and in partner countries, i.e., the current account adjusted for the output gap and oil prices in 2008.
2/ The current account norm that w ould stabilize the NFA at 2008 level.

B. High Debt

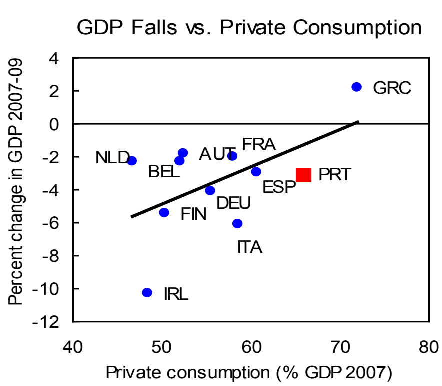
11. **Portugal's economy is one of the most indebted in the euro area** (Figure 3). Government debt has risen sharply over the past decade, corporate leverage has increased, and household debt, driven by low savings, is among the highest in the euro area.[1] This has been reflected in sustained large current accounts deficits financed mainly by bank borrowing from abroad, and a negative net international investment position of about 100 percent of GDP in 2008, one of the weakest among advanced countries.

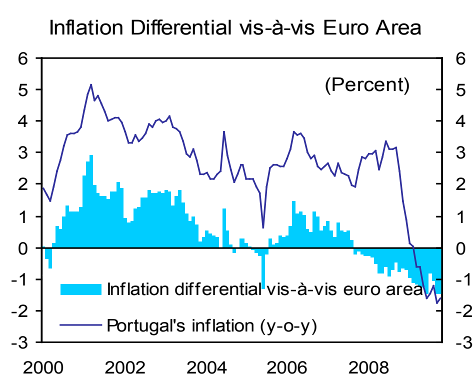
12. **Increasing debt in the context of the crisis has fostered rising risk premia**. Portugal's sovereign spreads have been volatile since the onset of the crisis (broadly in line with other euro area peripherals), reaching some 175 basis points over German 10-year bonds early in 2009, before moderating more recently. Similarly, increased corporate leverage and weakened repayment capacity has been reflected in higher corporate expected default frequencies.



C. The Global Crisis

13. **As elsewhere in Europe, the 2009 recession is set to be the most severe in decades** (Figure 4). After stagnating in 2008, output will likely contract by almost 3 percent in 2009 (somewhat lower than the euro area average), driven by particularly sharp declines in exports and investment. Given Portugal's relatively high share of private consumption in GDP, the output loss is relatively large. Despite a substantial rise in unemployment, wage growth remained brisk, and, with productivity falling, unit labor





[1] Despite the high debt levels, household net financial assets have been fairly high by EU standards (125 percent of GDP in 2008).

costs rose further. Signs of adjustment are, however, emerging, as prices have fallen faster than in the euro area (though coupled with strong real wage growth, this squeezed firms' profit margins), households are saving more, and the large current account deficit has narrowed somewhat.

14. **The banking system weathered the global crisis relatively well, but some risks have risen** (Figure 5). This resilience reflects pre-existing strengths, such as limited exposure to toxic assets, the absence of a property bubble, retail-based business models, and a sound supervisory/regulatory framework. But some vulnerabilities increased as investment portfolios suffered, credit quality declined, funding large wholesale borrowing requirements became more difficult, and the already high concentration of loans to large exposures rose.

15. **Recent consolidation helped the public finances enter the crisis in a relatively strong position by historical standards** (Figure 6). Between 2005–07, the government succeeded in reducing the structural balance by over 3 percentage points of GDP to around 3 percent of GDP, largely by cutting compensation via public sector administration reforms and upfront tax increases, notably via raising the standard VAT rate. Nevertheless, the fiscal position remained weak compared to euro area peers.

16. **The policy response has been supportive, as elsewhere in Europe.**

- *On the financial side*, the government took a range of measures including raising the coverage limit for deposit insurance and instituting facilities to recapitalize banks and guarantee their borrowing. These measures helped stabilize financial conditions: only two small banks have been intervened[2], the guarantee scheme has been used only moderately, and no bank has used the recapitalization scheme.

Portugal: Financial Sector Support Measures

Program	Amount (€billion)	Percent of GDP	Operations	Gross Treasury Financing	Actual use Nov. 29, 2009 (€billion)
Deposit Insurance	--	--	Increased to €100,000.	0	0
Debt Securities Guarantee	20	12.0	Provides guarantees to debt securities issued by credit institutions	0	5.0
Capital Injection	4	2.4	Government made €4 billion available to banks seeking to strengthen their capital	4	0.0
Total 1/	20	12.0		4	5.0

Source: Bank of Portugal.

1/ The maximum amount of 20 billion Euros is allocated to both the guarantee and capital reinforcement schemes, with the latter not exceeding 4 billion Euros.

[2] Banco Português de Negócios (BPN) was nationalized in late 2008 and its management was replaced. Banco Privado Português (BPP) received a state guarantee for a €450 million loan by six Portuguese banks. BPN is expected to be privatized in 2010 following recent approval by the Council of Ministers, while the government announced its intent of finding a resolution to BPP by end-2009.

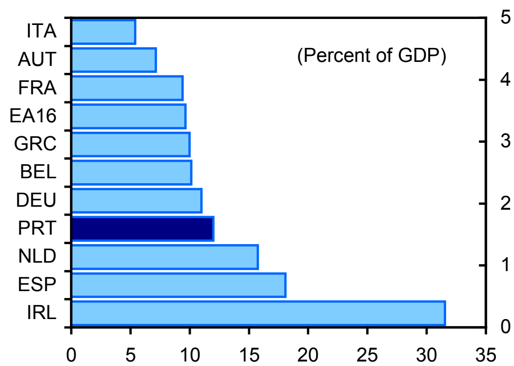
- *On the fiscal side*, stimulus measures amounted to some 1¼ percent of GDP over 2008–09 (broadly in line with other euro area countries). While expenditure measures focused on broadening social protection and increasing public investment were mostly temporary, tax reductions were largely permanent. Combined with the impact of the recession, the deficit and debt ratios rose sharply and the sovereign rating was cut.

Impact of Measures
(Percent of GDP)

	2008	2009	Total
Total (+ stimulus)	**0.2**	**1.0**	**1.2**
Revenue	**-0.2**	**-0.5**	**-0.6**
Lower tax on houses 1/		-0.1	-0.1
Reduction in VAT rate	-0.2	-0.2	-0.3
CIT reduction for SMEs		-0.1	-0.1
Reduction of social contributions		-0.2	-0.2
Expenditure	**0.0**	**0.5**	**0.5**
Public investment		0.1	0.1
Employment and Social protection		0.2	0.2
Support for SMEs, exporters		0.0	0.0
School modernization		0.1	0.1

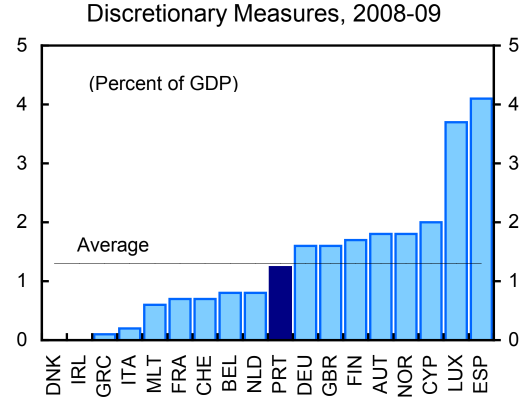
Sources: Ministry of Finance and staff estimates.
1/ Real estate tax and deductions.

Projected Debt Increase, 2007-09



Souce: WEO and staff estimates.

Discretionary Measures, 2008-09



Souce: IMF REO Europe May 2009 and staff estimates.

Euro area long-term foreign currency debt ratings by rating agency[1,2]

	Moody's	Outlook	S&P	Outlook	Fitch	Outlook
France	AAA	Stable	AAA	Stable	AAA	Stable
Germany	AAA	Stable	AAA	Stable	AAA	Stable
Netherlands	AAA	Stable	AAA	Stable	AAA	Stable
Spain	AAA	Stable	AA+	Negative	AAA	Stable
Belgium	AA+	Stable	AA+	Stable	AA+	Stable
Ireland	AA+	Negative	AA	Negative	AA-	Stable
Slovenia	AA	Stable	AA	Stable	AA	Stable
Italy	AA	Stable	A+	Stable	AA-	Stable
Portugal	AA	Negative	A+	Negative	AA	Negative
Cyprus	AA-	Stable	A+	Stable	AA-	Stable
Slovakia	A+	Stable	A+	Stable	A+	Stable
Malta	A+	Stable	A	Stable	A+	Stable
Greece	A+	Negative	A-	Negative	BBB+	Negative

[1] Using S&P common scale. As of December 9, 2009.
[2] In October 2008 the Eurosystem lowered the credit threshold for marketable and non-marketable assets from A- to BBB-. This measure is set to remain in force until end-2010.

17. **Political support for reform may need broadening.** The Socialist Party was re-elected in September 2009, but lost its overall majority. While there seems consensus among the main parties to comply with the SGP in general, pressure for further stimulus is strong. Combined with the Presidential election in 2011, significant new reforms may prove challenging.

III. The Outlook: Bleak

18. **Staff's baseline scenario envisages modest adjustment, weak growth and continuing unsustainable imbalances** (Tables 1–4). Growth is projected to strengthen only gradually in the context of a weak external environment, for example, in Spain (Box 1). Domestic demand will likely remain subdued, with consumption constrained by the weak labor market and the growing debt service burden, while weak profitability and uncertainty about growth prospects would dampen the rebound in investment. With continued deterioration in credit quality and rising funding costs (as extraordinary monetary loosening is reversed), banks will likely become increasingly risk averse, constraining credit supply. Fiscal policy would consolidate from 2011. Modest structural reforms are projected to foster a gradual recovery in competitiveness and productivity, but not sufficiently to restart the income convergence process or to substantially reduce the large current account deficit. Both the external indebtedness and public debt ratios would continue to worsen.

Comparison of Growth Outlook
(Percent)

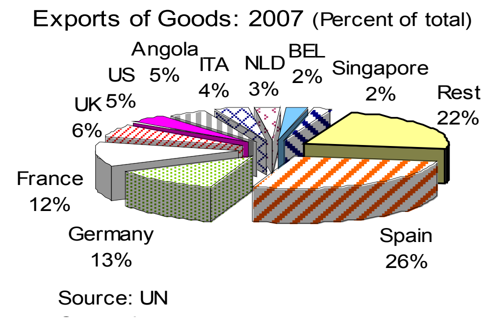
	2007	2008	2009					2010		
			BoP	MoF	OECD	EC	Staff	OECD	EC	Staff
Real GDP	1.9	0.0	-2.7	-3.4	-2.8	-2.9	-2.7	0.8	0.3	0.5
Private consumption	1.6	1.7	-0.9	-1.4	-1.0	-0.9	-0.9	0.6	0.6	0.3
Public consumption	0.0	1.1	2.1	-0.6	1.4	1.7	4.4	0.6	0.7	0.7
Gross fixed investment	3.1	-0.7	-13.1	-14.1	-13.6	-15.2	-15.0	0.4	-4.1	0.0
Exports	7.8	-0.5	-13.1	-11.8	-14.7	-14.0	-14.4	1.7	0.7	1.3
Imports	6.1	2.7	-11.7	-11.1	-14.4	-13.7	-12.2	1.0	-0.2	0.6
CPI inflation	2.5	2.7	-0.9	0.1	-0.2	-1.0	-0.9	0.7	1.3	0.8
Partner countries real imports	7.2	1.6	…	-11.6	...	...	-16.1	…	…	0.0
Current account (percent of GDP)	-9.4	-12.1	…	…	-9.7	-10.2	-9.9	-10.7	-10.2	-10.2
Current account (including capital transfers)	-8.1	-10.5	-8.6	-8.2	…	…	-8.6	…	…	-8.9

Sources: Bank of Portugal Economic Bulletin (Autumn 2009); Ministry of Finance (May 2009); OECD Economic Outlook (Nov 2009); EC Autumn Economic Forecasts 2009; and IMF staff projections.

19. **Portugal's vulnerabilities give rise to the risk of a more disruptive scenario.** Eventually, incomes and spending need to be aligned. The longer the imbalance persists, the greater the risk that the adjustment will be sudden and disruptive, affecting all sectors of the economy. This could be further exacerbated by risks of contagion from other highly indebted advanced countries, especially in the region. To assess such a risk, staff's "forced adjustment" scenario assumes a permanent increase in Portugal's risk premium of 175 bps (as at the peak of the recent crisis), based on simulations using the IMF's Global Integrated

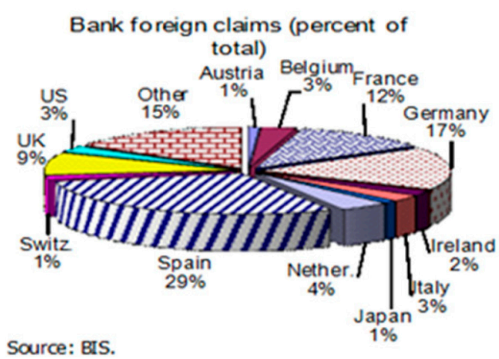
Box 1. Spillovers from Spain to Portugal

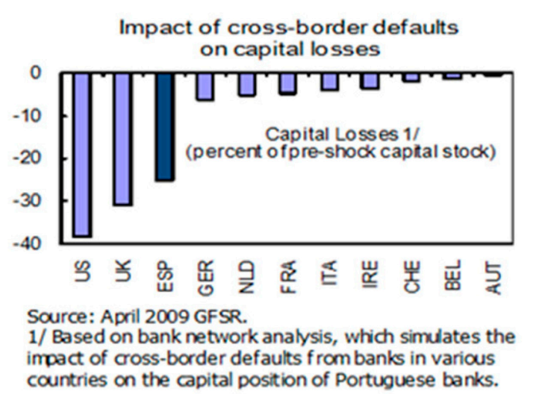
One of the key risks for Portugal's growth outlook relates to the length and depth of the economic downturn in Spain, given the strong real and financial sector interlinkages.



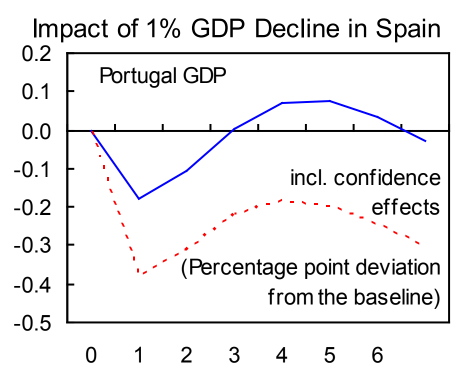
- **Trade linkages**: With an export share of goods of 25–30 percent, Spain is Portugal's most important trading partner. In addition, Spain accounts for around 15 percent of tourism receipts and around 15 percent of service exports.

- **Financial linkages**: At end-March 2009, 30 percent of foreign claims of Portugal's banks were on Spanish institutions. Using *network analysis*, which tracks the pass-through effects of defaults from banks in trigger countries on the Portuguese banking system, an initial default from Spanish banks would produce an estimated capital loss to Portuguese banks of 25 percent of their initial capital. Analysis by Gameiro (2008)[1] also suggests strong correlation of equity risk premia between Portuguese and Spanish markets (0.71).





Simulations using a 3-country version of the GIMF model suggest that a 1 percent decline in Spain's GDP reflecting a temporary but persistent shock to consumption and investment lowers Portugal's GDP by nearly 0.2 percent in the first year. Factoring in potential adverse effects on consumer and investment confidence arising from developments in Spain, the impact would likely be bigger (close to 0.4 percent) and longer-lived, with the level of GDP remaining below the baseline scenario for a prolonged time.



1/ Bank of Portugal, 2008 Autumn Economic Bulletin.

Monetary and Fiscal (GIMF) Model, leading to economy-wide deleveraging, more compressed domestic demand and faster adjustment of the current account. In addition to the impact of sustained lower growth on domestic demand, the impact of higher bond yields would make consolidation substantially more difficult, requiring additional measures to offset higher interest costs and without additional structural reform, growth and unemployment outcomes deteriorate (Figures 7 and 8).

Authorities' views

20. **The authorities broadly shared staff's near-term outlook, but views differed somewhat on the impact of the recent reforms on medium-term growth.** BdP officials saw a risk of protracted growth weakness over the medium-term reflecting the long-awaited adjustment in household balance sheets. While acknowledging the large uncertainty about future growth prospects, the Ministry of Finance and other officials saw a somewhat stronger recovery in outer years, reflecting recent structural reforms.

IV. The Policy Agenda: Smoothing the Adjustment

21. **Alternatively, Portugal could embark on a program of comprehensive reforms to raise its longer-term growth potential, correct its imbalances, and restart the convergence process.** Although significant reforms have been undertaken in recent years, much more is needed to significantly improve longer-term economic performance. This calls in particular for the government to reduce its deficit, firms to be more efficient, labor to be more flexible and productive, and households to save more. Such reforms would also help investors differentiate more between Portugal and other highly-indebted advanced countries. GIMF model simulations suggest that such a scenario could indeed significantly improve output and labor market outcomes (mainly by boosting investment), but, as international experience suggests, the adjustment period would be lengthy (Annex I). This challenging agenda will thus require broad-based support and determined political leadership over many years, with the benefits taking similarly long to materialize.

22. **Other countries have overcome similar challenges from very difficult starting positions with comprehensive policy packages:** Canada, Australia, United Kingdom, New Zealand, Ireland, and the Netherlands all have undertaken path-breaking fiscal and structural reforms in the 1980s and 1990s, and, indeed, Portugal itself has reduced real wages in its pre-euro past and substantially cut its fiscal deficit between 2005–07. Empirical evidence suggests that recoveries from economic crises often serve as an opportunity for reform and that it is best to undertake them early in a government's term and with broad-based support. Again, examples from other countries can help, such as independent commissions to set the agenda (France's Attali Commission and Australia's Productivity Commission) or monitor public finances (Sweden's Fiscal Policy Council), and pacts with social partners (the Netherlands' Wassenaar agreements).

A. Fiscal Sector: Deep and Lasting Consolidation Required

Near and medium-term outlook

23. **Unchanged policies point to a further deterioration in 2010.** Even assuming tight expenditure control, the fiscal deficit is projected to increase to 8.6 percent of GDP, and the structural deficit to over 7 percent of GDP, reflecting existing policy measures and structural effects that alter the composition of tax bases (higher NAIRU and permanent erosion of the VAT tax base).

Timing of the Stimulus Reversal
(Percent of GDP)

	2009	2010	2011	Nature
Total (+ stimulus)	**1.0**	**0.5**	**-0.9**	
Revenue	**-0.5**	**0.0**	**0.2**	
Lower tax on houses	-0.1			Permanent
Reduction in VAT rate	-0.2			Permanent
CIT reduction for SMEs	-0.1	-0.1		Permanent
Reduction of social contributions	-0.2		0.2	Temporary
Expenditure	**0.5**	**0.5**	**-0.7**	
Public investment	0.1	0.1	-0.2	Temporary
Employment and Social protection	0.2			Mixed
Support for SMEs, exporters	0.0	0.1	-0.1	Temporary
School modernization	0.1	0.1	-0.2	Temporary
Change in unemployment benefits	0.0	0.1	-0.1	Temporary
Pension and other benefits indexation		0.2		Permanent

Sources: Ministry of Finance and staff estimates.

24. **Current policies are not enough to achieve the government's deficit target of 3 percent of GDP by 2013.** The planned unwinding of measures, continued spending control and some revenue recovery will still result in the deficit declining to only 5¾ percent of GDP in 2013—with the debt ratio close to 100 percent of GDP. This may test the limits for Portugal's sovereign rating and leave Portugal with even less scope for countering any future downturns.

Composition of Fiscal Balance (Unchanged Policy)
(Percent of GDP, otherwise indicated)

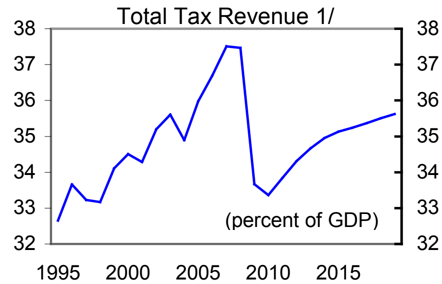
	2008	2009	2010	2011	2012	2013	2014
		Staff projections					
Overall balance	**-2.7**	**-8.0**	**-8.6**	**-7.3**	**-6.6**	**-5.7**	**-5.0**
Temporary factors (one-off)	0.8	0.1	0.0	0.0	0.0	0.0	0.0
Cyclical factors	0.1	-1.4	-1.5	-0.9	-0.6	-0.3	-0.1
Structural balance	**-3.5**	**-6.6**	**-7.1**	**-6.4**	**-6.0**	**-5.5**	**-5.0**
Changes in structural balance	-0.3	-3.2	-0.4	0.7	0.5	0.5	0.5
Policy measures	-0.2	-1.0	-0.3	0.9	0.5	0.5	0.5
Other (incl. change in tax base)	-0.2	-2.2	-0.1	-0.2	0.0	0.0	0.0
Memorandum items							
Output gap (percent)	0.4	-2.6	-2.1	-1.6	-1.0	-0.4	-0.1
Unemployment rate (percent)	7.6	9.6	11.0	10.3	9.5	8.9	8.5
General government debt	66.3	75.8	83.3	89.2	93.8	97.1	99.4

Source: Ministry of Finance, and staff estimates.

25. **There are additional downside risks associated with this modest fiscal consolidation scenario.**

- Achieving the necessary spending restraint will be challenging. Although some savings will likely accrue from the recent public administration and social security reforms, these are uncertain. Transfers in kind (associated with health expenditure) have increased on average 10 percent a year since 2005. In addition, the large civil service compensation increase in 2009 (2.9 percent against inflation expected at 2.5 percent at the time) casts doubt about the feasibility of containing the wage bill for a sustained period.

- Portugal depends more heavily on consumption taxes than euro area peers. Indirect tax collection fell by 2½ percent of GDP in 2009 relative to 2007. While the reduction of the standard VAT rate by 1 percentage point in 2008–09 partly accounts for the decline (impact of 0.3–0.4 percent of GDP a year), weak prospects for consumption growth going forward owing to households' need to adjust balance sheets, increase downside risks to revenue.



Source: Ministry of finance and staff projections.
1/ Includes social security contribution.

- Gross financing needs reach about 14 percent of GDP (€23.6 billion) in 2011, nearly 40 percent of total tax revenue. Although debt management is strong, this will come as many other advanced economies will be issuing heavily.

Longer-term outlook

26. **Portugal, like most advanced countries, faces significant challenges associated with population aging**. As a result of recent reforms of the social security system, the EU Aging Working Group projects the costs associated with aging to rise by only 3½ percent of GDP between 2007 and 2060 in Portugal—significantly lower than other European countries. But the underlying assumptions could prove optimistic. In particular, labor productivity growth is assumed to stabilize at 1.7 percent, significantly higher than the recent average of about 1 percent. And while pensions are now indexed to CPI inflation and real GDP growth which would mitigate increases in pension expenditure[3], the recent decision to overrule the formula and grant 1–1¼ percent increase in 2010 for lower

[3] The 2006 social security reform changed the indexation rule for pensions from minimum wages to a formula involving CPI inflation, real GDP growth, and the pension level. If growth is below 2 percent, pensions are indexed to the past 12-month average CPI inflation excluding housing.

pensions and a freeze for others instead of indexing to the negative CPI inflation is problematic, especially with replacement rates set to fall in the future.

27. **A balance sheet approach also suggests substantial consolidation is required** (Table 5). Without any consolidation, starting from a primary deficit of 4 percent of GDP in 2011 and using the European Commission's projected increase in aging costs, Portugal's intertemporal financial position would imply a negative net worth of some 180 percent of GDP in 2010 (222 percent excluding nonfinancial fixed assets). Eliminating this gap would require an upfront permanent improvement in the primary balance of more than 5 percentage points of GDP.

Impact of Measures on Net Worth
(Percent of GDP)

	Net worth 1/	Financial net worth
No adjustment (2011)	**-179**	**-222**
Adjustment (permanent from 2011)		
1 percent of GDP	-145	-188
2 percent of GDP	-111	-155
3 percent of GDP	-78	-121
4 percent of GDP	-44	-87
5 percent of GDP	-10	-54

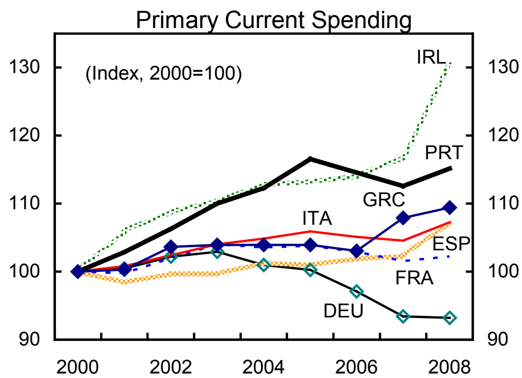
1/ Includes nonfinancial fixed assets. See Table 5 for more detail.

A more ambitious consolidation strategy

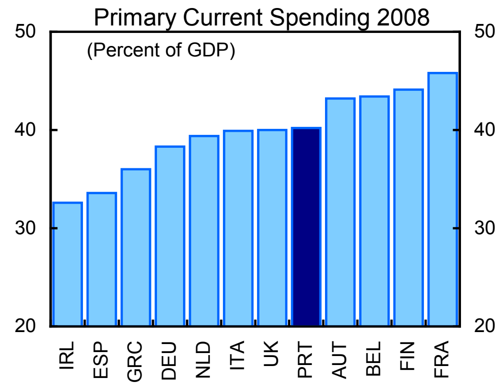
28. **To reinforce credibility and to put Portugal's public finances back onto a sustainable path, a more ambitious consolidation is thus called for.** Structural consolidation of somewhat more than 1 percent of GDP a year on average over the government's term would achieve the government's deficit target of 3 percent of GDP by 2013. Such an ambitious consolidation would also reduce the economy's vulnerabilities, improve confidence, and would, if well crafted, help boost the economy's longer-term growth potential. Given the economy's continued weakness in 2010, some back-loading would be appropriate, but a start should still be made. Specifically, it would seem important that the deficit should at least not widen in 2010, which would require at least ½ a percent of GDP tightening compared to unchanged policies. The 2010 public administration wage adjustment will be particularly important both in terms of credibility and supporting consolidation, especially after the large real increase in 2009 and the need to signal wage restraint to the private sector. An overarching need is to quickly adopt a credible medium-term strategy based on realistic projections and concrete measures.

29. **The consolidation should focus on reducing primary current spending, especially the public wage bill (building on recent reforms) and social transfers.** In particular, eligibility criteria for social benefits should be carefully assessed for effectiveness and health costs will need rigorous management. But the consolidation need is large enough that revenue enhancement should also be considered. Here, the focus should be on broadening the base of taxes by reducing tax expenditures and simplifying their administration. Raising the VAT rate, while generally undesirable, should be an option if other measures fall short. It will also be critical that existing policies that support

medium-term consolidation be fully implemented. In this regard, the 2010 exception to the recently-agreed rule should be a one-off with the costs recouped in future adjustments.



Source: Eurostat



Source: Eurostat

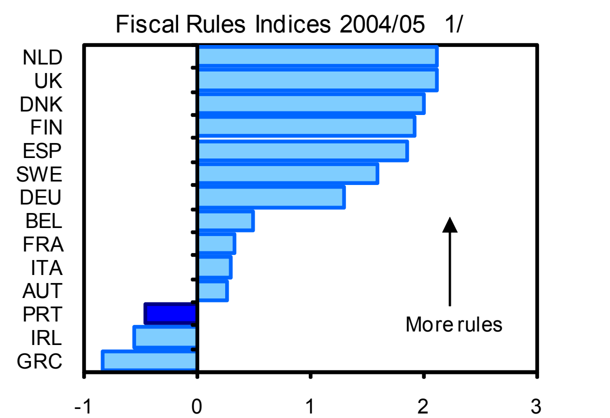
30. **Improving fiscal frameworks would support high-quality and durable consolidation.** Recent initiatives to develop performance budgeting to increase the low efficiency of public spending should be followed through. It would also be important to introduce a multi-year expenditure rule and a commitment to save any revenue overperformance. Establishing an independent fiscal council (like Sweden's or Belgium's) or a US-style Congressional Budget Office, might also help by providing independent analysis, forecasts and assessments, especially given the need to secure broad-based support. Significant progress has been made in improving the transparency and operating position of public enterprises—this needs to be continued, for example, by extending the coverage of public service agreements, consolidating ownership in the Ministry of Finance, and resuming privatization. Greater involvement of the Ministry of Finance in public-private partnerships, especially early in the design stage, will also help improve results and contain fiscal risk.

Public Enterprises: Government Participation
(As of September 30, 2009)

	Millions of euros	Percent of GDP
Total	**15,143**	**9.3**
Nonfinancial	9,930	6.1
Infrastructure	1,258	0.8
Transport	2,899	1.8
Health	1,720	1.1
Parpublica 1/	2,000	1.2
Others	2,054	1.3
Financial	5,115	3.1
Abroad	98	0.1

Source: Ministry of Finance.

1/ A state-owned holding company in charge of the management of equity stakes and real estate assets held by the State. Large holdings include EDP, REN, and TAP.



Source: European Commission, Economic Papers 377, 2009.
1/ Higher indices indicate higher disciplining effects of fiscal rules and budgetary institutions leading to smaller fiscal projection errors.

Authorities' views

31. **The authorities emphasized their commitment to achieving the 3 percent of GDP deficit target by 2013**. They stressed the importance of further reinforcing the credibility gained from the recent consolidation. While 2010 would be particularly challenging given the weak economy, a start to the consolidation process would still be made. It was also recognized that additional measures were required over the medium term, focusing on current primary spending, though it would be difficult to precisely delineate them within a short timeframe.

32. **The authorities underscored progress made on improving fiscal frameworks.** Preparation for introducing performance and medium-term budgeting in 2011 was underway, public enterprise performance was further improving, public administration reforms were bearing fruit, and recent social security reforms have enhanced sustainability. The authorities were not convinced that an independent fiscal council could play a major supporting role in Portugal, and stressed the importance of accountability and credibility of existing institutions in providing independent analysis, forecasts and assessments. Rollover risks were also not seen as significant, evidenced by the smooth placing of debt in 2009, and tighter spreads than many peers, reflecting the government's fiscal credibility.

B. Financial Sector: Mitigating Vulnerabilities and Fostering the Adjustment

33. **Financial stability has been maintained, though vulnerabilities—symptomatic of the macroeconomic imbalances—remain** (Table 6). The large current account deficit is largely intermediated by banks borrowing abroad, which is reflected in Portuguese banks' relatively heavy reliance on foreign wholesale financing and the high levels of credit and indebtedness of the private sector. The crisis has brought these vulnerabilities to the fore.

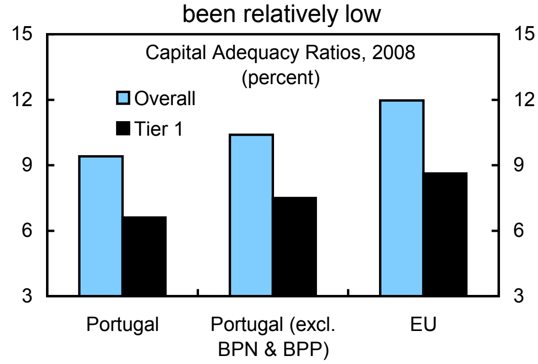
Vulnerabilities of the banking system

34. **Bank concentration and intermediation is high** (Figure 9). The top five banks represent two-thirds of banking sector assets, and though credit growth to the private sector has slowed in 2009, bank financing to the private sector represents some 200 percent of GDP, well above the EU average.

35. **Despite the crisis, Portuguese banks have expanded their balance sheets.** This was made possible primarily by rapid (and unsustainable) growth in deposits from customers who shifted resources away from volatile financial markets in 2008. More recently, banks have relied increasingly on wholesale funding to support their lending and investment activities. As a result, banks' leverage has increased over the past year, particularly in relation to European peers.

36. **Falling profits have dented banks' capital positions.** As the crisis unfolded last year, losses on both bank investment and credit portfolios increased progressively. With an overall capital adequacy ratio of 9.4 percent and 6.6 percent in relation to Tier 1 capital at end-2008, solvency ratios in Portugal, though above regulatory minima, remained below the EU average. Concerns about capital levels have also caused rating agencies to downgrade individual banks over the past year, including the larger banks.

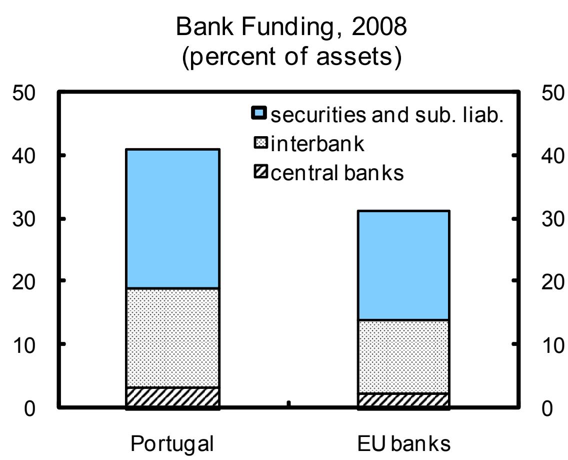
Capital adequacy ratios have been relatively low



Sources: Bank of Portugal, ECB and staff estimates.

37. **Credit risk is mounting as the economic downturn weakens banks' loan book** (Figure 10). NPLs have been increasing quickly, particularly for corporate loans and consumer credit, albeit from a low base. Banks' heightened risk aversion is reflected in rising credit spreads and slower rates of credit growth. Credit has tightened particularly on riskier loans and banks are reporting a decrease in the maturity of credit granted as well as higher collateral requirements. While housing prices in Portugal have not witnessed the boom-bust cycle of other countries, banks' credit portfolios are heavily exposed to the sector (60 percent of the total loan book is tied to real estate). In addition, already considerable concentration risk due to large exposures has risen, as banks increased their lending to more creditworthy corporates, reflecting inter-alia debt restructuring and increased inventory financing.

38. **Other risks remain.** Portuguese banks' investment portfolios are susceptible to both interest and equity risk. At the same time, banking sector reliance on wholesale funding remains substantial[4], accounting for 40 percent of total assets at end-2008 compared to 30 percent for the EU banks as a whole. While banks managed to access the interbank market and continued issuing securities despite the market turbulence, the maturity profile of outstanding bank



Source: Bank of Portugal and ECB.

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[4] Wholesale funding is defined as resources from central banks, other credit institutions and securities, and subordinated liabilities.

debt has shortened in recent years.[5] Looking forward, the liquidity profile of banks may also deteriorate as the temporary increase in assets eligible as collateral for ECB monetary policy operations expires, though this risk for Portuguese banks is very low.

39. **Despite mounting risks, stress tests conducted by the BdP suggest that banks would withstand large shocks.** Under a baseline stress test scenario, capital buffers would remain well above regulatory minima for the next two years. Under a more extreme scenario of a continued deterioration in international economic conditions which in particular heightens global uncertainty and risk perception towards the Portuguese economy, overall regulatory requirements would still be observed, but some capital increases would be needed to bring Tier 1 capital in line with BdP's recent recommendation on Tier 1 capital ratios. These relatively favorable results despite increasing corporate and household loan impairments and direct deductions to capital arising from the stock market shock mainly reflects the offsetting impact of substantial capital increases by banks in 2009 (see below and Annex II).

Fostering stability and adjustment

40. **The BdP and the government have taken a number of decisive measures to address these vulnerabilities which have helped ensure financial stability**. In addition to the government guarantee, recapitalization program, the extension of the deposit guarantee framework, and the recommendation to raise Tier I ratios, a number of other enhancements to the regulatory and supervisory framework were implemented. Banks successfully raised €3.3 billion in capital since the beginning of 2009, with the majority of banks (accounting for more than 87 percent of banking sector assets) reaching Tier 1 ratios over 8 percent by end-September.

41. **Further pro-active measures to address underlying vulnerabilities should be considered.** Many of these are already on the authorities' agenda and will need to be implemented in the context of the evolving European and international financial architecture, and it will be important to prepare the banking system for the coming changes, for example, via the envisaged industry-wide working group on regulatory reform. There are also some areas where Portugal may benefit from moving further or earlier.

- While for the banking sector as a whole the quality of capital is in line with international averages, current regulations that allow for significant shares of non-core capital in Tier I could be gradually tightened. The BdP had already increased its monitoring of liquidity indicators before the crisis, and the planned

[5] As of September 2009, wholesale borrowing with maturity of less than two years accounted for over 40 percent of the outstanding amount (up from around 10 percent a decade ago), though issuance of longer maturities has picked up again in 2009.

introduction of minimum liquidity ratios in 2010 would be a further welcome step. Over time, if private sector indebtedness does not adjust, consideration should be given to other ways to mitigate this macro-prudential vulnerability.

- The implications of the envisaged switch to the "twin peaks" model of financial sector supervision (with the BdP responsible for consolidated supervision and an autonomous agency for consumer protection) should be carefully assessed and cautiously implemented to build upon the strengths of the existing system.

- The existing toolkit for intervening troubled financial institutions should be reviewed in the light of recent experience. In particular, a special resolution framework for financial institutions could support faster, and less costly, resolution, and there seems scope for greater inter-agency coordination on such issues, for example, via strengthening the Domestic Standing Group (CNEF).

- The BdP already conducts thorough stress tests and intends to do more in the future. More timely and detailed disclosure of the results and methodology would help financial firms, authorities and the wider public in understanding, managing and preparing for these risks, as could increasing the periodicity of financial stability reports and providing multi-year macroeconomic projections. Transparency would also be enhanced by bringing disclosure requirements on loan losses by banks further into line with those of others in the euro area.

- To increase household saving, schemes such as complementary pensions could be further promoted. The recent survey of financial literacy should be followed up, possibly including establishing a nationally co-ordinated financial literacy campaign.

Authorities' views

42. **The authorities agreed that high debt levels of households and firms continue to weigh on financial sector prospects and that some risks have risen.** However, they viewed the adjustment process as already underway as household indebtedness has stabilized and the household savings rate has increased. In addition, in spite of the lower interest rate environment, credit growth continued to decline reflecting a sharp reduction in aggregate demand and, to a lesser extent, banks' heightened risk aversion. They also emphasized that while non-performing loans were rising, credit risk would be mitigated by the fact that housing prices have held up and were not subject to the boom-bust cycles experienced in other countries during the crisis.

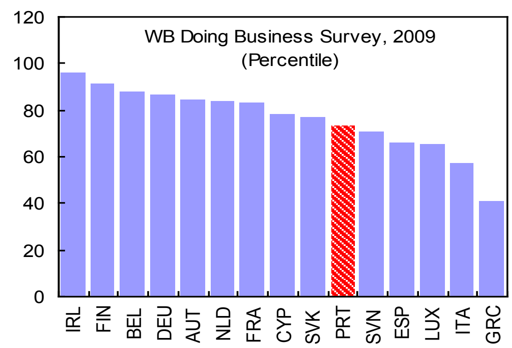
43. **The authorities stressed that banks have been resilient to the crisis and that their balance sheets have improved as a result of successful capital raising operations in 2009.** The authorities pointed out that wholesale funding conditions had improved from

the peak of the crisis, that spreads for the sovereign and the private sector had declined, Portuguese banks' recourse to exceptional ECB facilities had been modest, and that banks have managed to attract longer-term deposits. It was also noted that liquidity monitoring by the BdP had been intense and, partly as a result, banks' liquidity positions were strong.

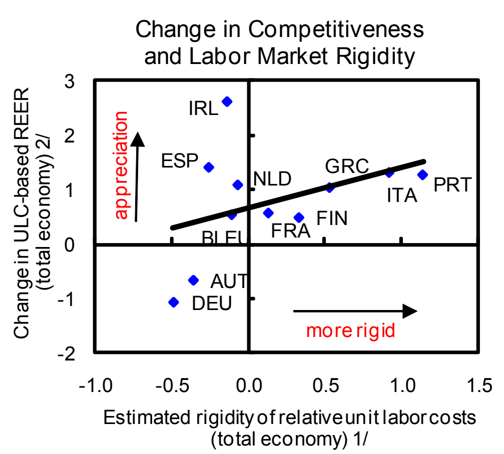
44. **The authorities broadly agreed with the financial sector reform agenda.** They stressed, however, that reforms would need to be closely coordinated with those taking place at the European level. The BdP expressed some concern that more detailed publication of individual stress tests might be counterproductive and that the NPLs concept reported by Portuguese banks was adequate given the lack of a clear global standard.

C. Fixing the Productivity and Competitiveness Problems

45. **While there are pockets of strength and reforms have been undertaken in recent years, more is needed** (Figure 11). Productivity growth remains weak, the competitiveness gap large, and Portugal continues to score poorly on various indicators of economic framework conditions. And while many of the problems are long-term, such as the judicial system and low levels of education, making Portugal's still-highly regulated product, service, and labor markets more competitive and flexible would provide a substantial boost and, critically, the right incentives to innovate and invest.



Source: World Bank



Source: European Commission
1/ The cyclical responsiveness of relative unit labor costs among euro area countries as in Arpaia and Pichelmann (2007).
2/ The average of annual percentage change in ULC-based real effective exchange rate from 1999-2008.

46. *Product and service markets*. The EU Services Directive should be grasped as an opportunity to make a clean sweep of legislation, including at local levels. The SIMPLEX program, which has already shown its usefulness, should be continued with greater focus on a few key problems, such as licensing, as planned. The effectiveness of the competition agency should also be further enhanced, for example, through strengthening the Competition Act.

47. *Labor markets.* The recent labor code revision is an important step and should be carefully implemented and assessed for effectiveness. The unemployment benefit system should be

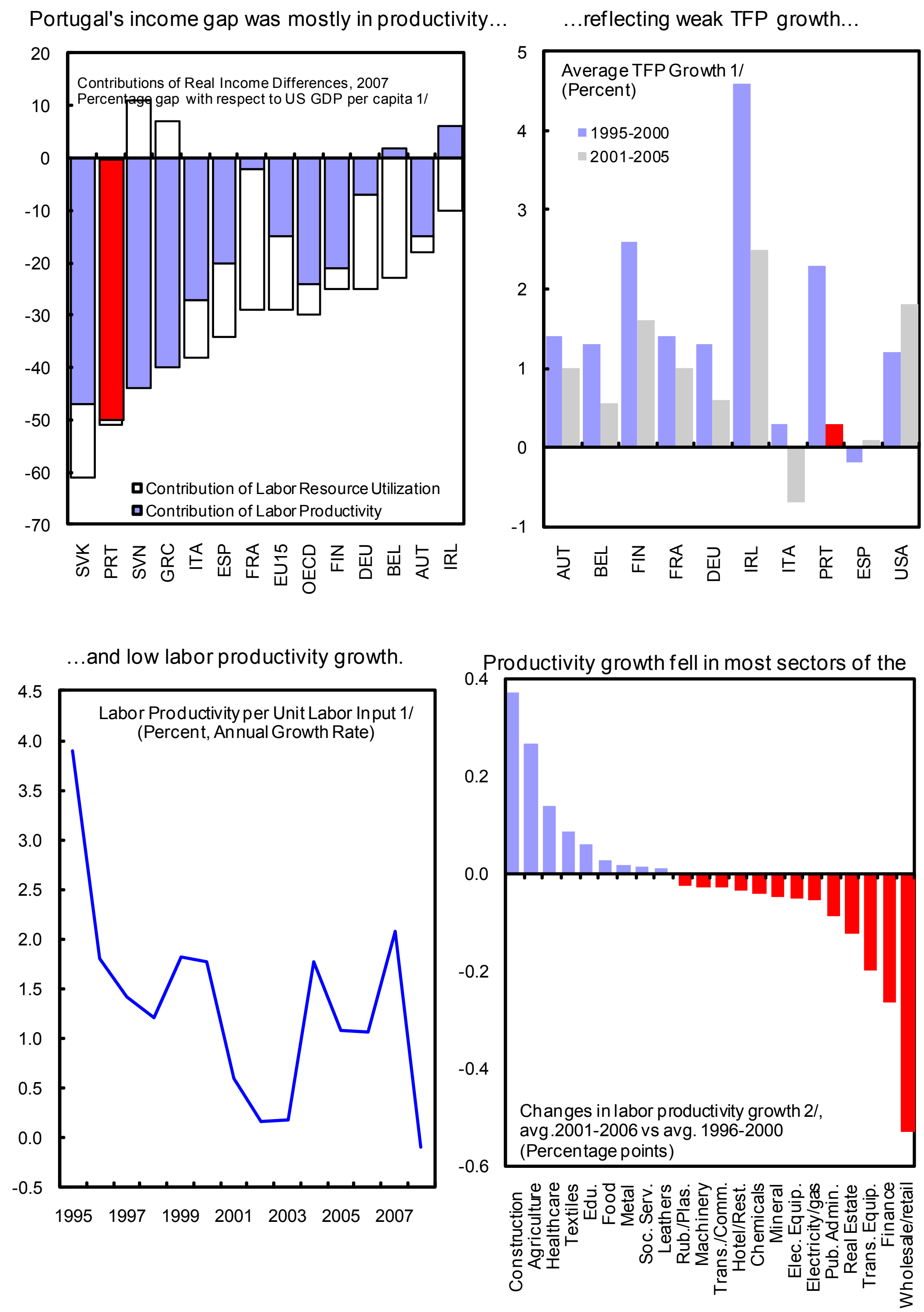
examined to see if it can be made more effective and better-targeted, especially in terms of incentives to find work over time. The planned large increases in the minimum wage now look even more out of line with economic fundamentals and should be reconsidered.[6]

Authorities' views

48. **The authorities emphasized the important progress on structural reforms in recent years.** On the product market front, the SIMPLEX programs continue to bear fruit, the EU services directive remains on track for approval at end-2009, and the Competition Agency had been effectively reorganized. The revision to the labor code introduced greater flexibility, especially for working-time adaptability, and substantially lowered the OECD's assessment of employment protection for Portugal. The strategy of enhancing public investment in tradable and R&D spending, focusing on where Portugal has a comparative advantage and world trade is growing, will also enhance competitiveness, as would the significant recent reforms of the education and health sectors. While acknowledging the potential importance of other reforms, the authorities stressed the need for fully implementing and assessing the impact of existing reforms.

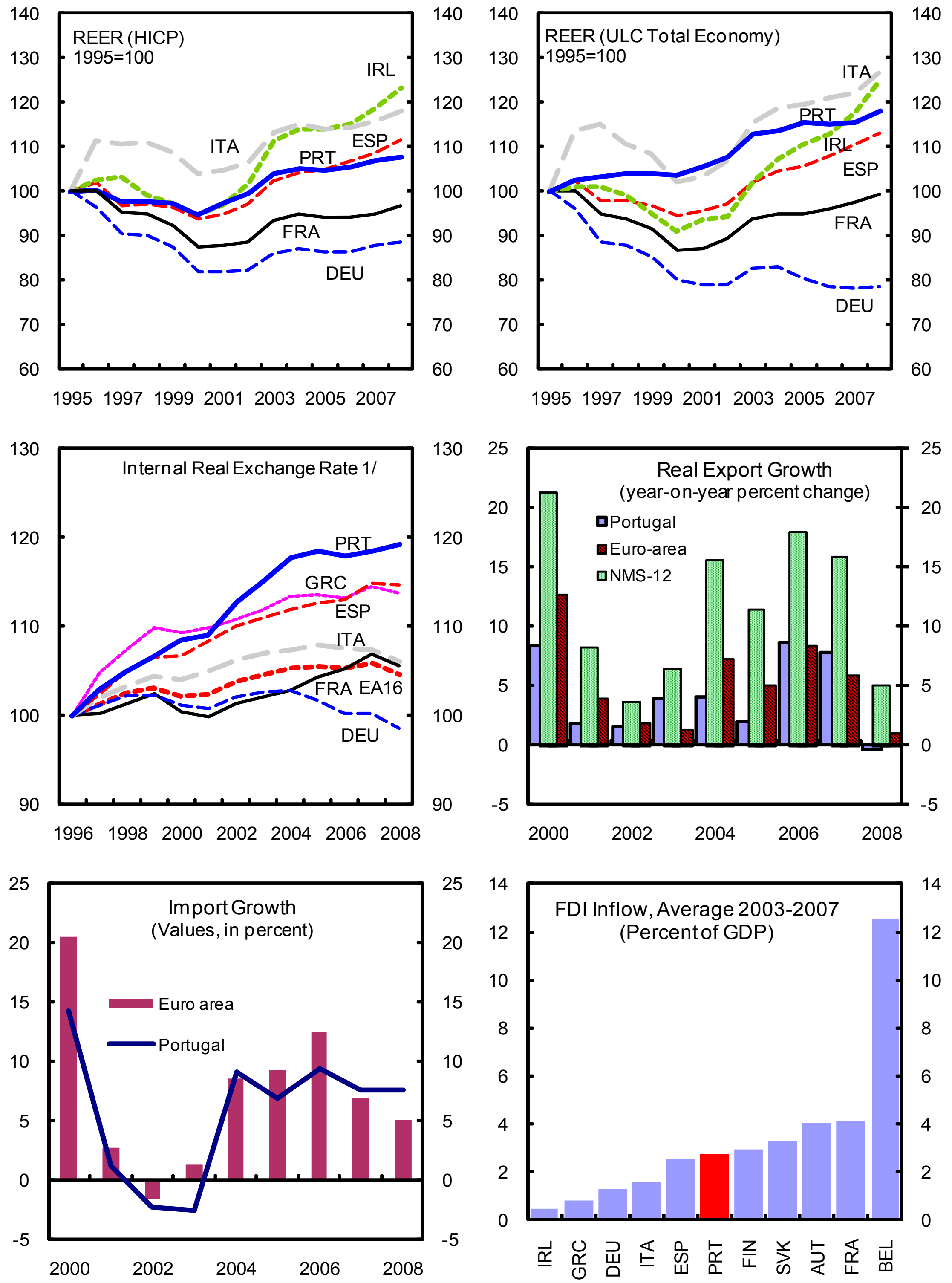
[6] At end-2006, the government and the social partners signed an agreement to increase the statutory minimum wage at an annual rate of about 5.3 percent over 2007–11. The statutory minimum wage covers about 5 percent of the workforce. Following the increases of about 5.6 percent in 2008 and 2009, the government has recently approved another 5.6 percent increase in 2010 to €475/monthly as planned.

Figure 1. Productivity Indicators



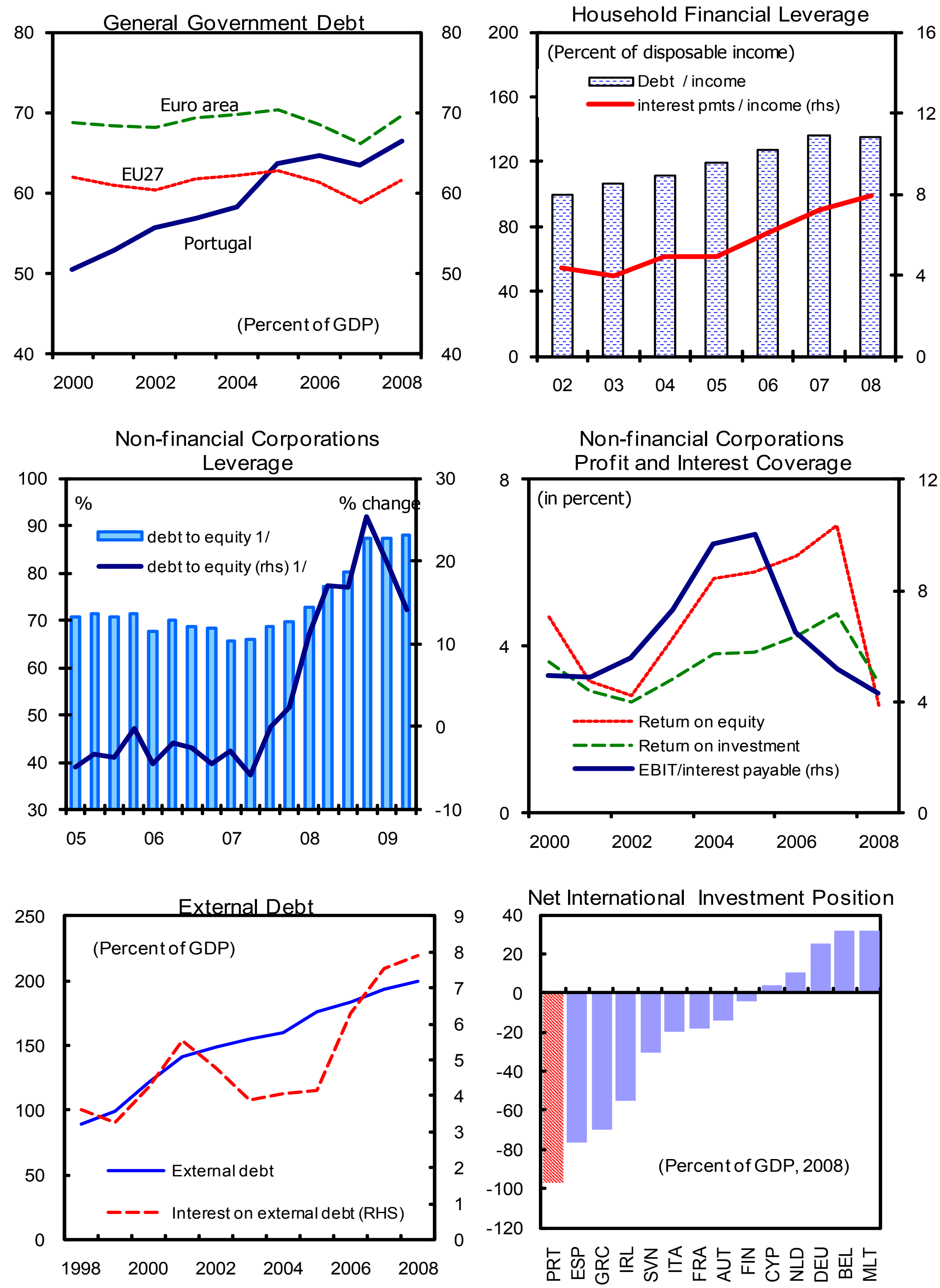
Source: OECD, BoP, and IMF Staff Calculations
1/ Data are from OECD. The latest available data for Portugal's total factor productivity growth were up to 2005.
2/ Data are from BoP.

Figure 2. Competitiveness Indicators



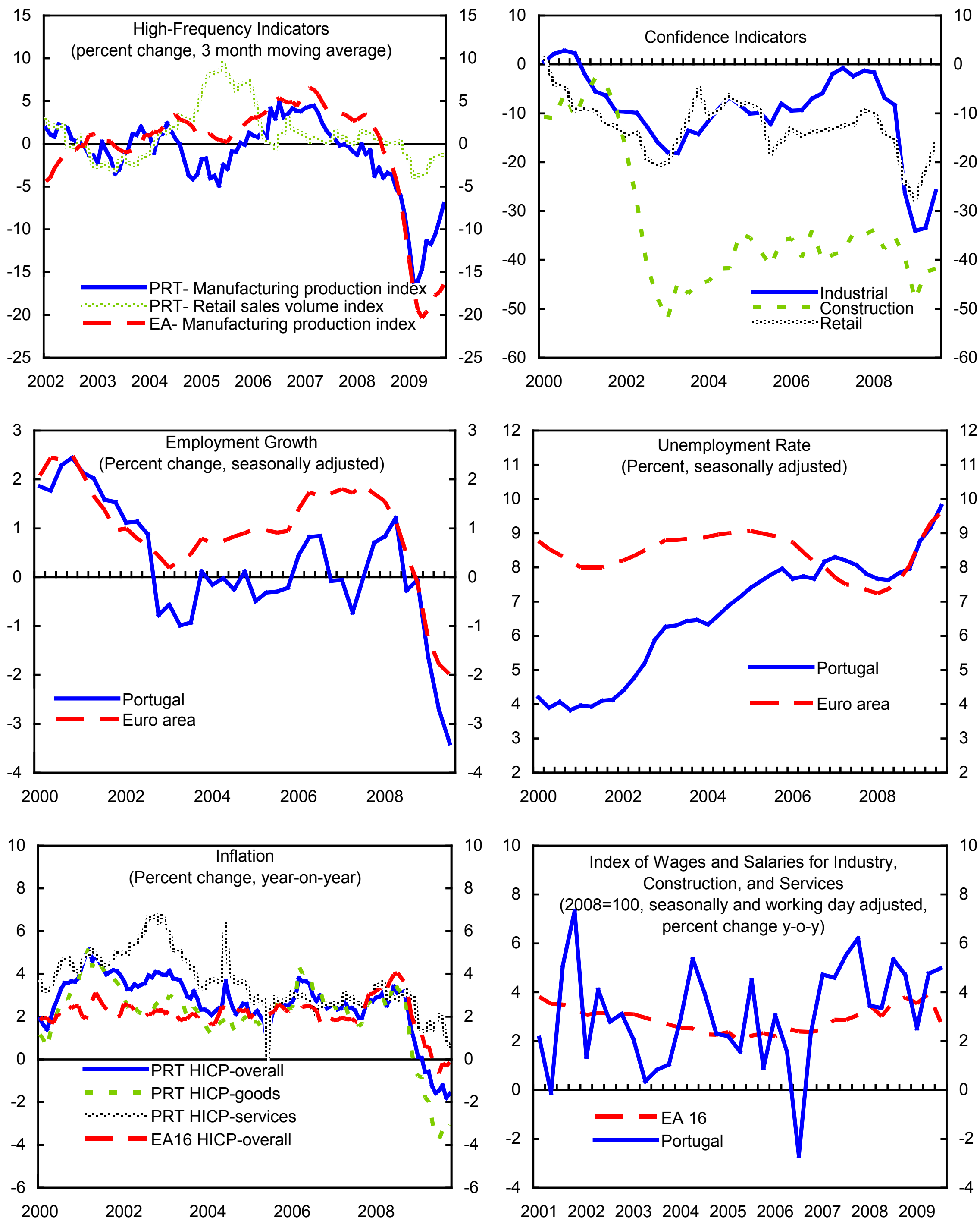
Source: European Commission, IFS Statistics, OECD, and IMF Staff Calculations
1/ The ratio of non-tradable to tradable prices proxied by using services vs manufactured goods prices.

Figure 3. Debt Indicators



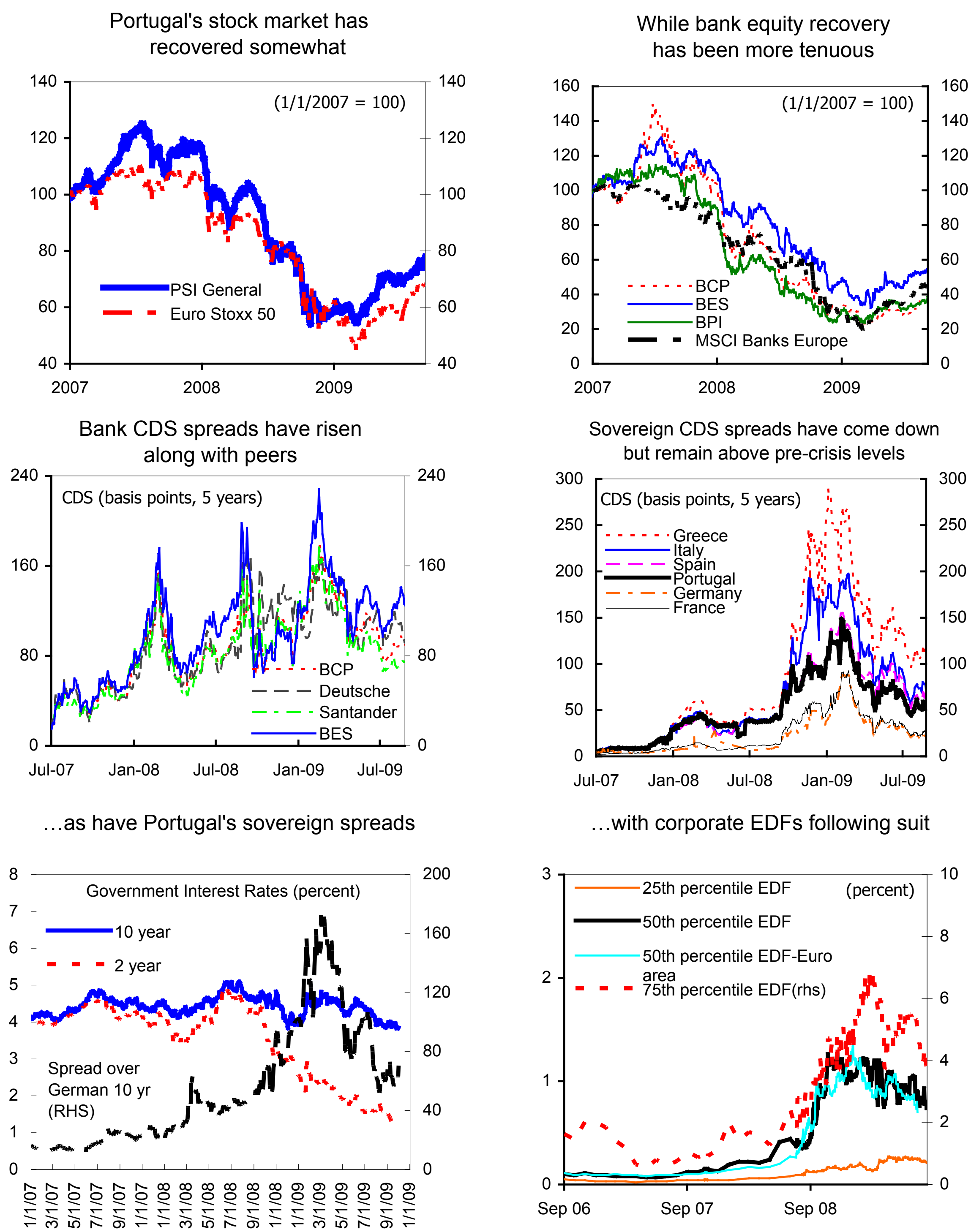
Sources: Bank of Portugal, Eurostat and staff calculations.
1/ Non-consolidated figures.

Figure 4. High Frequency Indicators



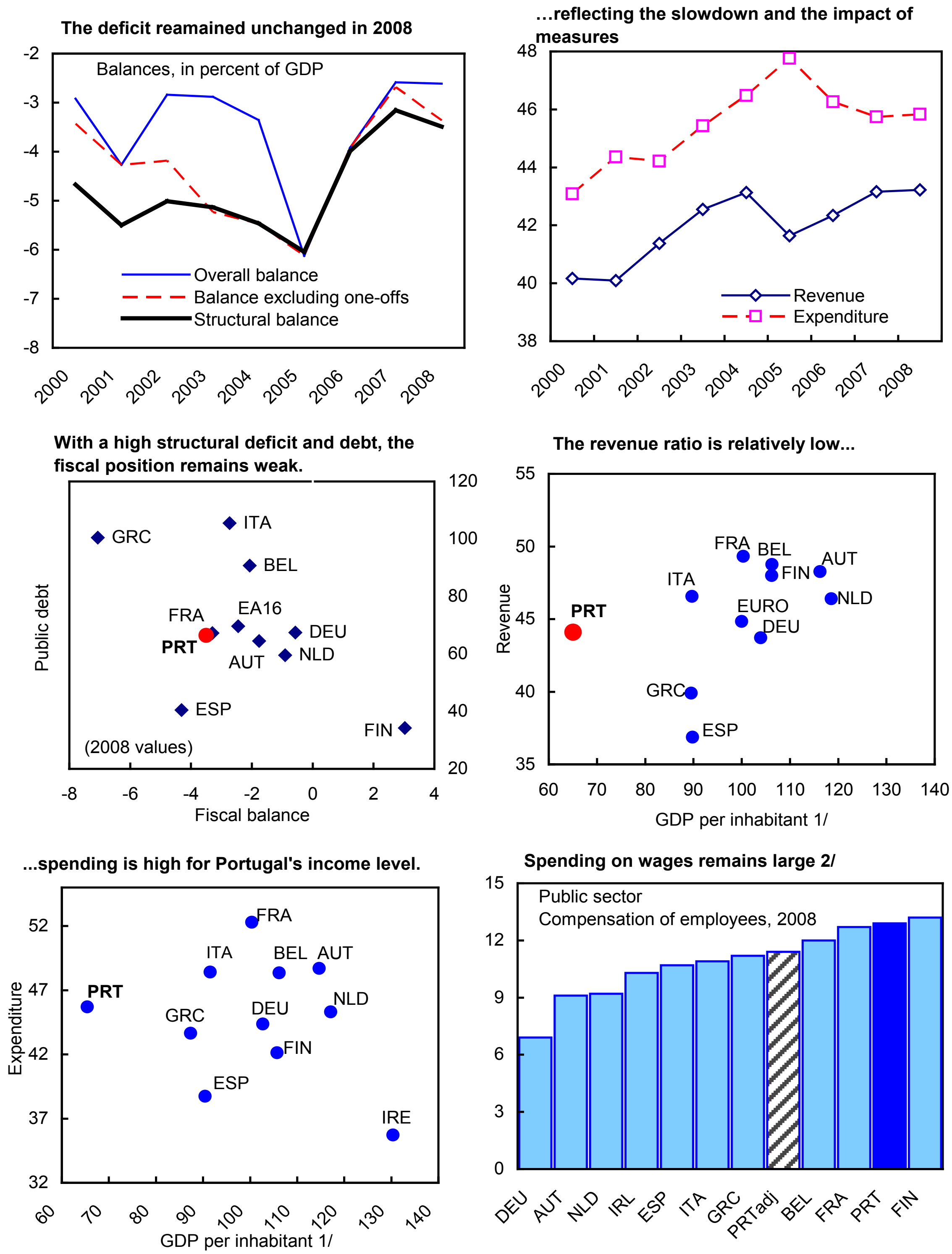
Source: Instituto Nacional de Estatística; Eurostat; and IMF Staff Calculations

Figure 5. Recent Financial Indicators



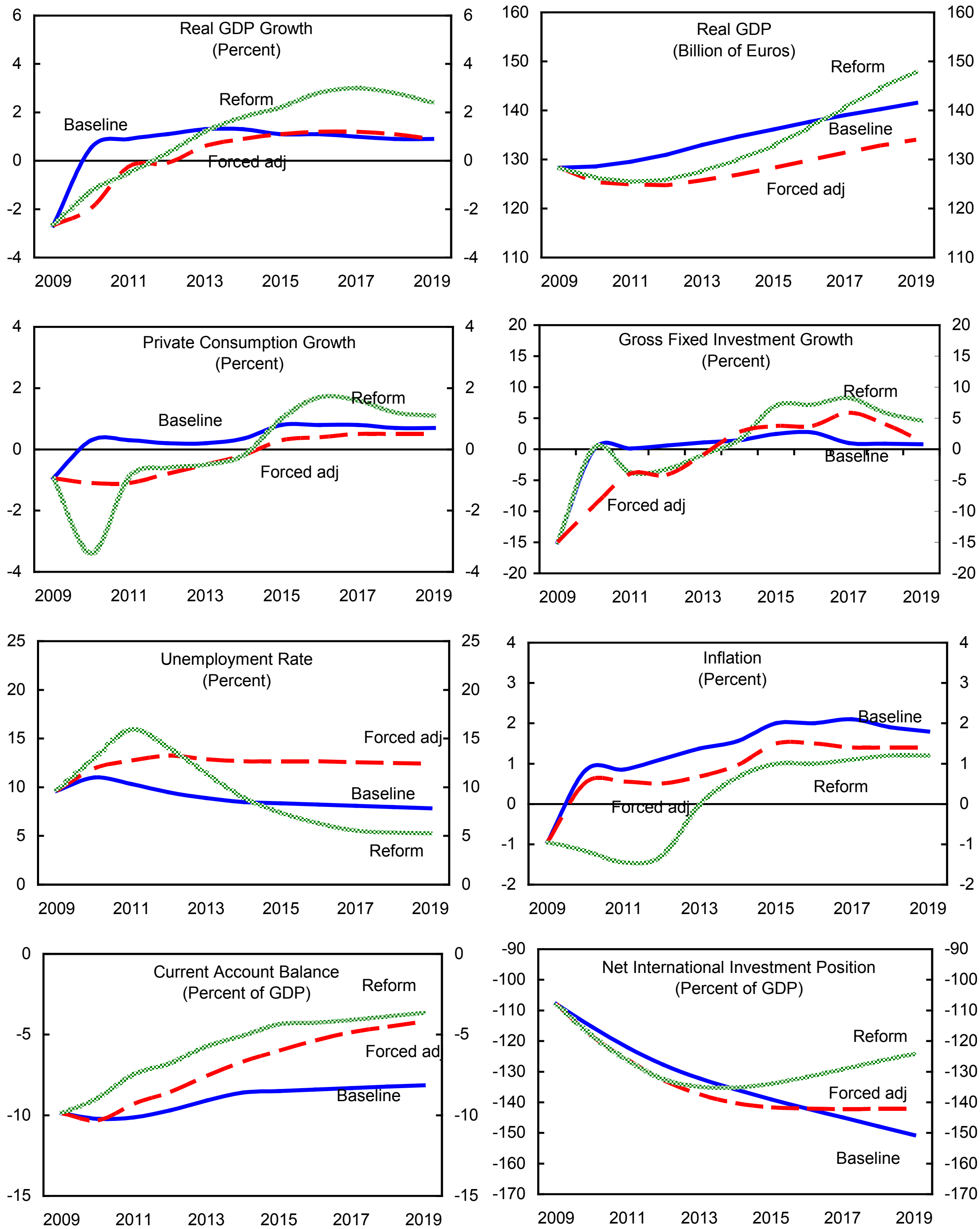
Sources: Thomson Financial, Bloomberg and Moody's KMV.

Figure 6. Fiscal Indicators
(Percent of GDP, unless otherwise indicated)



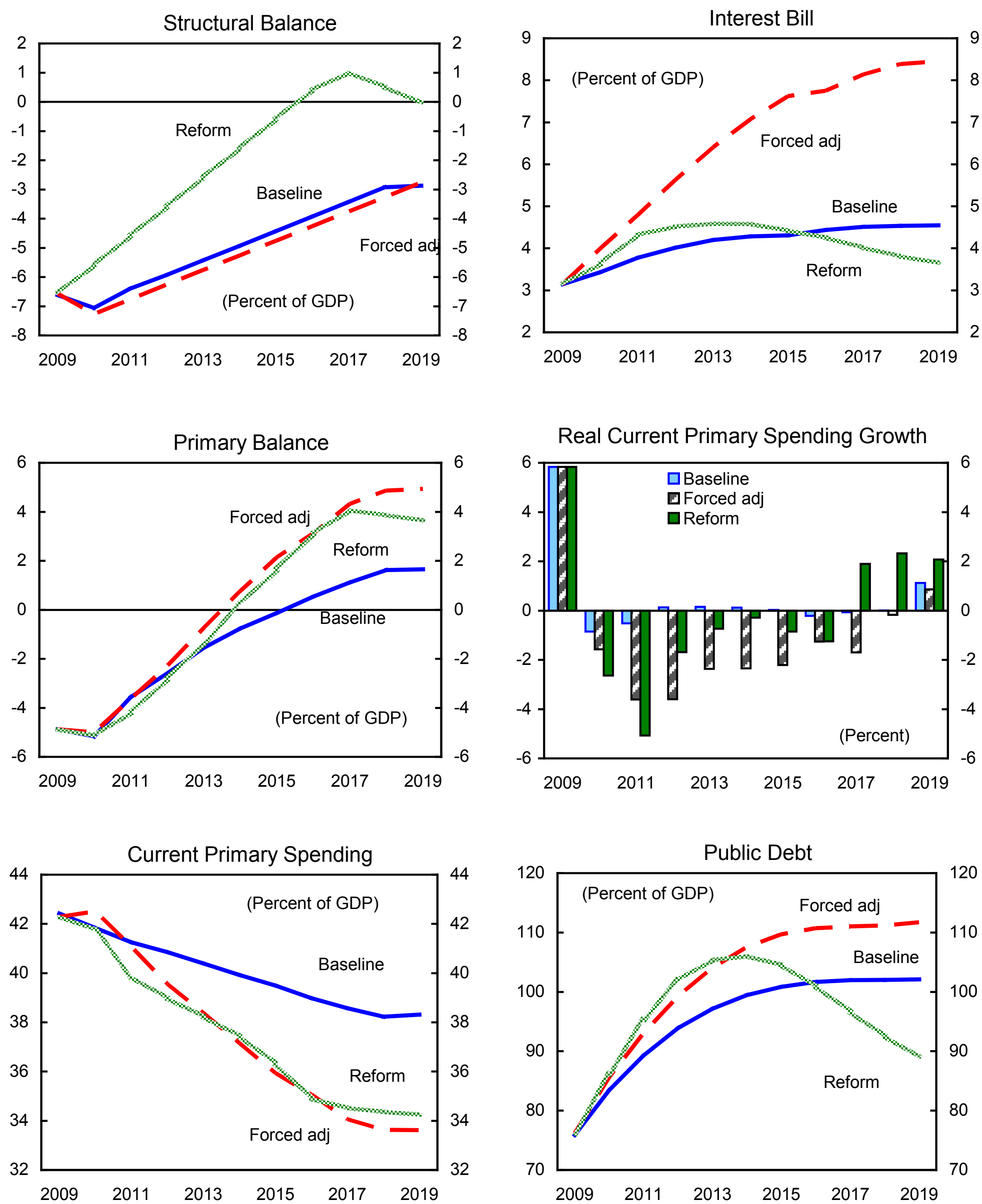
Sources: Bank of Portugal; IMF staff calculations; and Eurostat.
1/ euro area=100; data are as of 2007.
2/ PRT adj refers to compensation after the accounting change introduced from 2009.

Figure 7. Macroeconomic Indicators under Different Scenarios



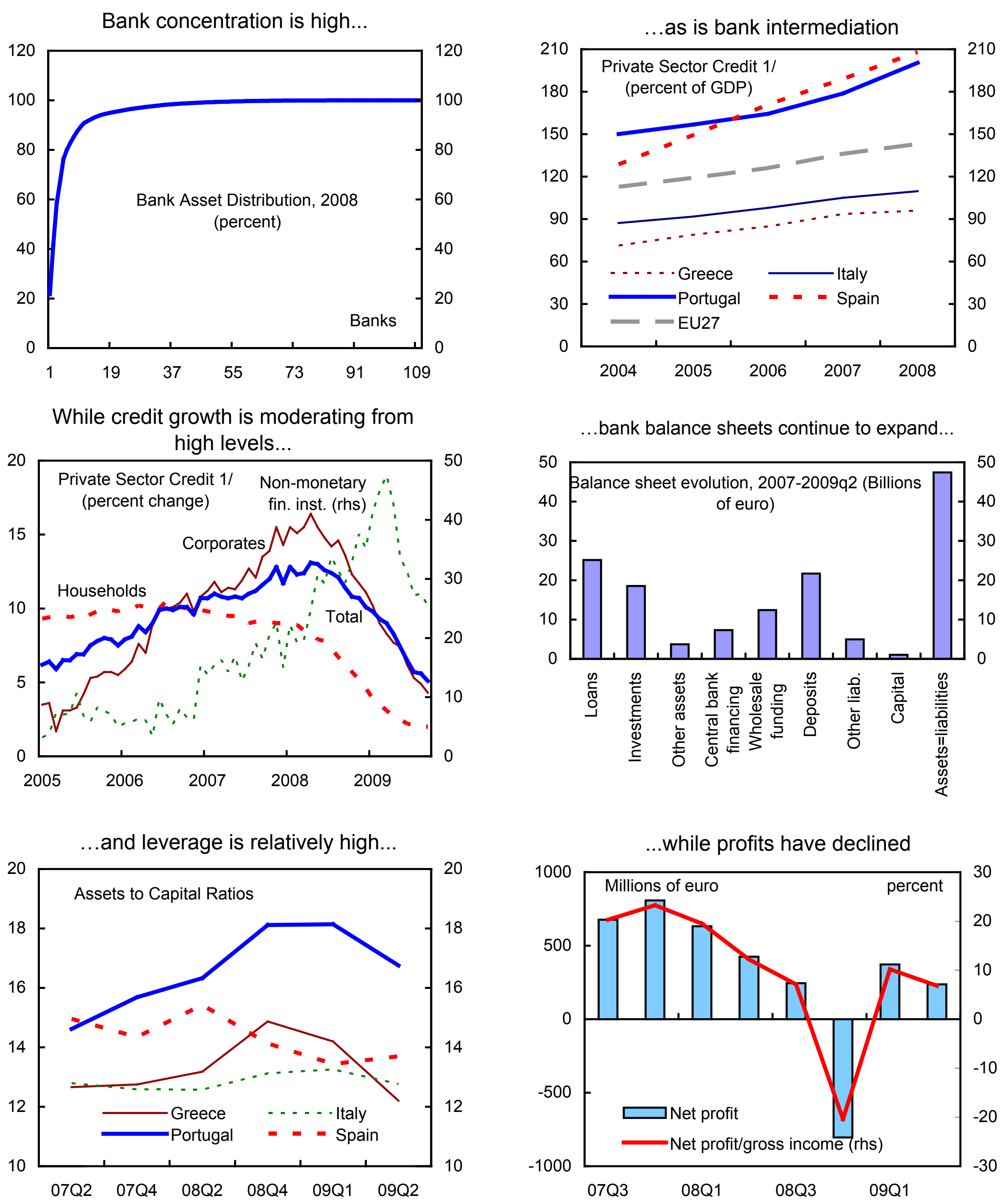
Source: Staff estimates.

Figure 8. Fiscal Indicators under Different Scenarios



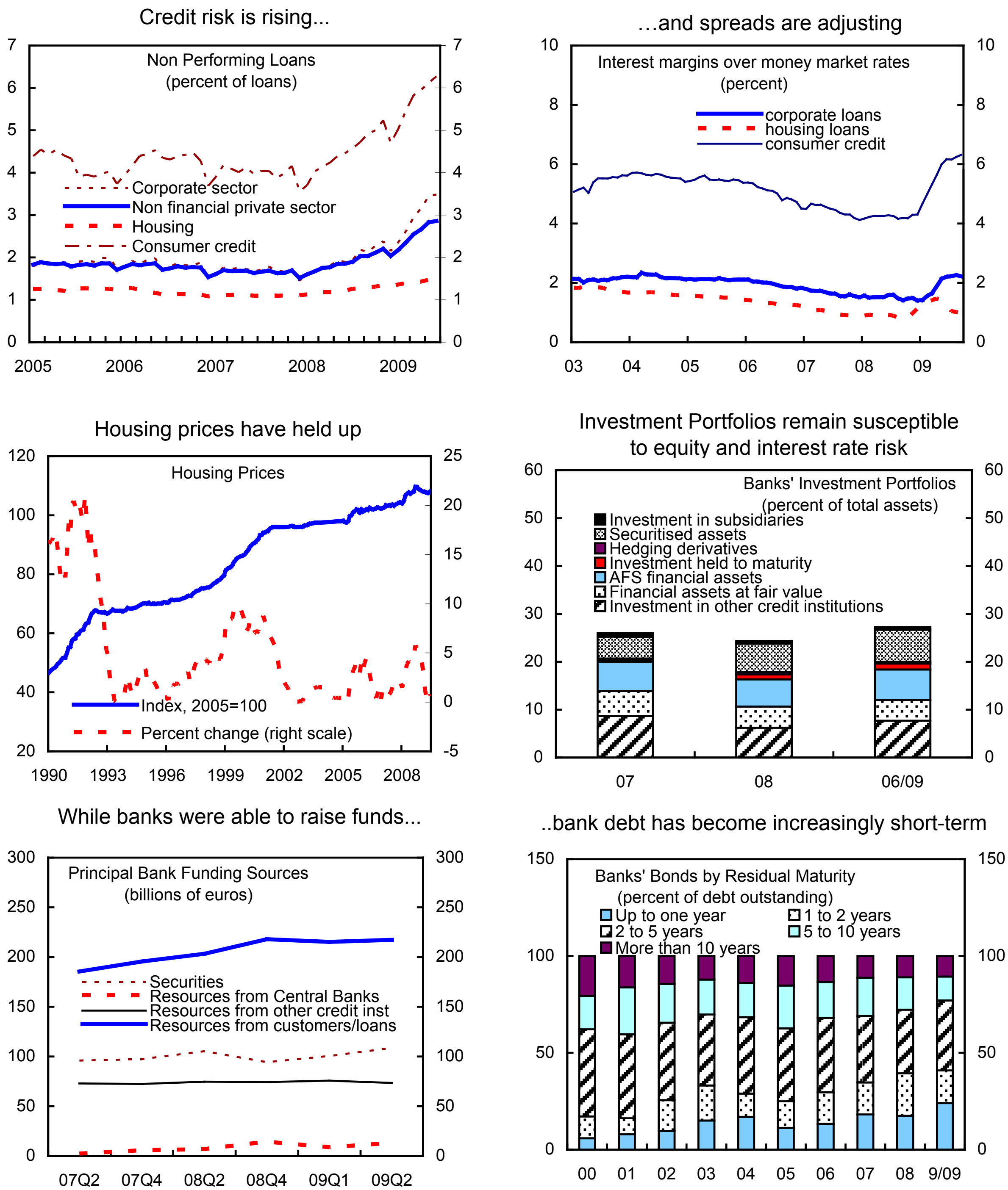
Source: Staff estimates.

Figure 9. Banking Sector Developments



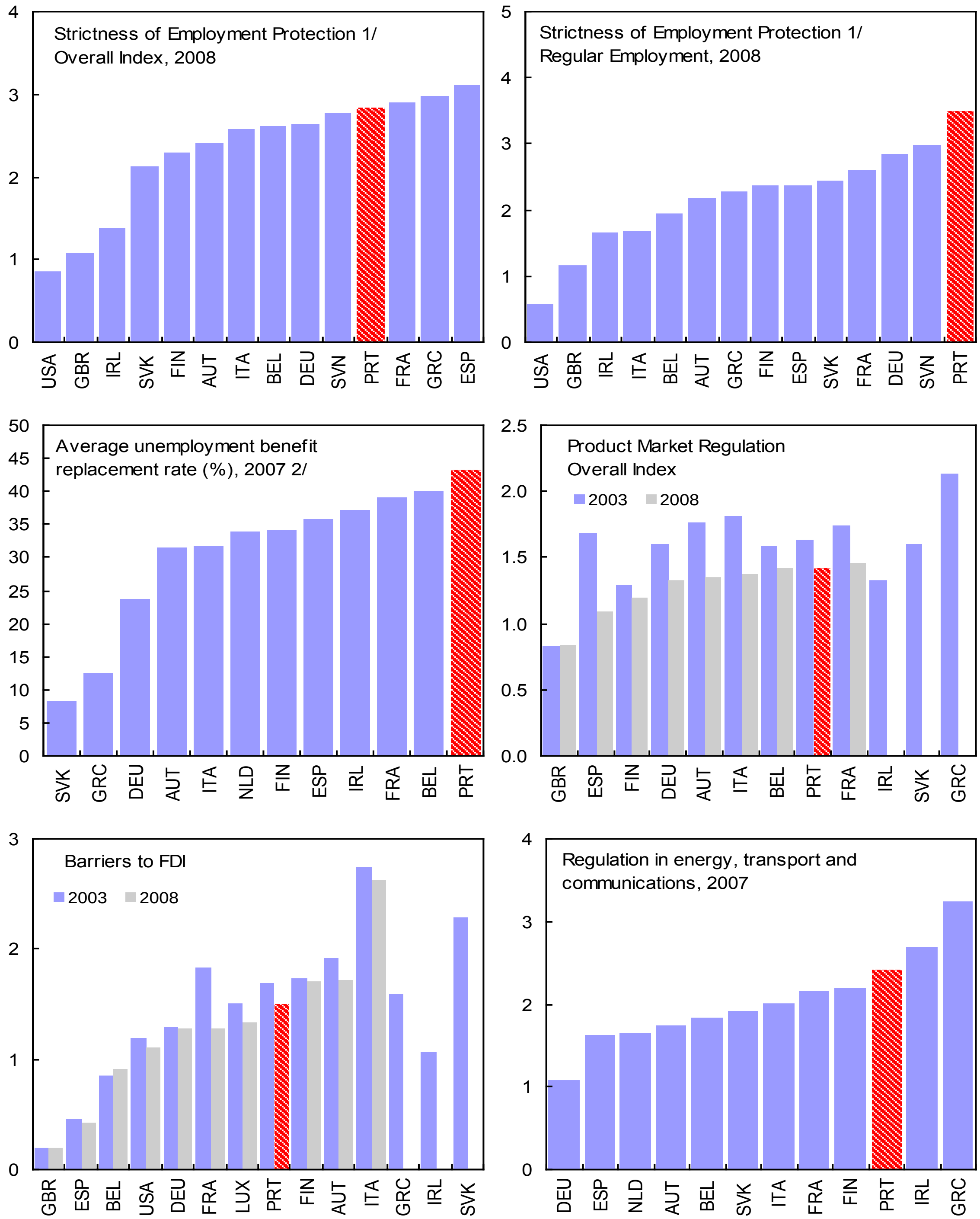
Sources: Bank of Portugal; Bank of Spain; Bank of Italy; Bank of Greece; and ECB.
1/ Adjusted for securitization operations.

Figure 10. Banking Sector Vulnerabilities



Sources: Bank of Portugal.

Figure 11. Labor and Product Market Indicators



Source: OECD

1/ The OECD indicators of employment protection are synthetic indicators of the strictness of regulation on dismissals. Data for Portugal and France are as of 2009.

2/ Average unemployment benefit replacement rate across two income situations (100% and 67% of APW earnings), three family situations (single, with dependent spouse, with spouse in work) and three different unemployment durations (1st year, 2nd and 3rd years, and 4th and 5th year of unemployment). The benefits are a percentage of average earnings before tax.

Table 1. Portugal: Selected Economic Indicators, 2004–10
(Changes in percent, except as otherwise indicated)

	2004	2005	2006	2007	2008	Proj. 2009	Proj. 2010	Latest %y-o-y	
Domestic economy									
Real GDP	1.5	0.9	1.4	1.9	0.0	-2.7	0.5	-2.5	Q3 09
Real domestic demand	2.7	1.6	0.7	1.7	1.3	-2.9	0.3	-2.5	Q3 09
Private consumption	2.5	2.0	1.9	1.6	1.7	-0.9	0.3	-1.1	Q3 09
Public consumption	2.6	3.2	-1.4	0.0	1.1	4.4	0.7	2.4	Q3 09
Gross fixed investment	0.2	-0.9	-0.7	3.1	-0.7	-15.0	0.0	-7.4	Q3 09
Foreign sector contribution	-1.4	-0.8	0.6	0.0	-1.4	0.5	0.2	0.2	Q3 09
Savings-investment balance (percent of GDP)									
Gross national savings	15.5	13.1	12.2	12.8	10.2	8.9	8.5	…	…
Private	17.9	16.3	13.8	12.8	11.1	15.1	15.2	…	…
Government	-2.4	-3.2	-1.6	0.0	-0.9	-6.2	-6.7	…	…
Gross domestic investment	23.1	22.6	22.2	22.2	22.3	18.8	18.7	…	…
Private	20.0	19.6	19.8	19.9	20.1	15.8	15.7	…	…
Government	3.1	2.9	2.4	2.3	2.2	3.0	3.0	…	…
Resource utilization									
Employment	0.1	0.0	0.7	0.2	0.5	-3.0	-1.6	-3.4	Q3 09
Unemployment rate	6.7	7.6	7.7	8.0	7.6	9.6	11.0	9.8	Q3 09
Real potential GDP	1.3	1.1	1.0	0.9	0.8	0.3	0.1	…	…
Output gap	0.0	-0.2	0.2	1.2	0.4	-2.6	-2.1	…	…
Labor productivity	1.4	0.9	0.6	1.7	-0.5	0.3	2.2	…	…
Compensation per worker (whole economy)	2.4	3.9	2.7	3.4	3.1	4.8	0.8	5.0	Q3 09
Unit labor costs (whole economy)	0.9	3.0	2.1	1.7	3.7	1.6	-1.3	…	…
Prices									
Consumer prices (harmonized index)	2.5	2.1	3.0	2.4	2.7	-0.9	0.8	-1.6	Oct 09
GDP deflator	2.4	2.5	2.8	3.0	2.0	0.5	0.9	1.1	Q3 09
External accounts									
Export volume (goods)	3.0	2.0	7.6	6.1	-1.4	-14.4	1.3	-9.9	Q3 09
Import volume (goods)	6.7	3.2	4.8	6.4	2.5	-12.2	0.6	-7.7	Q3 09
Export unit value (goods and services)	1.5	1.9	4.2	2.8	3.2	-4.9	1.2	-4.8	Q3 09
Import unit value (goods and services)	2.2	3.2	4.0	1.5	4.9	-8.7	1.0	-8.8	Q3 09
Current account (percent of GDP)	-7.6	-9.5	-10.0	-9.4	-12.1	-9.9	-10.2	…	…
Nominal effective exchange rate	0.8	0.1	0.2	1.3	2.0	…	…	2.5	Oct 09
Real effective exchange rate (CPI based)	1.0	0.2	0.7	1.8	1.2	…	…	1.5	Oct 09
General government finances (percent of GDP)									
Revenues	43.1	41.6	42.3	43.2	43.2	41.7	39.9	…	…
Expenditures	46.5	47.7	46.3	45.7	45.9	49.7	48.5	…	…
Overall balance	-3.4	-6.1	-3.9	-2.6	-2.7	-8.0	-8.6	…	…
Excluding one-off measures	-5.5	-6.1	-3.9	-2.7	-3.4	-8.1	-8.6		
Government debt, Maastricht definition	58.3	63.6	64.7	63.6	66.3	75.8	83.3	…	…
Financial variables 1/									
National contribution to euro area M3 2/	5.5	6.1	3.1	8.1	12.9	…	…	-1.4	Sep 09
Bank loans granted to the nonfinancial private sector 3/	6.1	7.7	8.7	9.9	7.1	…	…	2.8	Sep 09
Interest rates (percent)									
Overnight rate	2.2	2.4	3.7	3.9	2.4	…	…	0.4	Oct 09
Deposit rate, up to 2 years 4/	2.0	2.1	2.7	3.6	4.0	…	…	2.1	Sep 09
Loans granted to nonfinancial corporations 5/	4.3	4.4	5.4	6.2	6.1	…	…	3.5	Sep 09
Government benchmark bond	3.6	3.5	4.0	4.5	4.0	…	…	3.9	Oct 09

Sources: Bank of Portugal; Ministry of Finance; National Statistics Office (INE); Eurostat; 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.
4/ Deposits to the nonfinacial private sector with an agreed maturity up to 2 years (outstanding ammounts).
5/ Loans granted to nonfinancial corporations (outstanding ammounts).

Table 2. Portugal: Balance of Payments, 2005–14
(Percent of GDP)

					Projections					
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Current account	**-9.5**	**-10.0**	**-9.4**	**-12.1**	**-9.9**	**-10.2**	**-10.1**	**-9.7**	**-9.1**	**-8.6**
Trade balance	-11.0	-10.8	-10.8	-12.8	-10.2	-10.1	-9.6	-9.0	-8.2	-7.7
Exports fob	20.8	22.3	23.2	23.0	19.1	19.3	19.9	20.4	21.0	21.5
Imports fob	31.8	33.1	33.9	35.8	29.4	29.4	29.5	29.4	29.2	29.2
Services, net	2.6	3.2	4.0	3.9	3.0	3.0	3.1	3.3	3.5	3.7
Exports	8.2	9.4	10.4	10.8	8.9	8.9	9.0	9.2	9.3	9.5
Imports	5.6	6.2	6.4	6.8	5.9	5.9	5.9	5.9	5.9	5.9
Of which:										
Tourism	2.5	2.6	2.8	2.7	2.0	2.0	2.1	2.2	2.3	2.4
Exports	4.2	4.3	4.5	4.5	3.8	3.8	3.8	3.9	4.0	4.1
Imports	1.6	1.7	1.8	1.8	1.8	1.7	1.7	1.7	1.7	1.7
Income	-2.6	-4.1	-4.2	-4.7	-4.1	-4.6	-5.2	-5.5	-5.8	-6.0
Current transfers, net	1.5	1.6	1.6	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Private remittances, net	1.2	1.4	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Official transfers, net	0.3	0.2	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Capital account	**1.2**	**0.8**	**1.3**	**1.7**	**1.3**	**1.3**	**1.3**	**1.3**	**1.3**	**1.3**
Current account (including capital transfers)	-8.3	-9.2	-8.1	-10.5	-8.6	-8.9	-8.8	-8.4	-7.8	-7.3
Financial account	**8.8**	**9.1**	**8.1**	**10.8**	**8.6**	**8.9**	**8.8**	**8.4**	**7.8**	**7.3**
Direct investment	1.0	1.9	-1.1	0.6	2.1	1.1	1.0	0.8	0.7	0.7
Portuguese investment abroad	-1.1	-3.7	-2.5	-0.9	0.6	-0.4	-0.5	-0.6	-0.7	-0.8
Foreign investment in Portugal	2.1	5.6	1.4	1.4	1.5	1.5	1.5	1.5	1.5	1.5
Portfolio investment, net	-0.8	2.5	6.2	8.3	6.6	6.8	6.8	6.4	6.0	5.6
Equity securities	2.1	-0.2	-0.9	2.9	1.4	1.6	1.6	1.5	1.4	1.3
Long-term debt securities	-3.9	3.8	4.9	1.0	1.7	1.7	1.6	1.5	1.4	1.3
Money market instruments	1.0	-1.1	2.2	4.4	3.5	3.6	3.6	3.4	3.1	2.9
Financial derivatives	-0.1	-0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other investment, net	7.7	3.6	2.4	1.9	-0.2	0.9	1.0	1.0	1.0	0.9
Of which:										
Monetary financial institutions	4.6	6.6	4.9	3.5	...	...	...	...	...	...
Of which:										
Short-term	2.9	-0.9	-0.4	3.4	...	...	...	...	...	...
Long-term	1.8	7.5	5.3	0.1	...	...	...	...	...	...
Reserve assets	1.0	1.2	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Net international investment position 1/	-71.0	-80.7	-91.3	-97.1	-107.9	-115.3	-122.1	-127.8	-132.2	-135.8

Sources: Bank of Portugal; and IMF staff calculations.

1/ End-of-period data.

Table 3. Portugal: General Government Accounts, 2005 - 14 1/

	2005	2006	2007	2008	2009 SGP09	2009 ROPO	2009 IMF	Staff Projections 2010	2011	2012	2013	2014
						(Millions of euros)						
Total revenues	61,986	65,817	70,372	71,978	74,563	71,112	67,895	65,952	68,097	70,471	73,226	75,868
Current receipts	59,838	64,048	68,910	70,420	70,574	67,124	63,961	63,613	65,548	67,864	70,337	72,894
Tax revenue	34,958	37,666	40,441	40,808	41,572	38,563	35,469	35,949	37,019	38,303	39,832	41,428
On goods and services	22,384	23,947	24,535	24,291	25,030	22,893	20,210	20,670	21,327	22,026	22,896	23,777
Direct taxes	12,574	13,719	15,905	16,517	16,542	15,670	15,259	15,279	15,692	16,277	16,936	17,651
Social security contributions	18,697	19,360	20,717	21,552	19,235	18,866	19,345	19,141	19,853	20,687	21,390	22,086
Other current revenues	6,183	7,021	7,753	8,061	9,767	9,695	9,147	8,523	8,676	8,874	9,115	9,379
Capital revenues	2,148	1,769	1,462	1,559	3,988	3,988	3,934	2,339	2,549	2,607	2,890	2,974
Total expenditures	71,069	71,909	74,590	76,434	81,215	80,771	80,959	80,135	80,422	81,818	83,362	85,033
Primary current expenditures	60,786	62,344	64,309	67,103	68,665	68,721	69,001	69,025	69,275	70,181	71,261	72,477
Compensation of employees	21,541	21,174	21,059	21,436	18,718	18,718	18,812	18,807	18,868	18,932	19,044	19,179
Intermediate consumption	6,316	6,392	6,755	7,241	7,707	7,707	7,784	7,729	7,699	7,807	7,947	8,106
Subsidies	2,339	2,231	1,901	1,970	3,210	3,137	3,077	2,972	2,723	2,510	2,349	2,326
Social transfers	27,516	29,181	31,334	33,163	35,120	35,247	35,416	36,297	36,708	37,649	38,549	39,614
Other	3,075	3,366	3,260	3,293	3,910	3,912	3,912	3,220	3,277	3,283	3,372	3,252
Interest payments	3,887	4,267	4,592	4,835	5,626	5,126	5,120	5,660	6,339	6,892	7,403	7,776
Capital expenditures	6,396	5,298	5,690	4,497	6,924	6,924	6,838	5,449	4,807	4,745	4,697	4,779
Fixed capital formation	4,374	3,696	3,762	3,622	4,821	4,820	4,884	4,954	4,379	4,470	4,591	4,670
Net lending	2,022	1,602	1,928	875	2,104	2,104	1,954	495	429	275	106	109
Overall balance 2/ 3/	-9,083	-6,092	-4,218	-4,456	-6,652	-9,659	-13,064	-14,182	-12,325	-11,347	-10,136	-9,165
Excluding one-off measures	-9,083	-6,092	-4,381	-5,704	-6,652	-9,659	-13,226	-14,182	-12,325	-11,347	-10,136	-9,165
						(Percent of GDP)						
Total revenues	41.6	42.3	43.2	43.2	44.1	43.6	41.7	39.9	40.5	41.0	41.5	41.7
Current receipts	40.1	41.2	42.3	42.3	41.7	41.2	39.3	38.5	39.0	39.5	39.8	40.1
Tax revenue	23.4	24.2	24.8	24.5	24.6	23.6	21.8	21.8	22.0	22.3	22.6	22.8
On goods and services	15.0	15.4	15.0	14.6	14.8	14.0	12.4	12.5	12.7	12.8	13.0	13.1
Direct taxes	8.4	8.8	9.8	9.9	9.8	9.6	9.4	9.3	9.3	9.5	9.6	9.7
Social security contributions	12.5	12.5	12.7	12.9	11.4	11.6	11.9	11.6	11.8	12.0	12.1	12.2
Other current revenues	4.1	4.5	4.8	4.8	5.8	5.9	5.6	5.2	5.2	5.2	5.2	5.2
Capital revenues	1.4	1.1	0.9	0.9	2.4	2.4	2.4	1.4	1.5	1.5	1.6	1.6
Total expenditures	47.7	46.3	45.7	45.9	48.0	49.5	49.7	48.5	47.8	47.6	47.2	46.8
Primary current expenditures	40.8	40.1	39.4	40.3	40.6	42.1	42.4	41.8	41.2	40.8	40.4	39.9
Compensation of employees	14.4	13.6	12.9	12.9	11.1	11.5	11.6	11.4	11.2	11.0	10.8	10.6
Intermediate consumption	4.2	4.1	4.1	4.4	4.6	4.7	4.8	4.7	4.6	4.5	4.5	4.5
Subsidies	1.6	1.4	1.2	1.2	1.9	1.9	1.9	1.8	1.6	1.5	1.3	1.3
Social transfers	18.5	18.8	19.2	19.9	20.8	21.6	21.8	22.0	21.8	21.9	21.8	21.8
Other	2.1	2.2	2.0	2.0	2.3	2.4	2.4	1.9	1.9	1.9	1.9	1.8
Interest payments	2.6	2.7	2.8	2.9	3.3	3.1	3.1	3.4	3.8	4.0	4.2	4.3
Capital expenditures	4.3	3.4	3.5	2.7	4.1	4.2	4.2	3.3	2.9	2.8	2.7	2.6
Overall balance	**-6.1**	**-3.9**	**-2.6**	**-2.7**	**-3.9**	**-5.9**	**-8.0**	**-8.6**	**-7.3**	**-6.6**	**-5.7**	**-5.0**
Excluding one-off measures 3/	**-6.1**	**-3.9**	**-2.7**	**-3.4**	**-3.9**	**-5.9**	**-8.1**	**-8.6**	**-7.3**	**-6.6**	**-5.7**	**-5.0**
Memorandum items:												
One-off measures	0.0	0.0	0.1	0.8	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Structural balance (excluding one-off measures) 4/	**-6.0**	**-4.0**	**-3.2**	**-3.5**	**-3.3**	**-4.8**	**-6.6**	**-7.1**	**-6.4**	**-6.0**	**-5.5**	**-5.0**
Public debt (Maastricht definition)	63.6	64.7	63.6	66.3	69.7	74.6	75.8	83.3	89.2	93.8	97.1	99.4
Real increase in primary current spending 5/	4.6	-0.3	0.2	2.3	-0.1	…	5.8	-0.8	-0.5	0.1	0.1	0.1
Public consumption (% GDP) 6/	21.4	20.7	20.3	20.7			20.4	20.5	20.3	20.1	19.9	19.6
Public consumption growth (nominal, national accounts) 5/	7.5	0.5	2.9	4.4			3.3	1.6	1.0	1.2	1.5	1.7
Nominal GDP (millions of euros)	149,124	155,446	163,051	166,437	169,092	163,073	162,804	165,135	168,094	171,937	176,594	181,726
Output gap (percent of potential output)	-0.2	0.2	1.2	0.4	-1.4	…	-2.6	-2.1	-1.6	-1.0	-0.4	-0.1
Real GDP growth (percent)	0.9	1.4	1.9	0.0	-0.8	-3.4	-2.7	0.5	0.9	1.1	1.3	1.3

Sources: ROPO (Budgetary Policy Steering report); European Commission and IMF staff estimates.

1/ For 2008–10, staff projections are based on unchanged policies, and the envisaged savings from the reforms that have already been introduced (for example, of the social security system).
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.
5/ For 2009, annual percentage change after adjusting the level of compensation of wages in 2009 to have the same coverage and methodology.
6/ National accounts basis. Sum of wages, goods and services, transfers in kind, and others.

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

						Projections					
	1997–2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Real GDP	2.5	0.9	1.4	1.9	0.0	-2.7	0.5	0.9	1.1	1.3	1.3
Real domestic demand	3.0	1.6	0.7	1.7	1.3	-2.9	0.3	0.2	0.3	0.4	0.6
Private consumption	2.8	2.0	1.9	1.6	1.7	-0.9	0.3	0.3	0.2	0.2	0.4
Public consumption	3.1	3.2	-1.4	0.0	1.1	4.4	0.7	0.1	0.1	0.1	0.1
Gross fixed investment	3.2	-0.9	-0.7	3.1	-0.7	-15.0	0.0	0.1	0.6	1.1	1.9
Public	2.6	-5.7	-17.8	-0.4	-5.7	35.8	0.2	-12.7	0.5	1.0	0.0
Private	3.4	-0.1	1.9	3.6	-0.1	-20.7	0.0	2.6	0.6	1.1	2.2
Structure	2.3	-3.2	-5.4	-0.2	-5.7	-9.8	-0.9	-0.9	0.0	0.6	1.8
Equipment and machinery	4.3	1.3	3.7	6.0	3.5	-18.9	0.8	1.0	1.1	1.5	1.9
Change in stocks (contribution to growth)	0.0	0.0	0.0	0.1	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Foreign balance (contribution to growth)	-0.7	-0.8	0.6	0.0	-1.4	0.5	0.2	0.6	0.8	0.9	0.7
Exports of goods and services (real)	4.6	2.0	8.7	7.8	-0.5	-14.4	1.3	3.2	3.4	4.0	4.2
Exports of goods and services (nominal)	6.2	3.9	13.2	10.8	2.7	-18.6	2.5	4.6	4.8	5.5	5.7
Imports of goods and services (real)	5.5	3.5	5.1	6.1	2.7	-12.2	0.6	0.9	0.8	1.0	1.9
Real imports of partner countries (WEO)	7.6	8.0	9.0	7.2	1.6	-16.1	0.0	2.5	3.4	4.0	4.5
Export market share (2000=100)	102.0	87.9	87.7	88.2	86.4	88.1	89.2	89.8	89.8	89.8	89.5
Terms of trade	0.5	-1.3	0.2	1.3	-1.6	4.2	0.2	0.3	0.3	0.3	0.3
Savings-investment balance (percent of GDP)	-7.9	-9.5	-10.0	-9.4	-12.1	-9.9	-10.2	-10.1	-9.7	-9.1	-8.6
Gross national savings	17.9	13.1	12.2	12.8	10.2	8.9	8.5	8.4	8.9	9.5	10.1
Private	18.0	16.3	13.8	12.8	11.1	15.1	15.2	14.4	14.3	14.2	14.1
Government	-0.1	-3.2	-1.6	0.0	-0.9	-6.2	-6.7	-6.0	-5.4	-4.7	-4.1
Gross domestic investment	25.8	22.6	22.2	22.2	22.3	18.8	18.7	18.6	18.6	18.6	18.7
Private	22.2	19.6	19.8	19.9	20.1	15.8	15.7	16.0	16.0	16.0	16.1
Government	3.6	2.9	2.4	2.3	2.2	3.0	3.0	2.6	2.6	2.6	2.6
Resource utilization											
Population (15-64)	0.3	0.5	0.1	0.3	-0.1	0.0	-0.1	-0.2	-0.1	-0.2	-0.3
Labor force	1.7	1.0	0.8	0.6	0.1	-0.8	-0.1	-0.1	-0.1	-0.1	-0.1
Employment	1.2	0.0	0.7	0.2	0.5	-3.0	-1.6	0.6	0.9	0.5	0.3
Labor force participation rate	71.6	73.4	73.9	74.1	74.2	73.6	73.6	73.7	73.7	73.8	73.9
Unemployment rate	5.2	7.6	7.7	8.0	7.6	9.6	11.0	10.3	9.5	8.9	8.5
Potential output	2.2	1.1	1.0	0.9	0.8	0.3	0.1	0.3	0.5	0.7	1.0
Output gap	1.0	-0.2	0.2	1.2	0.4	-2.6	-2.1	-1.6	-1.0	-0.4	-0.1
Labor productivity	1.3	0.9	0.6	1.7	-0.5	0.3	2.2	0.3	0.2	0.8	1.0
Nominal wage (whole economy)	4.4	3.9	2.7	3.4	3.1	4.8	0.8	0.9	1.1	1.4	1.6
Real wage (whole economy)	1.5	1.8	-0.3	1.0	0.5	5.7	0.0	0.0	0.0	0.0	0.0
Unit labor costs (whole economy)	3.0	3.0	2.1	1.7	3.7	1.6	-1.3	0.6	0.9	0.6	0.6
Consumer prices (harmonized index)	2.9	2.1	3.0	2.4	2.7	-0.9	0.8	0.9	1.1	1.4	1.6

Source: IMF Staff Calculations

Table 5. Portugal - General Government Balance Sheet (Preliminary)
(Percent of GDP)

	2005	2006	2007	2008	2009	2010
Financial assets	29	29	27	27	27	27
Currency and deposits	5	5	5	4	4	4
Securities other than shares	1	1	1	1	1	1
Loans	3	3	1	2	2	2
Shares and other equity	16	15	15	16	16	16
Other accounts receivable 1/	4	4	4	4	4	4
Financial liabilities	74	73	71	75	84	92
Currency and deposits	11	12	12	12	12	12
Securities other than shares	54	53	50	57	66	74
Loans	5	5	6	4	4	4
Short-term	1	1	2	1	0	0
Long-term	4	4	4	4	0	0
Other accounts payable	3	3	3	3	3	3
Financial net worth	**-45**	**-44**	**-44**	**-48**	**-57**	**-65**
Nonfinancial fixed assets (net) 2/	43	43	43	43	43	43
Current net worth	**-2**	**-1**	**-1**	**-5**	**-14**	**-21**
NPV of future primary balances 3/					-157	-157
Intertemporal net worth					-171	-179
Intertemporal financial net worth 4/					-214	-222
Memorandum items:						
Public debt	64	65	64	66	76	83
GDP	149	155	163	166	163	165

Sources: Bank of Portugal and staff estimates.
1/ Includes insurance tech reserves.
2/ Based on estimates by Kamps (2004), the net capital stock in Portugal was about 43 percent of GDP in 2000
3/ Net present value of 50-year future primary balance projections in the baseline scenario of
unchanged policies. The discount rate is equal to the average interest rate on the public debt.
4/ Excludes fixed assets as these may not be marketable.

Table 6. Portugal: Selected Financial Indicators of the Banking System, 2002–09
(Percent)

	2002	2003	2004	2004 1/	2005 1/	2006 1/	2007 1/	2007 2/	2008 2/	2009 Jun 2/
Capital adequacy										
Regulatory capital to risk-weighted assets*	9.8	10.0	10.4	10.2	11.3	10.9	10.0	10.4	9.4	10.3
Memo item: Regulatory capital to risk-weighted assets**									10.4	11.3
Regulatory tier I capital to risk-weighted assets*	7.1	7.1	7.3	7.0	7.1	7.7	6.5	7.0	6.6	7.6
Memo item: Regulatory tier I capital to risk-weighted assets**									7.5	8.6
Capital (net worth) to assets 3/	5.6	5.8	6.1	5.1	5.8	6.4	6.4	6.4	5.5	6.0
Memo item: Capital (net worth) to assets 3/ **									6.1	6.6
Asset composition and quality										
Sectoral distribution of loans to total loans*										
Households	46.1	46.2	47.2	47.2	48.3	50.4	50.1	50.1	48.0	47.8
Of which: housing	35.5	35.9	36.8	36.8	38.2	40.1	39.6	39.6	37.8	37.9
Construction	7.9	8.2	8.2	8.2	8.3	7.9	7.8	7.8	7.9	8.1
Manufacturing	7.1	7.2	6.4	6.4	5.8	5.2	5.0	5.0	5.1	5.3
Agriculture	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.7	0.7
Services	26.9	28.2	27.3	27.3	26.7	26.1	26.0	26.0	27.4	27.0
NPLs to gross loans* 4/	2.3	2.4	2.0	1.6	1.5	1.3	1.3	1.5	1.9	2.8
Specific provision to NPLs 4/	62.8	73.0	83.4	72.0	79.0	80.5	75.7	74.1	66.5	72.7
NPLs net of provisions to capital* 4/	9.1	6.7	3.3	5.0	3.3	2.7	3.8	4.1	7.8	8.4
Large exposure to capital* 3/	119.9	94.1	91.4	97.5	75.8	86.9	91.6	92.0	78.1	75.0
Earnings and profitability										
ROA (post-tax)*	0.7	0.8	0.8	0.6	0.9	1.1	1.0	1.0	0.2	0.4
Memo item: ROA (post-tax)**									0.5	0.6
ROE (post-tax)*	11.7	13.9	12.8	10.8	16.8	17.0	15.2	14.8	3.5	6.8
Memo item: ROE (post-tax)**									8.0	9.2
Interest margin to gross income*	65.0	60.0	58.1	60.0	54.8	55.0	57.8	59.3	62.8	60.3
Noninterest expenses to gross income*	62.8	61.1	61.1	76.0	61.8	57.0	59.0	60.8	61.2	58.6
Financial margin to average assets	2.1	2.0	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.8
Liquidity										
Liquid assets to total assets* 5/	12.5	17.1	15.4	15.3	14.8	13.4	13.1	12.9	14.0	14.5
Liquid assets to total short-term liabilities* 5/	85.6	108.6	115.2	108.6	95.1	91.2	85.6	91.2	89.9	97.9
Liquid assets to interbank liabilities	80.0	100.7	99.5	113.3	100.4	101.6	99.0	73.3	75.5	82.5
Credit as percent of deposits* 6/	129.5	129.1	128.3	138.7	147.0	155.4	164.7	163.6	164.7	166.5
Loans as a percent of customers resources 7/	…	…	…	…	…	…	…	148.7	145.1	145.0
FX liabilities to total liabilities 8/	9.0	9.0	7.9	7.4	7.4	8.1	…	8.2	5.8	6.3
Sensitivity to market risk										
Net open position in FX to capital*	7.1	4.7	3.9	4.0	4.0	5.9	3.3	3.3	1.6	…
Net open position in equities to capital	1.8	0.2	1.8	1.8	1.8	2.6	2.3	2.1	0.2	…

Sources: Bank of Portugal; and IMF staff estimates.

Note: * denotes Core Financial Sector Indicators.
** Excluding BPN and BPP. The financial situation of these institutions required the intervention of the Portuguese government and Banco de Portugal in the last quarter of 2008.

1/ For 2005 and 2006 the figures are for the sample of institutions which had already adopted IAS, accounting for about 87 percent of the banking system total assets as of December 2004. To ensure comparability, the figures for 2004 and 2007 for this subsample are also presented.
2/ The sample of banking institutions under analysis was expanded in order to include the institutions that adopted IAS only in 2006.
3/ On accounting basis; consolidated.
4/ On a consolidated basis.
5/ Three-month residual maturity horizon.
6/ Credit includes securitized non-derecognized credit.
7/ Loans include securitized non-derecognized loans. Customers resources include debt securities issued by banks and placed with their customers.
8/ 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: Indicators of External and Financial Vulnerability, 2002–08
(Percent of GDP, unless otherwise indicated)

	2002	2003	2004	2005	2006	2007	2008
External indicators							
Exports (goods, annual percent change in euro)	0.8	3.1	4.9	4.1	12.0	8.9	1.1
Imports (goods, annual percent change in euro)	-2.9	-1.6	8.8	6.3	8.7	7.5	7.6
Terms of trade (goods and services, annual percent change)	1.6	0.4	-0.7	-1.3	0.2	1.3	-1.6
Current account balance	-8.1	-6.1	-7.6	-9.5	-10.0	-9.4	-12.1
Current account balance (including capital transfers)	-6.6	-4.2	-6.1	-8.3	-9.2	-8.1	-10.5
Capital and financial account balance	7.6	5.6	7.6	9.5	10.0	9.4	12.1
Of which : inward portfolio investment (debt securities, etc.)	7.9	9.0	7.6	9.9	6.7	11.1	15.7
Inward foreign direct investment	1.4	4.6	1.1	2.1	5.6	1.4	1.5
Other investment liabilities (net)	3.9	3.8	8.5	7.7	3.6	2.4	1.9
Central Bank foreign liabilities (billions of euro) 1/	8.7	2.7	8.6	12.8	6.8	6.3	19.0
Foreign assets of the financial sector (billions of euro) 2/	59.0	69.6	73.9	80.4	85.0	93.5	100.1
Foreign liabilities of the financial sector (billions of euro) 2/	102.0	116.2	118.1	128.2	150.6	162.6	145.4
Exchange rate (per U.S. dollars, period average)	1.1	0.9	0.8	0.8	0.8	0.7	0.7
Financial market indicators							
Public sector debt (Maastricht definition)	55.6	56.9	58.3	63.6	64.7	63.6	66.4
Money market rate - 3 month Euribor (period average in percent)	3.3	2.3	2.1	2.2	3.1	4.3	4.6
Money market rate (real, in percent)	-0.3	-0.9	-0.3	-0.1	0.0	1.8	2.0
Stock market index (PSI 20, 1992=3000)	5,824.7	6,747.4	7,600.2	8,618.7	11,197.6	13,019.4	6,341.3
Share prices of financial institutions (2005=1000)	734.9	763.9	855.9	1,065.1	1,435.5	1,505.7	558.6
Financial sector risk indicators							
Share of nonperforming loans in total loans 2/ 4/	2.1	2.1	1.8	1.7	1.5	1.5	1.9
Risk-based capital asset ratio 5/ 6/	9.8	10.0	10.2	11.3	10.9	10.4	9.4
Return on equity for the banking system (post-tax) 6/	11.7	13.9	10.8	16.8	17.0	14.8	3.5
Household debt							
Percent of disposable income	99.7	106.1	112.6	119.7	127.1	136.3	134.9
Percent of GDP	70.0	75.0	79.7	84.9	89.7	94.2	95.8
Nonfinancial corporate financial debt (percent of GDP)	109.4	112.0	107.7	111.6	114.7	121.8	134.6

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/ The real money market rate was obatained by deflating the nominal market rate with the average annual growth rate of the CPI
4/ NPLs concern households and nonfinancial corporations.
5/ Regulatory capital over risk-weighted assets.
6/ Consolidated data for the banking system. The figures for 2004 to 2006 are based on the sample of institutions that adopted IAS in 2005.
The sample of institution was expended in 2007 in order to include the institutions that adopted IAS later.

Table 8. Portugal: External Debt Sustainability Framework, 2004-2014
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	166.6	182.4	191.6	202.2	209.3	**206.5**	**211.5**	**216.2**	**220.1**	**223.0**	**225.4**	**-1.1**
Change in external debt	2.8	15.7	9.2	10.7	7.2	-2.9	5.0	4.6	3.9	3.0	2.3	
Identified external debt-creating flows (4+8+9)	-3.5	4.5	-0.7	-1.5	6.2	9.9	3.7	2.7	1.2	-0.3	-1.3	
Current account deficit, including capital account and excluding interest payments	1.7	3.9	2.6	0.1	2.0	0.9	0.9	0.8	0.8	0.2	-0.2	
Deficit in balance of goods and services	7.5	8.4	7.6	6.8	8.9	7.2	7.1	6.5	5.7	4.8	4.0	
Exports	28.9	29.0	31.7	33.6	33.8	28.0	28.2	28.9	29.6	30.3	31.0	
Imports	36.3	37.4	39.3	40.4	42.7	35.3	35.3	35.4	35.3	35.1	35.1	
Net non-debt creating capital inflows (negative)	-2.4	1.8	-2.5	-0.2	0.1	-3.0	-2.5	-2.3	-2.2	-2.2	-2.2	
Automatic debt dynamics 1/	-2.9	-1.1	-0.8	-1.4	4.1	12.0	5.2	4.2	2.7	1.7	1.1	
Contribution from nominal interest rate	4.3	4.5	6.7	8.0	8.5	7.3	8.2	7.9	7.5	7.5	7.4	
Contribution from real GDP growth	-2.2	-1.5	-2.4	-3.1	0.1	5.8	-1.1	-1.9	-2.3	-2.8	-2.8	
Contribution from price and exchange rate changes 2/	-5.0	-4.1	-5.1	-6.3	-4.5	-1.1	-1.9	-1.9	-2.5	-3.1	-3.5	
Residual, incl. change in gross foreign assets (2-3) 3/	6.3	11.2	9.9	12.2	1.1	-13.9	-0.5	0.1	0.1	0.2	0.1	
External debt-to-exports ratio (in percent)	577.1	628.8	603.5	601.9	620.4	736.8	749.8	747.3	744.1	736.2	725.9	
Gross external financing need (in billions of US dollars) 4/	152.9	179.3	202.3	227.7	273.6	281.5	268.9	282.9	291.3	299.1	306.8	
in percent of GDP	85.3	96.5	103.6	101.9	111.8	119.1	111.3	114.6	114.8	114.2	113.4	
Scenario with key variables at their historical averages 5/						**206.5**	**203.1**	**199.7**	**197.0**	**194.9**	**192.6**	**-7.1**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	1.5	0.9	1.4	1.9	0.0	-2.7	0.5	0.9	1.1	1.3	1.3	
GDP deflator in US dollars (change in percent)	12.6	2.7	3.6	12.4	9.5	-0.7	1.6	1.3	1.7	1.9	1.9	
Nominal external interest rate (in percent)	3.0	2.8	3.8	4.8	4.6	3.4	4.0	3.8	3.6	3.5	3.4	
Growth of exports (US dollar terms, in percent)	16.5	4.1	15.0	21.2	10.0	-24.2	4.7	3.9	3.8	4.3	4.3	
Growth of imports (US dollar terms, in percent)	19.3	6.7	10.5	17.5	15.7	-24.5	4.2	1.5	1.2	1.3	1.8	
Current account balance, excluding interest payments	-1.7	-3.9	-2.6	-0.1	-2.0	-0.9	-0.9	-0.8	-0.8	-0.2	0.2	
Net non-debt creating capital inflows	2.4	-1.8	2.5	0.2	-0.1	3.0	2.5	2.3	2.2	2.2	2.2	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate,
ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

I. Structural Reforms in Portugal – Payoff and Sequencing [1]

1. **Securing fiscal sustainability and introducing comprehensive structural reforms to resolve macroeconomic imbalances and boost growth potential remain Portugal's key challenges**. Despite the recent wide-ranging reforms including the public sector administration reform, revisions to the labor code, and programs to cut red tape (SIMPLEX), a considerable competitiveness gap remains. In addition, the global financial crisis has further undermined Portugal's medium-term growth perspectives. With sizable fiscal and balance of payment deficits, a sustained period of adjustment will be required to close the competitiveness gap and restore the sustainability of public finances. The situation could be further exacerbated if the growth outlook in Spain, Portugal's key trading partner, remains persistently weak, and/or the recovery in the euro area takes place ahead of that of Portugal leading to a rise in interest rates.

2. **A wide range of literature suggests that there is a substantial margin in Portugal to improve competition in the labor and product markets.** The benefit would come through enhanced flexibility, a reduction in the regulatory and administrative burden, improved competition policy and law enforcement. [2] In the product market, studies suggest large benefits from greater competition in the nontradable sector including network industries and retail distribution. The OECD suggests that the scope of administered prices in services is larger in Portugal than in most OECD countries. In the labor market, various indicators suggest considerable scope for promoting higher labor mobility and wage flexibility. In particular, high employment protection legislation adds costs, dampening labor demand and job creation. At the same time, relatively generous unemployment benefits likely contribute to longer-term unemployment. Reforms to promote greater competition in the product and labor markets would help the Portuguese economy to unlock growth potential by increasing employment and income levels.

Model Simulations

3. **To analyze the macroeconomic benefits of reforms, this note uses a three-country version of the IMF's Global Integrated Monetary and Fiscal model (GIMF)** [3]. GIMF is a dynamic stochastic general equilibrium (DSGE) model with overlapping generations. The GIMF is well suited for conducting medium-term policy analysis, as it incorporates rich layers of intra-regional trade, production, and demand that allow the transmission mechanism to be fully articulated. [4] Fiscal policy aims at stabilizing

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[1] Prepared by Keiko Honjo.

[2] See for example Conway and Nicoletti (2006), Høj et al. (2007), and OECD Economic Surveys.

[3] Calibrated for Portugal, Spain, and the euro area excluding Portugal and Spain.

[4] For a complete description of the model, see Kumhof and Laxton (2009).

the government debt-to-GDP ratio over the long term by adjusting expenditure or taxes. Public investment is productive, enhancing private sector productivity. Governments levy lump-sum taxes, a consumption tax, a labor income tax, and a capital income tax. In addition, the model incorporates a wide range of rigidities in labor and product markets, reflecting, in part, barriers to competition. Monopolistic competition in labor and goods markets implies that wages and prices are higher than they would be under a more competitive environment; wages can contain a markup over the marginal rate of substitution between consumption and leisure; and prices can contain a markup over the marginal cost of production.[5]

4. **The impact of specific reforms is difficult to simulate because it depends critically on the design and implementation of the reform, and existing initial conditions**. Nevertheless, by varying the markups in labor and product markets, the model can illustrate the macroeconomic implications of structural reforms aimed at promoting competition. Using the OECD indicators of product market regulation and employment regulation, and available estimates of markups in the literature, the wage markup and the price markup of nontradable goods in Portugal are both set equal to 25 percent over the marginal cost, significantly larger than the average for the euro area. In contrast, greater competition in the tradable goods market implies a lower price markup, which is set to 10 percent, equal to that in the other economies.

Price and Wage Markups

	Wage	Tradable goods	Nontradable goods
Portugal	1.25	1.10	1.25
Spain	1.28	1.10	1.20
Euro area	1.15	1.10	1.15

5. **Reforms are introduced by reducing nontradable goods and wage markups in Portugal by 5 percentage points**. At the same time fiscal adjustment is introduced aiming at achieving a balanced budget in 7 years based on a reduction in public spending. The impact of the reforms and fiscal adjustment is assessed relative to an unchanged policies baseline.

Fiscal adjustment: A cut in government consumption frees up resources for private sector consumption and investment. The simulation suggests that in the long-run, output would be about 2 percent higher than the baseline, with higher employment (hours worked) and a higher capital stock (see table below).

Fiscal adjustment and labor market reform: The model simulations suggest that a permanent reduction in the wage markup results in large gains in terms of GDP, employment, and consumption. In the long-run, output would be about 3 percent higher than the baseline owing to higher employment (hours worked) and a higher capital stock. A lower price for labor relative to capital encourages firms to adopt more labor-intensive technologies and increases their labor demand. Moreover, labor market reforms on their own result in a

[5] Labor market markup is defined by *Real wage = (labor market markup) * (the marginal rate of substitution)* while price mark up is defined by *Price =(goods market markup)*(marginal cost of production).*

permanent fall in real wages paid by firms because goods and services prices do not decline in proportion with wages, as monopolistic firms extract higher rents and limit the expansion of output. Despite lower real wages, households still benefit from the labor market reform as consumption steadily increases (7.6 percent higher in the long-run) reflecting higher human and financial wealth associated with increased dividend income from firms and an improvement in Portugal's net foreign debt position as the current account improves.

Fiscal adjustment and product market reform: Product market reform in the nontradable sector drives down prices of final goods, inducing real exchange depreciation. This causes demand for final goods to increase, leading firms to increase output of both final and intermediate goods and to employ more capital and labor. Higher labor demand drives real wages up while capital becomes relatively more affordable reflecting lower prices of nontradable goods. As a result, firms shift to more capital-intensive technology. In the long-run, while both hours worked and capital are higher, the key contribution to the increase in output comes from a significant boost in capital (4.6 percent higher than the baseline).

Impact of Reforms in Portugal
(Percent deviation from baseline)

	5 Years	10 Years	Long Run
Fiscal adjustment			
GDP	-1.9	-1.1	2.0
Consumption	-2.5	-0.9	6.4
Capital stock (utilized)	-2.2	-1.5	1.6
Hours worked	-0.3	0.5	2.0
Real wages (firms)	-3.6	-1.5	-1.0
Labor market reform			
GDP	0.6	1.1	1.3
Consumption	-1.4	-0.2	1.2
Capital stock	-0.3	0.4	0.7
Hours worked	1.3	1.5	1.3
Real wages (firms)	-2.1	-0.8	-1.0
Product market reform (nontradable goods)			
GDP	1.1	1.9	2.7
Consumption	-2.3	-0.8	1.7
Capital stock	0.7	2.4	3.6
Hours worked	1.8	1.5	1.6
Real wages (firms)	0.1	1.9	2.0
Fiscal adjustment and labor market reform			
GDP	-1.2	-0.1	3.2
Consumption	-3.9	-1.1	7.6
Capital stock	-2.4	-1.0	2.3
Hours worked	1.1	1.9	3.3
Real wages (firms)	-5.8	-2.2	-2.0
Fiscal adjustment and product market reform			
GDP	-0.7	0.7	4.6
Consumption	-4.9	-1.8	8.2
Capital stock	-1.4	1.0	5.1
Hours worked	1.5	2.0	3.6
Real wages (firms)	-3.6	0.6	0.9
Simultanerous reforms			
GDP	0.0	1.8	5.8
Consumption	-6.2	-2.1	9.2
Capital stock	-1.6	1.6	5.8
Hours worked	2.9	3.2	5.0
Real wages (firms)	-5.9	-0.3	0.2

6. **In the short-run, greater competition in product and labor markets in the context of a monetary union implies Portugal would go through a sustained period of inflation below the baseline and that of the euro area**. Given the small size of Portugal, an inflation differential does not prompt a change in the euro area policy rate. As a result, real interest rates in Portugal would rise. With large household debt, higher real interest rates would dampen consumption during the early phase of reforms, but as competitiveness

improves boosting external demand and hence financial wealth (as the current account improves), consumption would rise above the baseline.

7. **Simultaneous implementation of both labor and product market reform would facilitate labor market reform**. Especially in the context of high unemployment, it may be politically difficult to introduce labor market reform that prompts initially a decline in employment[6] and a permanent decline in real wages over the long-run. A simultaneous implementation of labor and product market reforms would prevent real wages from declining permanently relative to the baseline. The benefit would be substantially larger with large permanent increases in real wages (over 10 percent higher than the baseline) if both reforms are jointly implemented in the euro-area, as synchronized euro area-wide reforms would lead to lower interest rates throughout the area, making the transition easier.

8. **Simulation results also suggest that if there is a full credibility of the implementation of the reforms, product and labor market reforms could be introduced sequentially and still produce the same long-term benefits**. This is because of the rational expectation and forward-looking behavior of private agents. A clear announcement of the detail of a labor market reform at the time of introducing product market reform would prompt agents to incorporate the expected impact of upcoming labor market reform into their decision making today. On the other hand, if private agents only reflect policymakers' commitment to the reform agenda only when it is effectively introduced, then delaying one reform would only result in prolonging the adjustment period with higher real interest rates and lower consumption.

9. **One important caveat to the simulations is that the analysis abstracts from productivity growth, the central driver of economic progress**. Studies indicate that more competitive labor and product markets are associated with faster productivity growth.[7] Moreover, evidence also suggests that there is an important complementarily between product and labor market reforms. Greater competition in the product market may reduce not only the goods price markup but also the wage markup, which could boost employment more than the simulation suggests.

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[6] Product market reform also lowers employment in the short-run.

[7] See for example Nicoletti and Scarpetta (2003) and (2005).

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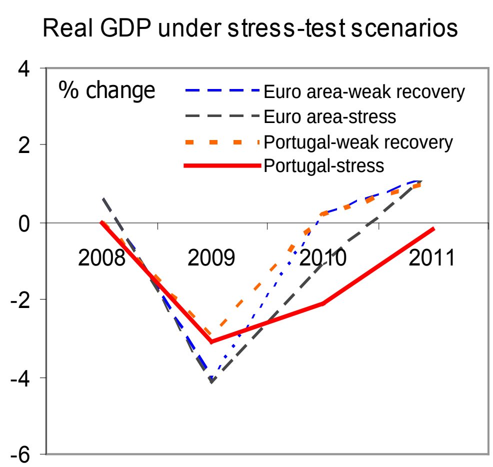
II. Implication of Vulnerabilities for Banks: Stress Test Analysis[1]

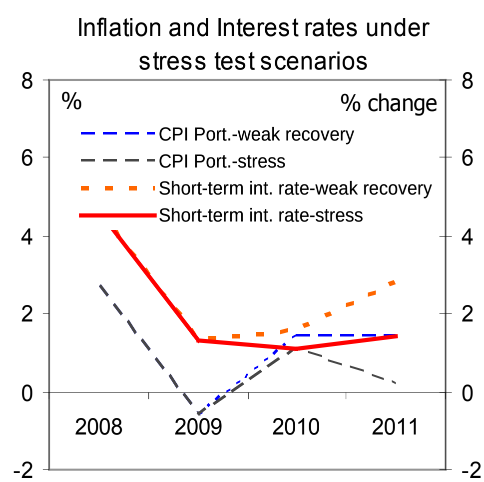
1. **Stress tests were conducted to quantify the implications of balance sheet vulnerabilities for banks' capital positions.** The stress tests, designed by the BdP in consultation with the IMF country team, evaluated two alternative scenarios for the six largest banks in Portugal, accounting for 80 percent of total banking sector assets.

2. **The stress test exercise used a top-down approach under two alternative scenarios.** The international environment under the weak recovery scenario (baseline) uses ECB projections from September 2009, and the stress scenario is modeled using NiGEM, whereas the Portuguese economy was modeled according to Portugal's quarterly economic model. The projection horizon goes out through 2011, with June 2009 bank accounts providing the anchor for the exercise.

3. **The main sources of risk—namely credit risk and market risk—are taken into account.** Market risk is evaluated both for the banks' own portfolios, as well as their employees' defined-benefit pension plans. Credit risk is modeled using default probabilities for non-financial corporations and households estimated from auxiliary models. A cash flow approach to interest rate risk in the banking book is also taken into account.

4. **Under the weak recovery scenario, the international environment and the Portuguese economy would improve modestly over the forecast horizon.** Euro area growth is expected to recover to 1.2 percent in 2011, inflation should remain subdued and short term interest rates are projected to increase gradually as monetary easing unwinds. Growth projections in Portugal will behave in much the same way as the Euro area as private consumption and investment progressively recover.





[1] Prepared by Peter Kunzel.

Estimated Loss rates, Default Probabilities and Loss Given Default Assumptions

	Loss given default	Loss rates 2008	2009	2010	2011	Default Probabilities 2008	2009	2010	2011
Non-financial corporations									
Weak recovery	0.45	1.33	1.54	1.34	1.61	2.97	3.43	2.98	3.61
Stress scenario	0.45	1.33	1.55	1.75	2.08	2.97	3.44	3.9	4.62
Households-housing									
Weak recovery	0.15	0.31	0.32	0.44	0.82	2.04	2.16	2.96	5.47
Stress scenario	0.15	0.31	0.32	0.64	0.97	2.04	2.16	4.29	6.45
Households-consumption and other									
Weak recovery	0.45	2.36	3.15	3.56	4.24	5.24	7.00	7.92	9.43
Stress scenario	0.45	2.36	3.15	3.67	4.3	5.24	7.00	8.15	9.55

Source: Bank of Portugal.

5. **Under the stress scenario, the global recession persists through 2010 and growth remains negative for Portugal through 2011.** Economic developments in 2010 will be driven by renewed global real and financial sector weaknesses, with negative shocks to private consumption and investment, as well as a concomitant decline in stock markets worldwide and in Portugal (by 30 percent in Q4 2009). The assumed stress scenario would represent the most severe recession on record, with a cumulated economic contraction for Portugal of 5.4 percentage points between 2008 and 2011.

6. **Against the background of heightened global uncertainty, risk perception towards the Portuguese economy is assumed to increase under the stress scenario as well.** Interest rate spreads on government securities and consumer and household credit widen to their peak over the past year, and remain at that level over the forecast horizon. Housing prices are projected to fall by 10 percent over the forecast horizon whereas short-term interest rates are assumed to remain low over the forecast horizon, in line with the default monetary policy rule in NiGEM.

7. **Despite the mounting risks, the results of the stress test suggest that banks would withstand large shocks.** Under the weak recovery scenario, capital buffers would remain well above regulatory minima for the next two years. In fact, both overall and Tier 1 capital ratios rise over the forecast period under the weak recovery scenario to 12.3 percent and 9.8 percent respectively for the banks examined as a whole. The increase in capital adequacy ratios despite an increase in net impairments on loans reflects bank capital increase operations during 2009 totaling €3.3 billion (equivalent to 1.2 percent of risk-weighted assets) as well as continued profitability of banks overall.

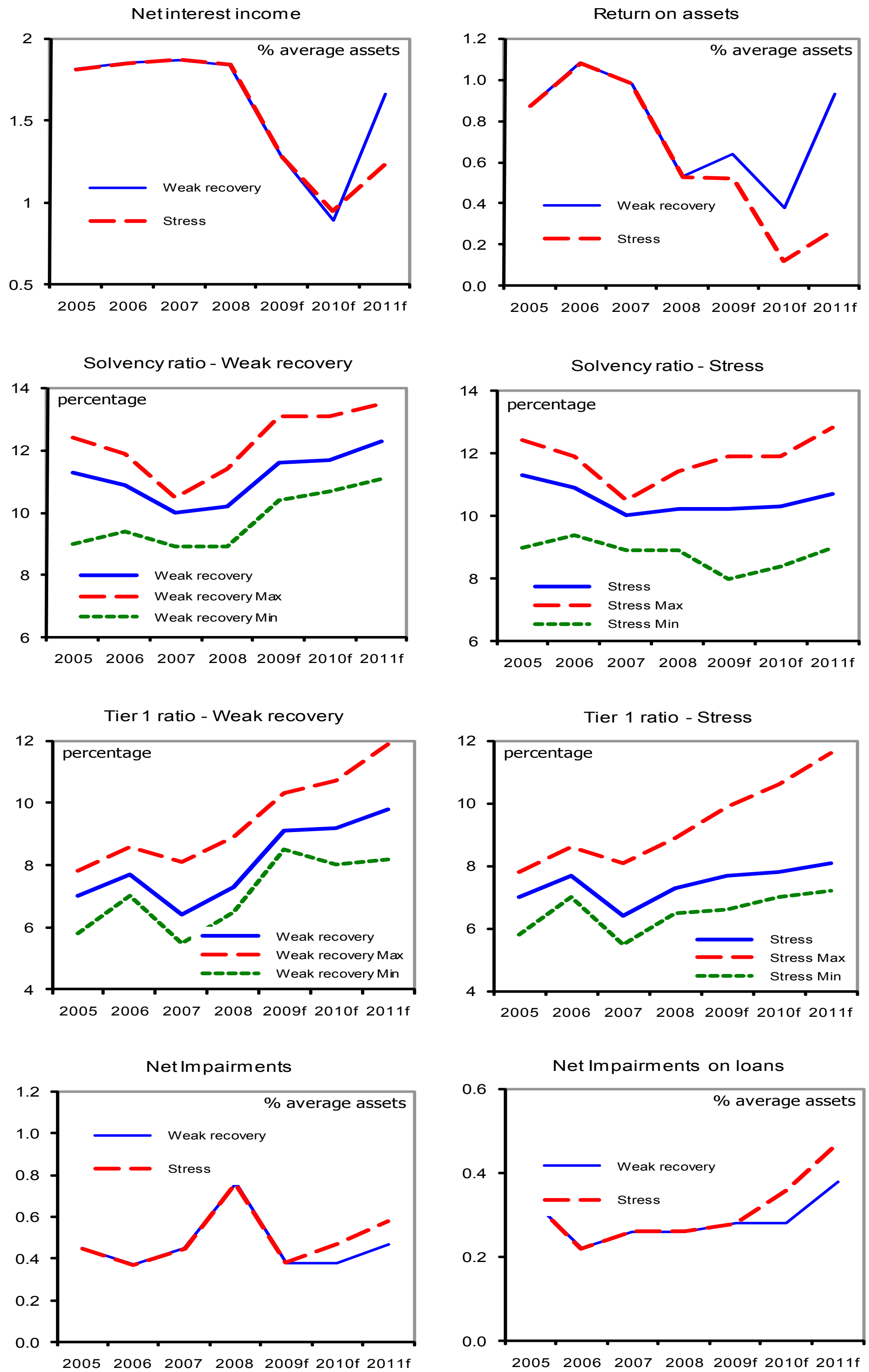
8. **Overall regulatory requirements would still be observed under the stress scenario, but some capital increases would be needed to bring Tier 1 capital in line with BdP's 8 percent recommendation.** The overall solvency ratio increases more modestly under the stress scenario (to 10.7 percent in 2011 from 10.2 percent in 2008), reflecting the offsetting impact of capital increases by banks against rising loan impairments and bank losses arising from the 30 percent stock market decline. While the Tier 1 ratio recovers to just over 8 percent for banks overall by 2011, some banks

would still remain below this threshold at the end of the forecast horizon, with the weakest banks registering a Tier 1 ratio of 7.2 percent. Robustness tests conducted by the BoP, using a scaling factor of 1.5 on expected loan losses, suggest that the Tier 1 ratio for banks as a whole would amount to 7.5 percent by 2011 (with the strongest bank registering a Tier 1 ratio of 11.3 percent compared to 5.6 percent for the least capitalized bank).

Impact of Various Effects on Tier 1 Capital of Banks
(% risk weighted assets)

	2008	2009	2010	2011
Weak recovery scenario				
After tax retained income:	…	0.5	0.3	0.7
o/w: Net impairments on loans	…	-0.2	-0.2	-0.3
Equity increases	…	1.2	--	--
Total Contribution	…	1.7	0.3	0.7
Memo: Tier 1 ratio	7.3	9.1	9.2	9.8
Max	8.9	10.3	10.7	11.9
Min	6.5	8.5	8.0	8.2
Stress scenario				
After tax retained income:	…	0.4	0.1	0.2
o/w: Net impairments on loans	…	-0.2	-0.3	-0.4
Impact on trading book	…	-0.1	--	--
Equity increases	…	1.2	--	--
Stock market shock	…	-1.4	--	--
Total Contribution	…	0.3	0.1	0.2
Memo: Tier 1 ratio	7.3	7.7	7.8	8.1
Max	8.9	9.9	10.6	11.6
Min	6.5	6.6	7.0	7.2

Source: Bank of Portugal.



Source: Bank of Portugal.

INTERNATIONAL MONETARY FUND

PORTUGAL

Staff Report for the 2009 Article IV Consultation—Informational Annex

Prepared by the European Department

December 18, 2009

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Appendixes

APPENDIX I. PORTUGAL: FUND RELATIONS
(As of December 11, 2009)

Staff team: J. Daniel (head), K. Honjo, P. Kunzel, P. Sodsriwiboon (all EUR) visited Lisbon November 19–30, 2009. It met with the Minister of Finance, the Governor of the Bank of Portugal, senior staff of several government ministries and agencies, representatives of regulatory agencies, and banks. Mr. Cardoso (OED) attended most meetings. The authorities released the mission's concluding statement.

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	682.35	78.67
Reserve position in Fund	185.07	21.34

III. **SDR Department**:

	SDR Million	Percent of Allocation
Net cumulative allocation	806.48	100.00
Holdings	833.18	103.31

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 1, 2008.

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. 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.** Since 2000 INE publishes a full set of national accounts based on *ESA95* methodology, including quarterly GDP estimates. Unemployment data 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. 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 indicate 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 December 8, 2009)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	12/07/09	12/07/09	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	11/09	12/09	M	M	M
Reserve/Base Money	10/09	11/09	M	M	M
Broad Money	10/09	11/09	M	M	M
Central Bank Balance Sheet	11/09	12/09	M	M	M
Consolidated Balance Sheet of the Banking System	10/09	11/09	M	M	M
Interest Rates[2]	10/09	11/09	M	M	M
Consumer Price Index	10/09	11/09	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	10/09	11/09	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	10/09	11/09	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	10/09	11/09	M	M	M
External Current Account Balance	09/09	11/09	M	M	M
Exports and Imports of Goods and Services	09/09	10/09	M	M	M
GDP/GNP	2009:Q3	12/09	Q	Q	Q
Gross External Debt	2009:Q2	09/09	Q	Q	Q
International Investment Position	2009:Q2	09/09	Q	Q	Q

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[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 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).

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 10/08
FOR IMMEDIATE RELEASE
January 20, 2010

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

IMF Executive Board Concludes 2009 Article IV Consultation with Portugal

On January 15, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Portugal. [1]

Background

The global economic crisis has severely affected the Portuguese economy. Output will likely contract by almost 3 percent in 2009, driven by sharp falls in exports and investment. Despite a substantial rise in unemployment to nearly 10 percent, wage growth remained brisk, and, with productivity falling, unit labor costs rose further. Encouragingly, some signs of adjustment are emerging, as prices have fallen faster than in the euro area (though coupled with strong real wage growth, this squeezed firms' profit margins), households are saving more, and the large current account deficit is estimated to have narrowed somewhat to under 10 percent of GDP. Still, with the economy's weak growth potential likely undermined by the global crisis and high debt levels, and given a likely eventual tightening in monetary conditions, growth seems set for a weak recovery of about ½ a percent in 2010.

[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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Following impressive fiscal consolidation achieved between 2005 and 2007, the global financial crisis prompted stimulus measures of some 1¼ percent of GDP over 2008–09, broadly in line with other euro area countries. Combined with the impact of the recession, the fiscal deficit increased to around 8 percent of GDP in 2009, with debt close to 80 percent of GDP. The fiscal stance is not expected to adjust substantially in 2010 but the government aims to achieve a deficit target of 3 percent of GDP by 2013. This will require structural consolidation of around 1 percent of GDP a year on average.

The banking system weathered the global financial crisis relatively well, reflecting pre-existing strengths, such as limited exposure to toxic assets, the absence of a property bubble, retail-based business models, and a sound supervisory/regulatory framework. However, some vulnerabilities increased as investment portfolios suffered, credit quality declined, funding large wholesale borrowing requirements became more difficult, and the already high concentration of loans to large exposures rose. The authorities have taken decisive steps to address these vulnerabilities, including raising the coverage limit for deposit insurance, instituting facilities to recapitalize banks and guarantee their borrowing, and recommending that all banks bring their Tier I capital ratios to 8 percent. Further pro-active measures are on the authorities' agenda—including introducing minimum liquidity ratios—which are expected to be implemented in the context of the evolving European and international financial architecture.

Executive Board Assessment

Executive Directors noted that as a consequence of the global economic crisis output in Portugal contracted significantly and unemployment rose substantially. Directors welcomed the authorities' rapid policy response. Signs of adjustment are now emerging, with prices falling faster than in the euro area, households savings increasing, and the large current account deficit narrowing. However, addressing long-standing imbalances, including low productivity, weak competitiveness, and high debt, will be key to reducing vulnerabilities and raising the economy's long-term growth potential. An ambitious policy response is needed with strong public support and determined leadership over many years.

Directors encouraged the authorities to prepare a credible fiscal consolidation plan that would prevent further deterioration in fiscal balances. They commended the authorities' commitment to the deficit target of 3 percent by 2013. Directors agreed that a start towards consolidation should begin this year. Efforts should focus on reducing the public wage bill and social transfers along with some revenue enhancement, especially by broadening the tax base and streamlining the process of tax administration. Improving fiscal frameworks, for example by introducing a medium-term expenditure rule could help strengthen the fiscal position.

Directors noted that the financial sector faced the crisis from a position of strength and weathered the crisis relatively well. They welcomed the decisive policy actions taken by the authorities to address vulnerabilities, especially by raising capital standards. Directors recommended that the authorities review the existing legal toolkit for intervening in troubled financial institutions and to give consideration to a special resolution framework for financial institutions and to enhance inter-agency coordination also in the context of evolving European and international financial architecture. They observed that the implications of the envisaged switch to the "twin peaks" model of financial sector supervision should be carefully assessed and the model cautiously implemented.

Directors agreed that improving productivity and external competitiveness remained critical to improving the economy's growth potential and restarting the income convergence process. They noted that the adoption and implementation of the European Union Services Directive would help foster competition and productivity. Directors commended the continued progress being made in cutting red tape and encouraged the authorities to further strengthen the Competition Act. They welcomed recent labor market reforms and encouraged the authorities to assess the effectiveness of the recent revision to the labor code. They recommended that the authorities review the unemployment benefit system, especially with a view to providing greater incentives to find work over time, and to ensure that adjustments to the minimum wage remain in line with economic fundamentals.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2009 Article IV Consultation with Portugal is also available.

Portugal: Selected Economic Indicators, 2004–10

	2004	2005	2006	2007	2008	2009 1/	2010 1/
Real economy (change in percent)							
Real GDP	1.5	0.9	1.4	1.9	0.0	-2.7	0.5
Domestic demand	2.7	1.6	0.7	1.7	1.3	-2.9	0.3
CPI (year average, harmonized index)	2.5	2.1	3.0	2.4	2.7	-0.9	0.8
Unemployment rate (percent)	6.7	7.6	7.7	8.0	7.6	9.6	11.0
Gross national saving (percent of GDP)	15.5	13.1	12.2	12.8	10.2	8.9	8.5
Gross domestic investment (percent of GDP)	23.1	22.6	22.2	22.2	22.3	18.8	18.7
Public Finance (percent of GDP)							
General government balance	-3.4	-6.1	-3.9	-2.6	-2.7	-8.0	-8.6
General government balance 2/	-5.5	-6.1	-3.9	-2.7	-3.4	-8.1	-8.6
Primary balance 2/	-2.8	-3.5	-1.2	0.1	-0.5	-5.0	-5.2
Public debt	58.3	63.6	64.7	63.6	66.3	75.8	83.3
Money and credit (end-of-period, percent change)							
Credit to the nonfinancial private sector 3/	6.1	7.7	8.7	9.9	7.1	...	...
National contribution to euro area M3 4/	5.5	6.1	3.1	8.1	12.9	...	...
Interest rates (end-period)							
Deposit rate, up to two years	2.0	2.1	2.7	3.6	4.0	...	...
10-year government bond yield	3.6	3.5	4.0	4.5	4.0	...	...
Balance of payment (percent of GDP)							
Trade balance	-10.3	-11.0	-10.8	-10.8	-12.8	-10.2	-10.1
Current account (including capital transfers)	-6.1	-8.3	-9.2	-8.1	-10.5	-8.6	-8.9
Net official reserves (billions of U.S. dollars, end of period)	10.7	10.9	9.4	10.8	12.6	...	...
Exchange rate							
Exchange rate regime -- euro-area member							
Present rate (December 7, 2009) U.S.$1.48 per euro							
Nominal effective rate (2000=100)	100.2	100.0	100.2	101.5	103.4	...	...
Real effective rate (2000=100)	100.1	100.0	100.7	102.4	103.6	...	...

Sources: Bank of Portugal; Ministry of Finance; and IMF staff estimates and projections.
1/ Figures for 2009 and 2010 are projections.
2/ Excludes one-off measures.
3/ Includes securitized loans and corrected for loan write-offs and reclassifications.
4/ Excludes currency in circulation held by nonbank private sector.

Statement by Arrigo Sadun, Executive Director for Portugal and

José Cardoso, Advisor to Executive Director

January 15, 2010

We thank the staff for their open, constructive, and comprehensive dialogue established with the Portuguese authorities. We consider the staff's report to be a quality analysis of the recent developments of the Portuguese economy, as well as a thorough discussion of the economic outlook. We broadly agree with the staff's appraisal and recommendations. However, we would like to highlight some issues and present a few comments on some specific issues.

1. Economic Overview

The economic recovery that started in late 2005, and gathered momentum in the following two years, was interrupted by the international financial crisis, but projections point to a gradual adjustment.

Real GDP growth dropped to 0.0 percent in 2008 and -2.7 percent in 2009. Although significant, the impact of the international financial crisis on the Portuguese economy was less severe than the one recorded on average in the euro area. In 2009, a positive growth differential (1.3 percent) was recorded between Portugal and the euro area — something that has not been observed since 2003 — revealing the relative resilience of the Portuguese economy.

However, throughout the report it is mentioned that the adjustment of the Portuguese economy may be sudden and disruptive (most notably in paragraphs 2 and 19). Even though the report acknowledges that the most likely scenario is one of a gradual adjustment, it does not duly emphasize the reasons underlying this conclusion. Five main issues that support a likely scenario of a gradual adjustment should be mentioned: (i) the overall robustness of the financial sector in the European context; (ii) the relatively long maturities of the external debt of the Portuguese economy (issued without currency risk); (iii) the sizeable external assets held by residents, amounting to around 150 percent of GDP; (iv) the non-existence of overvaluation in asset markets, notably in housing prices; and, finally, (v) the fact that Portuguese fiscal accounts stand at a relatively median position in the European context, in particular when the respective medium to long-run sustainability is assessed. The maintenance of these factors will be instrumental in ensuring that a sudden and disruptive scenario does not materialize. This should be the case even if economic imbalances persist in the Portuguese economy.

The economic deceleration occurred during the course of 2008, but it was more incisive starting in the last quarter of 2008, with the deepening of the international financial crisis.

In 2008, the deceleration of economic activity reflected the contraction in Gross Fixed Capital Formation (GFCF) and exports, in a context of growing deterioration of demand prospects in internal and external markets. Private consumption — countering the trend of the other expenditure components — recorded a rate of change similar to that of 2007, thus continuing to show a smoothing behavior. This behavior can be explained *inter alia* by the increase in disposable income — associated in particular with the labor market conditions — and the maintenance of a significant rate of growth of loans to households. The GDP intra-annual growth profile was characterized by a clearly downward trajectory during 2008, which worsened abruptly and severely during the last quarter of the year, in line with the strong international financial and economic deterioration. The deceleration of GDP in the last quarter was broad-based in terms of its major components, and it is worth highlighting the strong fall in volume in GFCF and in exports of goods and services. Unlike what happened in more recent years, private consumption grew at a rhythm inferior to that of disposable income, implying, for the first time since 2002, an increase in the households' savings rate, although not yet significant. Finally, the negative evolution of GDP *per capita* was marked by a negative contribution of total factor productivity, contrasting with positive contributions in the previous years.

The downturn in 2009 reflected, in contrast with 2008, a contraction of private consumption (particularly durable goods) and, as in 2008, a further decline in investment and exports.

The developments in demand reflected the high tension in the financial markets, which implied, on the one hand, a significant increase in the degree of tightening of financing conditions, namely a tightening of the criteria used by banks in the approval of new credit and an increase in risk premiums, despite the decline in interest rates in the money market. On the other hand, it may have contributed, in a large extent, to the collapse of international trade, as well as to the sudden deterioration of the economic agents' confidence. Regarding the households' savings rate, there was a significant increase in 2009, reinforcing the slight increase already recorded in 2008. The evolution of the savings rate may have reflected precautionary motives related to the high uncertainty associated with the magnitude and length of the financial crisis and its interaction with the economic activity, namely in what concerns the evolution of wealth and income. As in 2008, the negative evolution of GDP *per capita* was marked by a negative contribution of total factor productivity.

Since September 2007, year-on-year inflation has been lower than in the euro area.

Inflation, measured by the annual average rate of change in the Harmonized Index of Consumer Prices (HICP), dropped from 2.7 percent in 2008 to -0.9 percent in 2009. This led to a widening of the negative inflation differential with the euro area to -1.5 p.p. at the end of 2009. Since September 2007, inflation in Portugal has been the lowest or one of the lowest in the euro area. The negative inflation recorded in 2009 was a singular fact in the last decades. It was associated, on the one hand, with the strong recessive framework of demand at a global level, which contributed to a substantial decline in the prices of imports, in particular energy prices, and, on the other hand, with the strong contraction of domestic demand, which influenced the domestic pass-through of the decrease in prices at the international level, and contributed to the sharp decline in corporations' profit margins.

The collapse in demand led to a strong decline in employment and to a record peak in unemployment.

In 2008 there was a small decrease in the unemployment rate (0.4 p.p.) to 7.6 percent, reflecting essentially the growth in total employment due to the acceleration of the Portuguese economy during 2007. However, the unprecedented external shocks that hit the Portuguese economy in late 2008 and early 2009 have put a heavy toll on the activity of many firms. As a result, for the first time in Portugal's recent history, unemployment stood close to double digits, already in the third quarter of 2009 (9.8 percent), and this rate is expected to increase in 2010.

2009 recorded a fall in the net external borrowing requirements, as a percentage of GDP …

Among the reasons that contributed to the reduction in 2009 of the net external borrowing requirements (as measured by the combined current and capital account deficit as a percentage of GDP) stand out (i) the significant drop in oil prices, which led to an important improvement in the terms of trade, and consequently a reduction in the deficit of energy balance; and (ii) the reduction of interest rates, which led to a temporary inflexion in the upward trend of the income account deficit through its effects on debt service. An increase of the borrowing requirements of the general government sector was observed in contrast to a significant decrease in the borrowing requirements of the private sector, both by corporations and by households. The increase in borrowing requirements of the general government sector reflects — in the current context of a steep decline in economic activity — the growth of expenditure above nominal GDP growth, and the sharp reduction of tax revenues.

… but far from enough to reverse the continuous deterioration of the net international investment position.

Indeed, the high net external borrowing requirements recorded over the last decade have had the effect of a progressive deterioration of the international investment position of the Portuguese economy. The resulting debt service has absorbed progressively larger resources, directly contributing to the widening of the income account deficit. This deficit, which represented about 2 percent of GDP in 2000, reached a figure close to 4.0 percent of GDP in 2009, and is expected to increase in the near future.

However, the fact that resident sectors maintain a significant amount of external assets allows them to withstand disturbances in the international financing markets and, therefore, to sustain in the short-run a discrepancy between domestic savings and investment. Nevertheless, the possibility of a prolonged adjustment allowed by this significant amount of external assets does not eliminate inevitable inter-temporal solvency restrictions that will become active in a more or less distant future.

Portugal has revealed in the past the capacity to diversify exports.

Before the crisis, the Portuguese economy was revealing a deepening in the integration in global trade flows. This evolution was evident in very important structural indicators: first, the degree of openness of the Portuguese economy (measured from the joint weight of exports and imports on GDP), rose again significantly; second, the structure of goods exports by geographical area, in nominal terms, continued to reflect the growing weight of non-EU markets, in particular the Angolan market; and finally, buoyant exports of services are particularly noteworthy (with nominal growth exceeding growth in the euro area), showing an important development in the comparative advantage of the Portuguese economy.

The mention in Box 1 of the staff's report that "one of the key risks for Portugal's growth outlook" relates to the economic outlook for Spain seems somewhat overdone. Even though the idiosyncratic Spanish economic dynamics is undoubtedly important for Portugal, it is worth mentioning that this importance is second-order compared to the impact stemming from the global economic and financial outlook — which, to be sure, should also impact the Spanish economy in general equilibrium. Actually, the simulations using the 3-country version of the GIMF model presented in that Box confirm this assertion. The baseline results for the model suggest a very minor general equilibrium effect on the Portuguese economy stemming from a 1 percent GDP decline in the Spanish GDP. Only when confidence effects are factored in is this impact magnified. However, the calibration of these confidence effects is naturally *ad-hoc* and would depend on the underlying shock driving the GDP decline in Spain — a fact that is overlooked in Box 1. Moreover, from a medium-run perspective — and given the high degree of financial and economic integration of the Portuguese economy — a further diversification of Portuguese economic links toward other destinations (something that actually was already taking place before the crisis) is expected.

2. Fiscal Policy, Economic Stimulus, and Exit Strategy

The "impressive fiscal consolidation achieved between 2005 and 2007", as assessed by staff, …

In September 2005, the Council of the EU decided that Portugal was in excessive deficit and addressed recommendations (with a view to bringing the situation of an excessive deficit to an end by 2008 at the latest). Following a successful fiscal consolidation, the general government deficit declined significantly from 6.1 percent of GDP in 2005 to 3.9 percent of GDP in 2006, and to 2.6 percent of GDP in 2007, therefore below the 3 percent of GDP reference value of the Stability and Growth Pact. During this consolidation process, there was only one marginal one-off operation (related to the renegotiation of a long-term concession for the exploitation of a dam) worth 0.1 percent of GDP in 2007. The structural balance (the cyclically-adjusted balance net of one-off and other temporary measures) improved by some 2 p.p. of GDP in 2006, followed by a further improvement by about 1 p.p. of GDP in 2007, thereby well beyond the fiscal efforts recommended by the Council of the EU (defined as 1.5 percent of GDP in 2006 and of, at least, 0.75 percent of GDP in 2007).

Based on the outcome already achieved in 2007, **the decision of the Council of the EU that Portugal was in excessive deficit was abrogated in June 2008, one year before the deadline**. In 2008, and despite the drop in economic growth from almost 2 percent in 2007 to 0.0 percent, the fiscal deficit stood at 2.7 percent of GDP, although with recourse to temporary measures (around 1 percent of GDP).

On a long-term perspective, Portugal was among the Member States with the highest expected increase in population ageing-related expenditure in the 2005-2050 period. However, **as a result of the reforms in public pension systems in 2006, Portugal was reclassified in October 2007 from a high-risk country to a medium-risk country concerning the sustainability of public finances**.

… allowed some fiscal room for maneuver to introduce, in the context of the international crisis, stimulus measures in 2008 and 2009.

As staff mentioned in the report, the "recent consolidation helped the public finances enter the crisis in a relatively strong position by historical standards". In response to the economic downturn, Portugal adopted a number of discretionary measures, in particular in the context of the **European Economic Recovery Plan (EERP)**. The fiscal stimulus measures were essentially **timely, targeted, and temporary**.

The measures focused on social protection to the most vulnerable groups of the population, including the employability of young and old workers through a targeted lowering of social contributions in 2009; an increase in public investment mainly based on the modernization of schools; the incentive to investment by means of a tax credit in 2009; and the enhancing of competitiveness and support of exports by backing some specific credit and insurance market mechanisms. All these measures were taken in the context of the EERP and on top of a number of other separate measures that had already been announced by mid-2008 — and included in the 2009 State Budget — to support households and firms. Already in March 2008, the Government had announced a reduction of the standard VAT rate by one p.p. from 21 percent to 20 percent from July 2008 onwards.

The expansionary fiscal stance was significant in 2009 …

According to the official estimates, the total cost of these stimulus measures represented 1.2 percent of GDP in 2009, which was broadly in line with other euro area countries. Combined with the impact of the recession, the general government deficit is expected to have reached around 8.0 percent of

GDP in 2009, reflecting the growth of expenditure above nominal GDP growth, and the sharp reduction of tax revenues.

The major negative impact on revenues was felt on VAT (State VAT receipts dropped by 19.4 percent until November, on a public accounts basis), reflecting the downturn in economic activity, and also, although to a lesser extent, the referred cut in the standard VAT rate and some measures leading to the frontloading of refunds compared to the previous year's pattern. Revenue from the corporate income tax has also been very negatively affected by the cyclical position of the economy (State corporate income tax receipts declined by 24.9 percent until November, on a public accounts basis).

… and it will be gradually reversed starting in 2010 contributing to the correction of the excessive deficit by 2013.

Within the framework of the Stability and Growth Pact, and following the action already taken to other euro area members earlier in the year, in November 2009 the Council of the EU decided: (i) Portugal, and eight other euro area members, were in excessive deficit and (ii) taking into account the special circumstances — associated essentially with the severe economic downturn in 2009 — **the deadline for the correction of the excessive deficit was set for 2013**.

Accordingly, **the Portuguese authorities have to ensure an average annual fiscal effort of 1.25 percent of GDP over the period 2010-2013, which is a quite ambitious challenge**. The adjustment should start gradually in 2010 and should be enhanced in the subsequent years. Following the beginning of a new legislative cycle in late October 2009, the 2010 State Budget is being finalized and it will be presented to the parliament this month for approval. Subsequently, an update to the Stability and Growth Programme will also be elaborated and submitted to the European Commission.

The impact of the global crisis and the expansionary fiscal policy on public debt will be significant.

Before the global crisis, the public debt recorded in 2007 (63.6 percent of GDP) finally reversed the past growing trend. However, under the recent adverse circumstances, and also as a consequence of the expansionary fiscal policy, a significant growth of public debt is expected and unavoidable. Careful monitoring of debt levels is of the utmost importance.

3. Financial Sector

In the context of the EU, measures to strengthen the financial sector were made available.

In response to the turmoil in the international financial markets in late 2008, and as part of concerted actions with other European countries, Portugal implemented measures to (i) strengthen the financial institution's information disclosure and transparency obligations; (ii) strengthen the guarantee of bank deposits (from EUR 25,000 to EUR 100,000 per depositor and per bank); and (iii) make available an amount of up to EUR 20 billion for the granting of State guarantees and to strengthen credit institutions' capital (not exceeding EUR 4 billion in this latter case). Banks used this financial support in limited amounts and essentially during the peak of the crisis. For the financial markets, almost as important as actually using any financial support, is the possibility of doing so, without actually doing it. These measures had no negative impact in the fiscal accounts.

Banks have continued to perform financial intermediation in a relatively smooth way …

Portuguese banks have been able to adapt to the particularly negative context deriving from the current international economic and financial crisis. In fact, the evolution of bank lending to the non-financial private sector in 2009 was globally in line with the usual determinants governing demand for credit — interest rate and aggregate demand components. Banks even succeeded, to a certain extent, in providing for the greatest financing needs of companies against a backdrop of particularly adverse financing conditions in international markets and a sudden unexpected drop in demand, in the last quarter of 2008 and the first quarter of 2009. The banks have also been reinforcing their own funds in the context of the economic and financial crisis, particularly in the first half of 2009. The reinforcement of their capital position was particularly visible in their Tier 1 capital adequacy ratio, recording a significant concentration at around 8 percent, which corresponded to the minimum value among the main banking groups in June 2009. Most institutions have, therefore, brought forward Banco de Portugal's recommendation to raise Tier 1 capital adequacy ratio to a value equal to or exceeding 8 percent by September 30, 2009.

… standing in a relatively favorable position in terms of profitability, liquidity, and solvency …

The main issues related to financial stability are analyzed in Part B of Section IV of the staff's report. Unfortunately the analysis does not constitute a balanced account of the vulnerabilities and mitigating factors facing the Portuguese financial sector. In fact, while the report rightly emphasizes the existence of mounting risks — mostly associated with falling profits in the context of the crisis, with increasing credit risk and with the exposure to equity risk — it does not emphasize equally the structural presence of important mitigating factors. Among these stand (i) the reinforcement of the banks' own funds in the first half of 2009; (ii) the fact that the banks' financing is fundamentally denominated in euro and for medium to long-term maturities; (iii) the non-overvaluation in the real estate market; (iv) the absence of a subprime segment in mortgage credit in Portugal; (v) the fact that the exposure of Portuguese banks' asset portfolios to the complex assets that were at the core of the financial crisis is insignificant; (vi) the small weight in total credit of the most vulnerable households in terms of credit risk; (vii) the relatively moderate debt service ratio of households — despite their high indebtedness levels — due to the relatively long maturities of mortgage loans, which are predominant in total credit to households; and (viii) the recent globally favorable evolution of liquidity indicators of Portuguese banks.

This latter issue deserves further elucidation. In fact, even though the liquidity position of Portuguese banks is an important dimension of the assessment of financial stability — in particular in the aftermath of the financial crisis — the staff report is surprisingly silent on this issue. In 2009, and in line with global trends, Portuguese banks started issuing in wholesale debt markets in progressively less unfavorable conditions — namely at longer maturities (3 and 5 years) — and, in a large measure, without government guarantees. This way, the issuance of debt was again the main source of financing of Portuguese banks in 2009. Meanwhile, customer deposits remained an important source of financing for banks, with a notable acceleration of household deposits for maturities over 2 years being recorded in 2009. These are favorable developments in terms of liquidity risk, given the higher stability of these resources. This fact, coupled with the deceleration of credit, implied that the declining trend in the credit-deposit ratio, started in the second half of 2007, continued in 2009. In addition, liquidity gaps — which establish a relation between highly liquid assets and volatile liabilities — recorded an improvement in the maturities up to 3 months in the first half of 2009. The improvement in the gap up to one month was particularly sizeable, with the main banking groups recording positive gaps. In the horizon up to one year, the gap turned more negative, albeit comparing favorably with the situation before the financial crisis. This latter development is however expected to be temporary, in particular if the access to international wholesale debt markets continues to improve, which will allow the lengthening of debt maturities, in line with what has been observed in 2009.

Therefore, it is fair to conclude that the profitability, liquidity, and solvency of the Portuguese banking system currently stand in a relatively favorable position in the European context.

… and revealing a high degree of resilience even under extreme stress tests.

The balance of vulnerabilities and mitigating factors facing the Portuguese financial system has actually been assessed under particularly severe conditions in the stress test exercises undertaken by Banco de Portugal. In one of the scenarios, activity contracts 5.4 percentage points between 2008 and 2011, equity prices fall 30 percent in late 2009, and housing prices fall 10 percent throughout the projection horizon. Even under such stringent circumstances, all banks would observe the overall regulatory requirements throughout the projection horizon. This result stems *inter alia* from the relative resilience of the banks' financial position to credit risk, due to the concentration of credit in household mortgages and in large firms, both of which display relatively low probabilities of default. These conclusions are alluded to, but not duly emphasized, in the staff's report, which instead opts to focus on the vulnerabilities of the system. The sentence in bold in paragraph 33 — which summarizes the section — is symptomatic of this assertion: "Financial stability has been maintained, though vulnerabilities — symptomatic of the macroeconomic imbalances — remain". However, what the exercises indicate is that even under an extreme configuration of shocks stressing the banks' underlying vulnerabilities, the banking system in Portugal would continue to display a high degree of resilience.