June 2013
IMF Country Report No. 13/160

Portugal: Seventh Review Under the Extended Arrangement and Request for Modification of End-June Performance Criteria—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Portugal.

In the context of the seventh review under the extended arrangement and request for modification of end-June performance criteria, the following documents have been released and are included in this package:

- The staff report for the Seventh Review Under the Extended Arrangement and Request for Modification of End-June Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on May 11, 2013, 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 May 31, 2013. 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 Press Release summarizing the views of the Executive Board as expressed during its June 12, 2013 discussion of the staff report that completed the request and/or review.

- A statement by the Executive Director for Portugal.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Portugal*
Memorandum of Economic and Financial Policies by the authorities of Portugal*
Technical Memorandum of Understanding*

*Also included in Staff Report

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: http://www.imf.org

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

PORTUGAL

June 12, 2013

SEVENTH REVIEW UNDER THE EXTENDED ARRANGEMENT AND REQUEST FOR MODIFICATION OF END-JUNE PERFORMANCE CRITERIA

EXECUTIVE SUMMARY

All performance criteria and structural benchmarks underpinning the review have been met. More broadly, there has been strong progress in reducing economic imbalances—some two-thirds of the 10 percentage points of GDP structural primary adjustment required to stabilize public debt has been effected and the current account deficit has narrowed sharply. Partly reflecting these developments as well as the current yen for yield, Portugal was able to return to the international bond market in January for the first time since early 2011.

The economic outlook, however, remains somber. Strong export growth, which has hitherto helped offset the contraction in domestic demand, has of late started to decrease reflecting weakening demand from the rest of the euro area. The labor market situation also remains extremely difficult, with unemployment already at some 18 percent and employment losses set to continue.

The seventh review program discussions focused on recalibrating the fiscal targets to take into account the revised macroeconomic outlook, policies to address the impact of a recent Constitutional Court ruling, and finalizing the ongoing public expenditure review. With the financing picture having improved, the authorities and staff agreed that there is a strong case for revisiting the mix between adjustment and financing toward the latter. Consequently, the deficit targets have been eased—by 1 and 1½ percentage points of GDP in 2013 and 2014, respectively. There was however also broad agreement that the scope for more financing was limited given fragile trajectory for public debt—set to peak at 124 percent of GDP on current policies and outlook.

Risks to the attainment of the program's core objectives remain high. The solid social and political consensus that to date has buttressed strong program implementation has weakened significantly. Economic recovery is also proving elusive. And with the program bereft of tools to boost competitiveness in the near-term, there is a high risk that adjustment will continue to take place through more demand compression with too little compensating expenditure switching due to higher exports—particularly in light of still difficult euro area economic environment.

Staff supports the authorities' request for completion of the seventh review. The purchase released upon completion of this review would be in an amount equivalent to SDR 574 million.

Approved By
Poul M. Thomsen and Martin Mühleisen

Discussions took place over several visits in Lisbon during February 25-March 14, April 15-17, and May 7-11. The staff team comprised A. Selassie (head), D. Gershenson, M. Goretti, H. Lin, and S. Roudet (all EUR); A. Piris and Y. Miao (SPR); A. Lemgruber (FAD); C. Verkoren and M. Anthony (MCM); W. Bergthaler (LEG); and A. Jaeger and M. Souto (Res. Reps). Mr. Cardoso (OED) also participated in meetings.

CONTENTS

TABLES

APPENDIXES

BACKGROUND

1. The seventh program review took place against the backdrop of good progress in reducing economic imbalances but extremely weak economic conditions, and renewed policy implementation challenges:

- All performance criteria and structural benchmarks underpinning the review have been met.[1] More broadly, some two-thirds of the close to 10 percentage points of GDP structural primary adjustment required to stabilize public debt has been effected through end-2012, and still more adjustment has already been legislated and is under way. The banking sector has been successfully recapitalized and liquidity buffers remain comfortable. The current account correction has continued to exceed expectations. There has also been notable progress in alleviating policy-induced distortions in the labor market and significant steps to facilitate product market competition. And reflecting this progress as well as the current quest for yield, Portugal was able to return to the international bond market in January for the first time since early 2011.

- However, the economic outlook is markedly worse than previously expected. Strong export growth, which has hitherto helped offset the contraction in domestic demand, has of late started to decelerate reflecting weakening demand from the rest of the euro area. Coupled with fragile domestic investor sentiment and the suffocating private sector debt overhang, it is generating stronger-than-expected headwinds to economic activity and fiscal performance. The recession is now set to be deeper than previously envisaged, with negative consequences for unemployment. Given the prevailing nominal rigidities, this is a stark reminder of the high risk that adjustment will continue to take place through further economic contraction rather than an improved supply response

- And in early April, the Constitutional Court found a number of 2013 budget provisions unconstitutional, opening up a fiscal gap of about 0.8 percent of GDP. As importantly, the ruling also raised questions about the feasibility of some policy and reform options planned to underpin fiscal adjustment going forward.

2. Discussions consequently focused on recalibrating the program to take into account the revised macroeconomic outlook as well as addressing the impact of the Court ruling. Particularly in light of the improved financing environment, the authorities and staff agreed that there was scope to allow automatic stabilizers to operate fully to accommodate the impact of lower growth and higher unemployment on the fiscal accounts. Alternative measures have also been identified to close the fiscal gap resulting from the Constitutional Court ruling for 2013 and to underpin the required fiscal adjustment in 2014. Beyond fiscal issues, discussions focused on actions to facilitate orderly restructuring of the corporate sector, alleviate the tight credit conditions facing

[1] Due to the delay created by a Constitutional Court ruling and the need to meet the prior actions, the controlling test date for this review is end-March (originally, end-December). With the 8th review Board discussion scheduled to take place after June 30, 2013, the controlling performance criteria for the 8th review will be those set for end-June.

smaller firms, and advance the program's broad structural agenda to reduce nominal rigidities and boost competitiveness and growth.

3. **Risks to the attainment of the program's core objectives remain high**. Successful completion of the program requires (i) continued strong policies and reform implementation, (ii) resumption of growth and (iii) a supportive euro area environment to allow the government to deepen and broaden market access. But developments on all these fronts have been challenging of late:

- *Politics*. The hitherto sturdy social and political consensus that has buttressed strong program implementation has weakened significantly. In this context and with financing conditions having improved as markets debt tolerance has improved, the appetite for reform is waning.

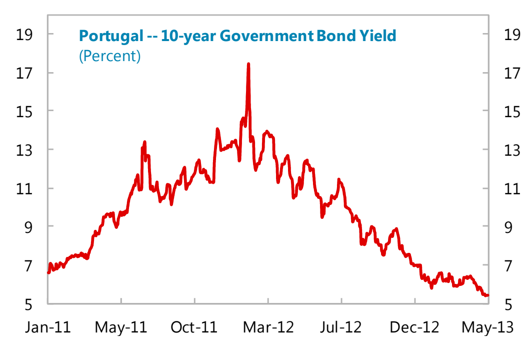
- *Recovery*. As noted, economic recovery is also proving elusive. To some extent, the relaxation of the pace of fiscal adjustment should help going forward. But with the program bereft of tools to boost competitiveness in the near-term, there remains a risk of adjustment taking place through more demand compression, with too little compensating expenditure switching due to higher exports and import substitution.

- *Euro area*. The drag on exports and sentiment from the difficult broader euro area economic environment is greatly exacerbating the already difficult domestic economic conditions.

ECONOMIC DEVELOPMENTS AND OUTLOOK

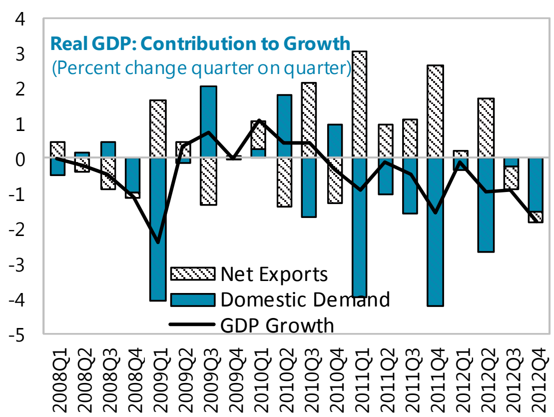
A. Recent developments

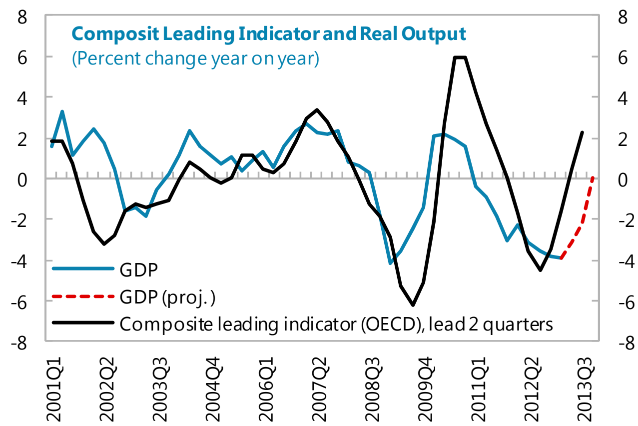
4. **Playing off the current global liquidity glut and improved sentiment towards Portugal, market access has resumed.** In mid-January, the government was able to reopen a five-year bond, borrowing €2.5 billion (1½ percent of GDP) at a yield of just under 5 percent. This was followed in early May by a new 10-year bond issue, raising some €3 billion at a yield slightly below 5.7 percent. The two bond issues were met with strong demand—mainly from nonresidents—with a marked increase in interest from long-term investors at the second issue. The yields are also 100-200 basis points below what is assumed for comparable maturities in staff's debt sustainability analysis. In a further sign of improved confidence and continued support from European partners—including the expected extension of loan maturities (see paragraph 40)—S&P revised the country's sovereign rating outlook from negative to stable. Investor interest was also apparent in the successful privatization of the airport concessionaire ANA, which was sold for €3.1 billion (1.9 percent of GDP) in a process that attracted several strong bids



Source: Bloomberg

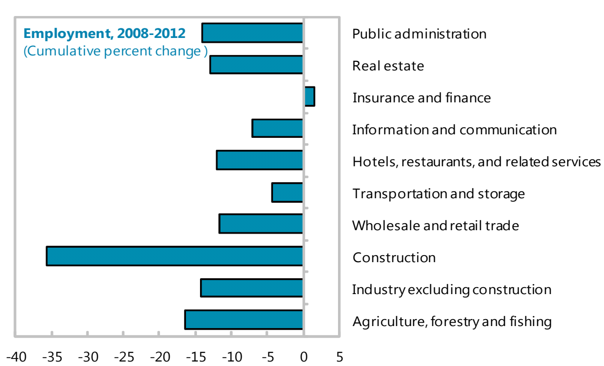
5. **However, the real economy continues to struggle.** As in other euro area countries, the contraction in output was pronounced in the fourth quarter, with GDP shrinking by 1¾ percent from the previous quarter (compared to 1 percent assumed under the program). As a result, output contracted by 3¼ percent in 2012. This was sharper than the 3-percent decline expected at the time of the sixth review and reflected lower public consumption and investment. Exports were also lower, but were matched by additional import compression. With real disposable income under pressure, the household saving rate is at all-time highs, and activity remains hampered by unprecedented balance sheet deleveraging of the corporate sector in the context of high interest rates and significant domestic and external uncertainties. Preliminary data indicates that output contracted at a slower pace (-0.3 percent quarter-over-quarter) in the first quarter of this year, consistent with a stabilization of high-frequency and leading indicators (Figure 1).

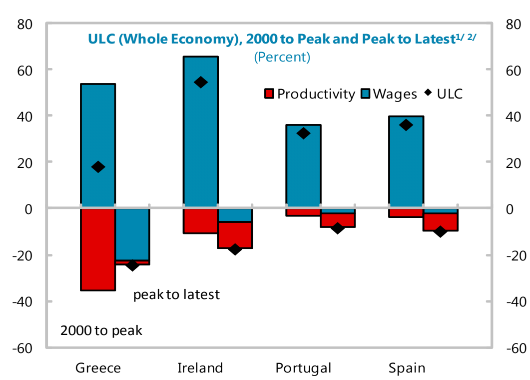




Sources: OECD; INE; and IMF staff estimates.

6. **Labor market conditions remain extremely difficult, with adjustment taking place mainly through labor shedding.** The overall unemployment rate rose further to some 17¾ percent in the first quarter of 2013 (from 17 percent in the fourth quarter), with more than half unemployed for over a year. Among the young, the unemployment rate is markedly higher still at some 40

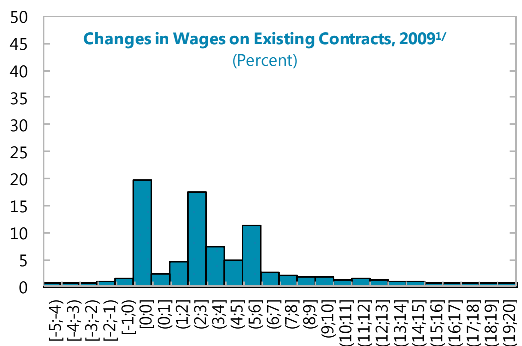


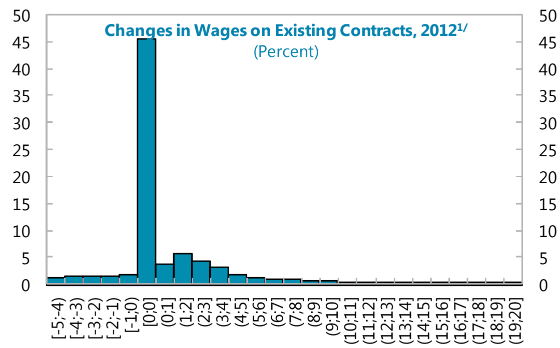


Sources: Labor Force Survey: Eurostat and IMF staff calculations.

1/ For Greece, latest is 2012Q3. All others is 2012Q4.
2/ ULC data for Greece is ULC calculated by Eurostat; all others are based on compensation per employee.

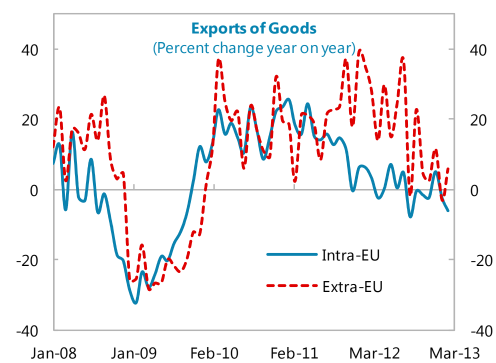
percent (Figure 2). Compensation per employee for the economy as a whole declined by 2½ percent in 2012, but this reflected in large part cuts in public sector wages which are being reversed in the wake of the Constitutional Court ruling. Overall, it remains unclear how long it will take for labor market adjustment to be completed without policy-induced changes to facilitate nominal wage declines. So far nominal wage increases for existing contracts in the private sector have decelerated but still remain slightly positive despite the depressed economic environment (see charts and Figure 2). Absent greater wage flexibility, this could portend more labor shedding and lower aggregate income.





Source: Portuguese Ministry of Economy and Employment.
1/ Distribution of percent change in base wage in January from the same month of the previous year. The sample consists of about 18,000 salaried employees each year, who remain in their jobs and pay social security.

7. The turnaround in the external imbalance has been rapid, but export growth has of late been decreasing. Broad-based export growth combined with import compression has only partially offset the contraction in domestic demand. Nevertheless, the current account deficit has shrunk to 1.5 percent of GDP in 2012, an adjustment of 10 percentage points from its peak in late 2008. However, with external demand waning (particularly from the euro area) and tradable sector competitiveness only slowly improving, net exports gains are not yet stabilizing output To some extent, the 2-percent decline in exports volumes in the fourth quarter (with respect to the previous quarter) partly reflected temporary factors.[2] But with output forecast to contract in the euro area in 2013—and markedly so in Spain, Portugal's main trading partner—the headwinds to export growth in the near term are set to be significant.



Sources: INE; and IMF staff estimates.

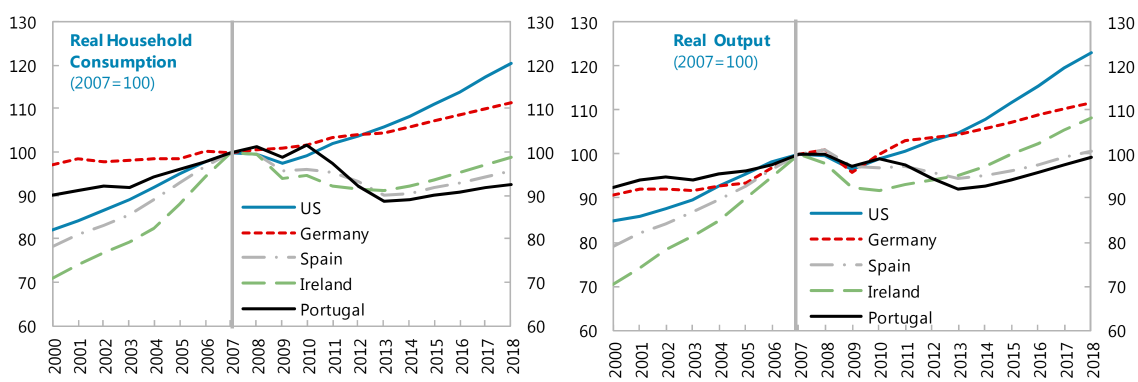
8. Improvements in external competitiveness indicators remain limited. Economy-wide unit labor costs (ULC) declined by 3¾ percent in 2012 (and they currently stand at about 8 percent

[2] Export performance in the last quarter was affected by the strikes of port workers that persisted through end-2012 and temporary shut-down of some factories.

below its 2009 Q1 peak).[3] But, again, this was driven mainly by wage cuts in the public sector, and productivity growth through across-the-board job shedding (see chart). Overall, about one-fourth of the increase in unit labor costs since 2000 has been reversed so far in Portugal—in line with other periphery countries. But the adjustment in the relative prices of nontradables to tradables versus trading partners and the gains in the private sector ULC have been limited. It thus remains unclear if the gains to date will be sufficient to ensure that the external adjustment endures once the economy recovers (Appendix IV).

B. OUTLOOK

9. The recession is still expected to trough later this year, but following a deeper output contraction. The 2013 growth projection has been revised down by 1¼ percentage points to -2¼ percent. This revision was motivated by the need to incorporate the large negative carry-over from the 2012 outturn (accounting for one-half of the revision), a revised assessment of domestic demand prospects, particularly for investment (accounting for one-fourth of the revision), as well as the latest outlook for partner country demand, which was projected to be weaker by almost 1¼ percentage points (accounting for the remaining one-fourth of the revision). A modest recovery is expected in the fourth quarter of the year—one quarter later than previously thought—underpinned by a gradual increase in investment outlays by more export-oriented firms, particularly in equipment and machinery, as capacity constraints become more binding. Reflecting weaker activity and with the impact of indirect tax measures and administered price increases dissipating, inflation is expected to average around ¾ percent in 2013. Unemployment rate projections have been revised up—reaching an average of 18½ percent in 2014.



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

10. Risks to the new baseline remain tilted to the downside:

- In the near term, the main risk is that a combination of fiscal adjustment and private sector deleveraging could curtail growth even more than projected.

[3] Unlike GDP deflator and/or ULC based REERs, the CPI-based REER does not show much sign of improvement in recent months. This discrepancy reflects VAT rate increases that adversely affected consumption prices. ULC and GDP deflators, on the other hand, were affected government consumptions and reductions in public wages.

- The uncertain growth prospects in Europe also elevate the risk of demand for Portuguese exports remaining weak going forward. Moreover, the current strength of the euro could limit further gains in market share in the important export markets outside the euro area.

- With only modest improvement in price-competitiveness indicators, there remains a risk that ongoing reforms—however comprehensive—will be insufficient to boost supply conditions in a timeframe and magnitude that prevent a protracted demand slump.

- Finally, the political and social situation—already under significant strain—could deteriorate further, thereby complicating the reform process.

ADVANCING FISCAL CONSOLIDATION

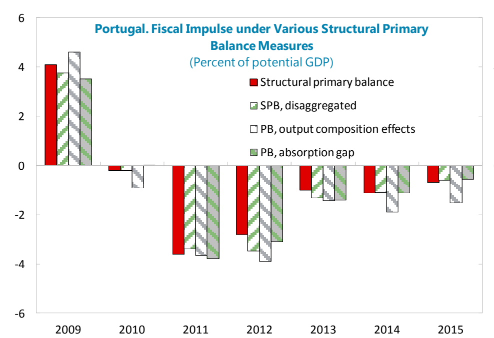
A. Recent Fiscal Developments

11. Achievement of the 2012 deficit objective reflects a sustained adjustment effort:

- The authorities offset broad-based weak revenue collections in the last quarter with expenditure savings, particularly by reducing intermediate consumption and slowing public investment outlays. Consequently, the general government deficit for program purposes is estimated at 4.7 percent of GDP, smaller than the 5 percent foreseen at the time of the last review.

- The ESA-definition (headline) deficit for 2012 is estimated at 6.4 percent of GDP, reflecting a number of one-off transactions that were booked differently when the program objectives were established. These transactions are excluded from the program deficit measure because they either are related to banking sector support or represent accounting reclassifications and not discretionary activity of the government.[4]

- Underlying fiscal adjustment has been impressive. Adjusting for one-off transactions and the impact of the business cycle, the structural primary balance improved by close to 3 percentage points of GDP in 2012, bringing the cumulative adjustment already effected under the program to about 6¼ percentage points of GDP, out of the required total of 10 percentage points of GDP. Other metrics that take



Source: IMF staff calculations.

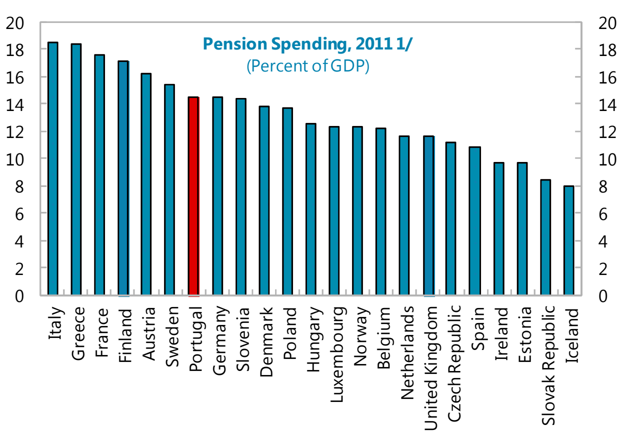
[4] These one-off transactions include: (i) the revenue from the sale of the airport concessionaire ANA, which is now booked as a financing transaction (€1.2 billion) rather than a deficit-reducing flow; (ii) the capital injection for the bank CGD, recorded as a capital transfer (€750 million) rather than an acquisition of a financial asset; (iii) the conversion of a loan to the SOE Sagestamo into a capital injection (€750 million), also recorded as a capital transfer; and (iv) impairments of assets transferred from the bank BPN to special purpose vehicles within the general government perimeter created to manage these assets (€100 million).

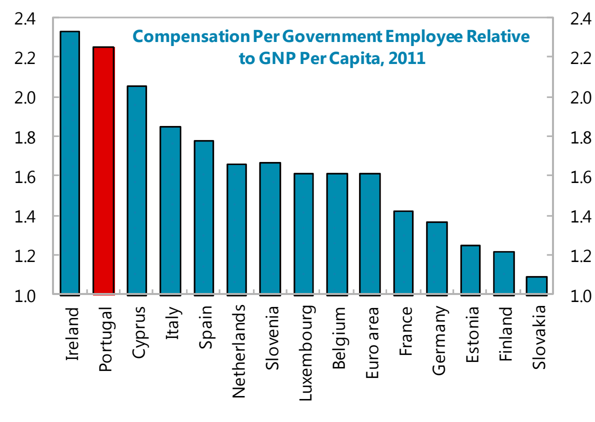
into account effects of the change in GDP composition also indicate that about two-thirds of the required adjustment has already been affected (see chart).

12. The Constitutional Court (CC) in early April declared a number of provisions of the 2013 State Budget Law unconstitutional:[5]

- The cuts in the 14th monthly payment to public wage earners and pensioners, a measure that was projected to yield net savings of about 0.7 percent of GDP, were struck down. Among other reasons, the CC assessed that these measures violated the principles of equality and proportionality contained in the Constitution since public sector employees would be affected more than other segments of society and public sector employees at lower income levels were disproportionally affected.

- The contribution on sick leave and unemployment benefits, estimated to yield savings of 0.1 percent of GDP was also ruled unconstitutional. The CC held that this measure violated the principle of proportionality as it would reduce incomes for recipients below socially acceptable income levels.





Sources: Eurostat; OECD; AMECO; and IMF staff calculations.
1/ For Belgium, Iceland, Spain, and Slovak Republic, 2010 levels are shown.

13. While the government had made encouraging progress on the Public Expenditure Review (PER), the Constitutional Court ruling delayed the process somewhat. Following two years of the revenue-driven adjustment, the authorities have been keen to switch to a more expenditure-based approach. They launched in late 2012 a comprehensive review of the functions of the state, aimed at identifying specific savings measures to underpin adjustment over the next few

[5] After the 2013 State Budget Law entered into force, a number of petitions were filed to challenge the constitutionality of certain provisions, including by the President of the Republic. The remainder of the challenged provisions was upheld.

years.[6] Given that Portugal's spending is heavily concentrated on social transfers and public wages, accounting for about two-thirds of the total, the PER has been somewhat focused on these outlays.[7] In particular, given relatively high public employment, high wage premium in comparison to the private sector, and more generous public sector wages and pensions than in peer countries (see charts), the authorities aim at generating the necessary savings while improving skill levels and efficiency in the public administration and making the pension system more equitable (MEFP, ¶7-8). The CC ruling, however, raised questions regarding the feasibility of some of the reforms that were under consideration, requiring more time to fine tune the exercise and limit future legal risks.

14. Fiscal structural reforms are broadly on track.

- *Public Financial Management*. Following the incorporation of the Treaty on Stability, Coordination, and Governance in the EMU (Fiscal Compact) into the domestic Budgetary Framework Law (BFL)—an important step to strengthen the medium-term budget framework—the authorities have now launched further reforms aimed at streamlining budgetary procedures.

- *Expenditure controls and arrears*. The new expenditure commitment control system is now fully operational in the majority of the budgetary entities, and the General Inspectorate of Finance has been controlling implementation. The underlying stock of arrears (i.e. before the settlement program) declined by €700 million in the fourth quarter of 2012, but increased slightly in February, a dynamic typical at the beginning of the fiscal year, and breaching the related continuous indicative target; still, the stock of domestic arrears was reduced by €1 billion between September 2012 and February 2013. The authorities remain committed to settle the remaining stock, which stood at 2.6 percent of GDP in February 2013.[8]

- *Revenue Administration.* Reform is advancing, with the Large Taxpayer Office operational (end-December Structural Benchmark) and ongoing efforts to improve compliance through better revenue analysis and various projects; including on VAT invoicing and certain risk prone industry groups. Timely conclusion of the property revaluation project—involving appraising some 5 million properties—was key to underpinning one of the important tax handles in the 2013 budget. A recent FAD mission identified the need to increase the focus on protecting PIT revenues.

[6] The IMF has contributed to the discussion by providing technical assistance; see *Portugal: Rethinking the State—Selected Expenditure Reform Options*, IMF Country Report 13/6.

[7] See Chapter IV in Country Report No 13/18 (*Growth-Friendly, Equitable, and Sustainable Fiscal Reform in Portugal*)

[8] The health sector settlement program (€1.5 billion) has been concluded. An additional €432 million financing line has been approved to continue settling health arrears, to be implemented starting in 2013Q2. The implementation of the €1 billion credit line is ongoing, and local governments' arrears have started being cleared (about € 140 million has already transferred to municipalities by end-March 2013, following the approval of the Court of Audits). Finally, Madeira has been negotiating bank loans (€ 1.1 billion), backed by central government guarantees, in order to pay arrears. These arrears have already been subject to factoring arrangements. These transactions will thus have no impact in general government debt.

- *Public-Private Partnership*. The authorities have accelerated the PPP institutional reforms, including by making the PPP unit quasi-operational. PPP contracts' renegotiations—a paramount initiative to support the envisaged 2013 fiscal savings on PPPs—are well advanced.

- *Local and Regional Finances.* The draft regional and local finance laws were submitted to Parliament by end-2012 (structural benchmark). These aim at establishing a more effective inter-governmental fiscal framework. Key elements include: the extension of the principles of the BFL to sub-national governments; the revision of local and regional indebtedness rules; the creation of a municipal insolvency fund; and the establishment of a coordination council between the central and sub-national governments. Specific improvements in local level taxation have also been proposed, but no structural change to the transfer system has been envisaged.

- *Tax courts*. The rate of resolution of high-value tax court cases by the task forces since May 2011 has been very encouraging. In addition, the authorities continue to focus their efforts to further speed up tax court litigation.

B. Policy Discussions

15. In view of the significant deterioration in the macro-fiscal outlook, there was agreement that the fiscal deficit path under the program needed to be recalibrated. Even though the end-2012 program cash deficit target was met, underlying revenue performance in the last quarter of 2012 was weak reflecting weaker economic conditions. This implied a significant negative carry-over from 2012 (of at least ½ percent of GDP) and together with the markedly worse prospects for growth and employment in 2013 meant that maintaining the headline deficit objectives unchanged would have entailed even more drag on output and employment. And with the financing picture having improved, the authorities argued that there was a strong case for revisiting the mix between adjustment and financing. Staff agreed. But both sides also recognized that the scope for financing was not unlimited and that the implications for the debt trajectory could not be ignored.

Portugal: General Government Balances
(Percent of GDP, unless specified otherwise)

	2011	2012	2013	2014	2015
Sixth review fiscal path					
Overall balance, program 1/	-4.0	-5.0	-4.5	-2.5	-2.0
Overall balance	-4.4	-5.0	-4.5	-2.5	-2.0
Excluding one-offs	*-7.4*	*-6.0*	*-4.5*	*-2.5*	*-2.0*
Primary balance	-0.4	-0.8	-0.2	2.1	2.7
Excluding one-offs	*-3.4*	*-1.8*	*-0.2*	*2.1*	*2.7*
Fiscal impulse (change in structural primary balance; percent of potential GDP)	3.5	2.5	1.9	1.8	-0.2
Seventh review fiscal path					
Overall balance, program 1/	-4.0	-4.7	-5.5	-4.0	-2.5
Overall balance	-4.4	-6.4	-5.5	-4.0	-2.5
Excluding one-offs	-7.4	-5.8	-5.6	-3.7	-2.5
Primary balance	-0.4	-2.0	-1.1	0.4	1.8
Excluding one-offs	-3.4	-1.4	-1.2	0.7	1.8
Fiscal impulse (change in structural primary balance; percent of potential GDP)	3.6	2.8	0.7	1.5	0.6

1/ Excludes the impact of several large transactions in 2011 and 2012, as explained in table 2, footnote 4.

16. The revised fiscal targets accordingly take into account several considerations: (i) accommodating the operation of automatic stabilizers; (ii) continuing to advance structural fiscal adjustment; and (iii) containing the debt-to-GDP ratio to facilitate a deepening of market access. In particular, the headline deficit path is being revised to 5½ percent of GDP for 2013, 4 percent for 2014, and 2½ percent in 2015. This delays the attainment of the Stability and Growth Pact (SGP) deficit threshold (3 percent of GDP) by one year while keeping Portugal on track to meet its fiscal compact (and Budget Framework Law) objective of reducing the overall structural deficit to ½ percent of GDP by 2017.[9] The effect of these changes and shift in the composition of adjustment (particularly in 2013, see below) is to allow the remaining fiscal adjustment to be more evenly spread over 2013-15.

17. Agreement was also reached on measures to offset the gap created by the Court ruling and allow the revised 2013 fiscal target to be achieved. In light of the need to identify adjustment measures that would generate savings rapidly, about a quarter of the measures are of a temporary nature, including the reprogramming of EU structural funds and some expenditure compression. The rest of the gap is being filled by front loading some of the PER measures. As a *prior action* for the completion of this review, the authorities have submitted to Parliament a supplementary budget that ensures that these savings are realized (MEFP, ¶6).

18. Advancing the PER implementation process in the coming months will be critical for achieving the 2014 deficit target. Permanent spending cuts have now been identified with an expected yield of some €4.7 billion (2.9 percent of 2013 GDP) in net savings[10], with a one-off cost of €0.5 billion (0.3 percent of GDP) due to severance payments to be paid in 2014. The savings are distributed into three areas: pension reform; changes to the public sector employment and wage rules; as well as line ministries' goods and services budget. In view of PER's importance for fiscal adjustment going forward, its adoption and publication of the 2013-17 medium-term fiscal framework—including specific measures for 2013-14 to meet the revised deficit targets (See Appendix I)—by the Council of Ministers is a prior action for the completion of this program review; it was met in early May (MEFP, ¶7). Following the currently ongoing public consultation process, some elements of the PER could still be modified—there is for instance strong opposition to the introduction of a sustainability contribution on pensions—but with a commitment from the authorities to offset any changes by equivalent permanent measures. Some elements of the PER require significant legislative amendments, and to ensure that this process get underway in time submission of the relevant draft laws and legislative proposals to Parliament have been set as structural benchmarks, to be met in June and July (MEFP, ¶8).

---

[9] Staff assumes no structural primary effort after 2015; an additional effort of about 0.6 percent of GDP will be needed to achieve the fiscal compact objective.

[10] This amount is cumulative, covering 2013-14.

19. Given the risks highlighted by the recent Court ruling, the authorities will take a number of steps to mitigate potential legal issues. First, they intend to rely as much as possible on general laws—rather than on one-year budget laws—consistent with the structural nature of the reforms. This will open the possibility for prior review by the Court (before draft legislations are signed into laws), thus allowing early reaction on the part of the government in case these reforms raise constitutional issues. Second, they will justify the reforms by stressing the need to comply with the fiscal sustainability rules embedded in the recently-ratified Fiscal Compact which now ranks higher than ordinary legislation. Finally, to respond to the issues raised by the Court in its recent ruling, expenditure reforms will be designed with the principle of public/private sector and intergenerational equity in mind.

20. The outlook for public debt remains very fragile (see Appendix II). The debt-to-GDP ratio is now projected to peak at close to 124 percent of GDP in 2014, two percentage points higher than had been expected at the time of the sixth review.[11] This reflects the higher deficit path as well as the downward revision to nominal GDP, only partially offset by one-off transactions such as the planned sale of foreign assets of the social security fund and transfer of the government's shares in state-owned bank CGD to Parpública, a state-owned holding company that is not part of the general government.[12] Beyond this, the sizeable contingent liabilities of the public sector—including the 9 percent of GDP in debt of the SOEs that are classified outside the general government—remain a significant source of risk to debt sustainability.[13] Finally, while debt remains sustainable under the baseline scenario, as also highlighted in previous reports, a combination of plausible shocks could generate unsustainable debt dynamics.

21. The privatization process is expected to continue in 2013. The privatization of the flag carrier TAP—postponed after the sole bidder could not provide adequate financing assurances—is now scheduled to be re-launched later in the year. The sale of the postal company, CTT, is also expected to be launched in the second quarter and completed by year-end, while privatization of the rail cargo company CP Carga will get underway in the second half of the year. A strategic review of the water sector was completed in December 2012; next steps include the possible sale of the waste management company and assessment of potential for concessions and introducing private management in water companies. Binding offers for the sale of waste management business are currently anticipated for the end of 2013.Opening water concession to private capital and management is expected to take longer, because it requires substantial legal changes and participation of municipal governments.

22. Staff stressed the importance of enhancing tax compliance management to guard against revenue shortfalls. The authorities were of the view that tax compliance has not deteriorated significantly during the crisis. Nonetheless, staff highlighted the need for PIT and VAT

[11] IMF Country Report 13/18.

[12] The latter transaction will allow the repayment in kind of some of Parpública's loans to the government.

[13] For a detailed discussion of contingent liabilities, see IMF Country Report 12/77.

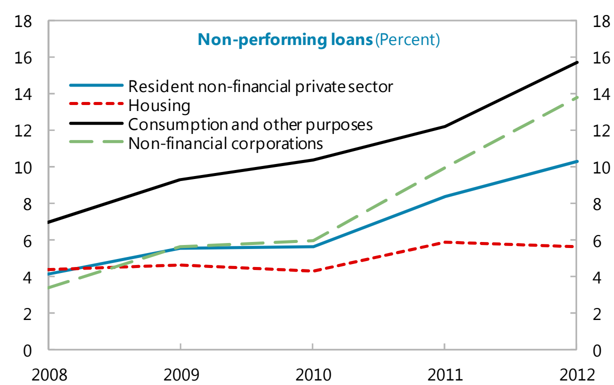
compliance actions, given the increasing incentives for tax evasion by firms and households in the current difficult environment. In particular, the mission strongly recommended adopting proactive short-term initiatives to promote voluntary compliance—including through communication campaigns and meetings with business associations—and focusing on taxpayer segments that are prone to high evasion. Looking ahead, a priority reform should be the establishment of a permanent Compliance Risk Management Unit to enhance the analytical and strategic capacity of the revenue administration. In addition, efforts should be made to strengthen the exchange of information between the tax and the anti-money laundering authorities and, more broadly, to make greater use of the anti-money laundering framework to support revenue collection.

23. With the PFM reform agenda broadly on track, discussions focused on PPPs and the health sector. On PPPs, discussions centered on the strategy underpinning the negotiations and key ways to ensure that the savings under the 2013 budget materialize as envisaged. Staff supported the authorities' strategy of reducing the fiscal burden from PPPs through a combination of cuts in operational and capital expenditures, as well as the reduction and convergence of the contracts' internal rates of return. As for the health sector, staff welcomed the development of an enhanced system for monitoring of fiscal outcomes, which will provide timely information on the general government health system and hospitals and thus help improve control over budget execution.

SAFEGUARDING FINANCIAL STABILITY

A. Recent Financial Developments

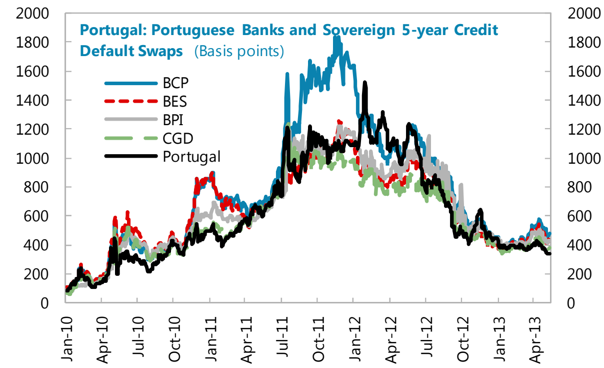
24. Bank capitalization has improved significantly following successful completion of the 2012 capital augmentation exercise.[14] All banks met the program Core Tier 1 target of 10 percent, with one aided institution already able to make early repayments to the State of the contingent instruments issued in June 2012. The latest round of stress tests (with September 2012 as reference date and a Core Tier 1 hurdle rate of 6 percent for the adverse scenario) indicates that banks' capital buffers are sufficient to withstand further deterioration of the operating environment. Moreover, Banco de Portugal's (BdP) recent On-site Inspection Program (OIP)—focused on assets related to construction and commercial real estate— highlighted only modest understatements of impairment levels that have meanwhile been addressed by the banks.



Source: Banco de Portugal

[14] On January 25, 2013, the Portuguese State injected €1.1bn in Rentipar-Banif, allowing the bank to meet the program's capital requirements. A private rights issuance is expected by June 2013, allowing the bank to further increase its capital buffer and repay part of the state aid received.

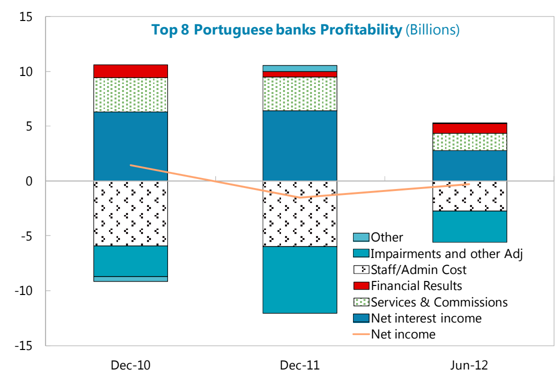
25. Funding pressures have also eased somewhat. In the context of sizable capital injections and stable deposits, banks have reduced their reliance on Eurosystem liquidity support by over €11 billion since the peak level reached in June 2012, including €3.5 billion in early repayments of the 3-year LTROs. The collateral buffer stands at around €28 billion or one year of banks' refinancing needs, and remains adequate to withstand potential shocks. Moreover, two of the major banks in the system have successfully returned to the international bond markets, although prospects for the rest of the banking system remain uncertain, tied as they are to broader market developments in the region.[15]



Source: Bloomberg.

26. But bank profitability remains under considerable strain, resulting in extremely difficult credit conditions for small firms:

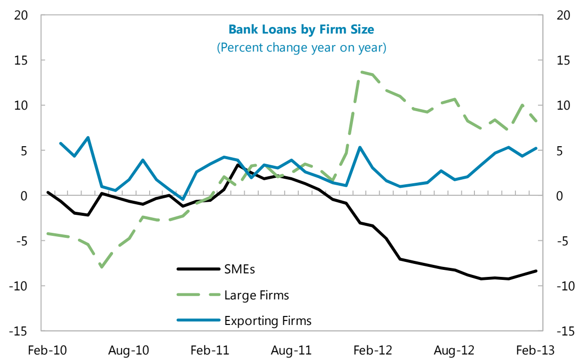
- While bond sales and other capital market transactions helped buoy the 2012 results of some banks, the 2013 Q1 results indicate a further decline in bank profitability and notably net interest income, in line with the weaker domestic environment and elevated impairments from corporates. Further, the low spreads on banks' legacy mortgage loans—with rates linked to the Euribor with a small fixed margin but with current funding costs much higher—are another source of significant drag on profits. Positive contributions from foreign operations and savings in operating costs help support banks' earnings but cannot fully offset the challenges that emanate from the difficult domestic environment.



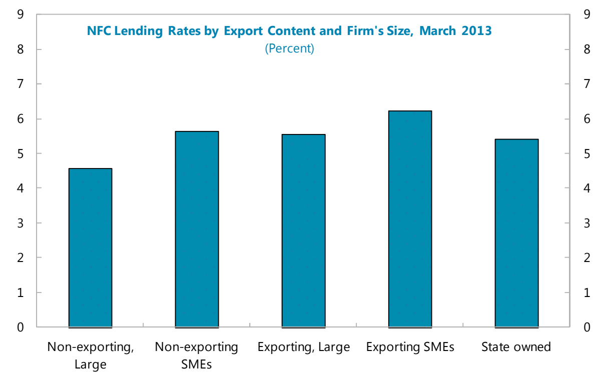
Source: Banco de Portugal

- Access to credit for the more indebted SME segment remains highly constrained. In aggregate terms, credit continues to contract, although at a slower pace in recent months, reflecting the ongoing deleveraging by banks and non-financial corporates, particularly in declining sectors like construction. But there is also evidence that the cost of credit, including for firms engaged in sectors faring better such as exports, remains very high. Lending rates on new corporate business are well above those in euro area peers, even for firms with comparable balance sheets strength. Staff analysis suggests that the still-high sovereign spreads as well as the weak domestic conditions and banks' profitability are at the root of the high lending rates in Portugal and, more generally, the credit segmentation in the periphery (Appendix III).

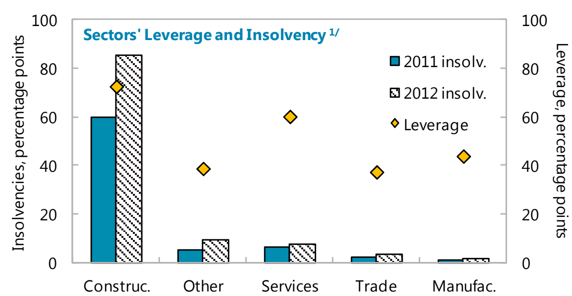
[15] Following their successful issuances in 2012, CGD placed a €750 million covered bond (5-year and 3.75 percent coupon) and BES—a €500 million senior unsecured bond (5-year and 4.75 percent coupon) in January of this year.



Sources: Banco de Portugal; and IMF staff estimates.



27. Against this backdrop, private sector deleveraging is advancing. Reflecting precautionary motives but also the need to service high debt burdens, both households and non-financial corporates continue to improve their financial balances. The gradual adjustment, however, has not been able to avoid a pronounced increase in corporate insolvencies. While the new restructuring tools, PER and SIREVE, are now fully operational, it is too early to judge their effectiveness in facilitating corporate debt workouts (Box 1). On the household side, an analysis of the household debt restructuring regimes by the BdP indicates that, as of April 2013, about €3 billion in credit had been considered under the general regime, with 56 percent of the terminated processes ending in the payment of overdue amounts. The number of processes under the extraordinary mortgage regime has been much smaller (with only €5 million of credit renegotiated), with negligible implications for the banks.

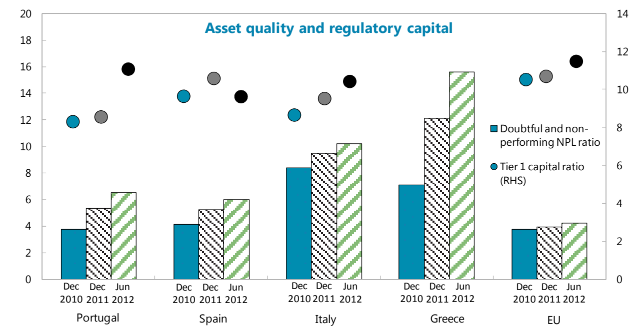


Sources: Banco de Portugal, COSEC, and IMF staff estimates.
1/ Leverage defined as debt over total assets. Insolvency defined as the number of insolvencies over total number of firms in each sector, with COSEC credit insurance.

28. Efforts by the authorities to further strengthen the bank recapitalization and resolution frameworks are ongoing. Parliament approved in May the amendments to the law governing banks' access to public capital, submitted earlier by the government (end-January structural benchmark) to allow the state—under strict guidelines—to exercise control over recapitalized institutions and to perform mandatory recapitalizations. The decree law on banks' contributions to the Resolution Fund, which entered into force in February 2013, foresees the payment of initial contributions by mid-2013, followed by the periodical contribution for 2013 in September. The review of the largest banks' recovery plans is progressing and recovery plans for other institutions are expected by end-November 2013. Banks' input for the resolution plans, following the supervisory notice on resolution plans, published in December 2012, is expected by end-July 2013.

B. Policy Discussions

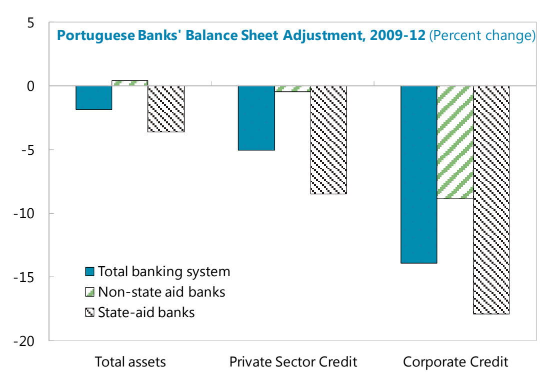
29. Notwithstanding the resilience of the banking system to date, the authorities and staff agreed that continued vigilance was needed. Impairment levels for vulnerable portfolios have already undergone close scrutiny—highlighting only modest impairment understatement—and the robust capital buffers offer protection against a potential further deterioration in banks' asset quality in case of worse-than-expected macroeconomic outlook. Over time, ongoing efforts to improve cost efficiency, together with gradually decreasing impairment flows are expected to contribute to the restoration of bank profitability, supporting banks' efforts to strengthen their capital base and thus allowing for a gradual repayment of state aid. The authorities and staff, however, agreed that vigilance remains necessary in light of the adverse operating environment and ongoing asset quality deterioration. Accordingly, and as part of its regular supervisory activity, the BdP will continue to carefully review banks' Funding and Capital Plans (FCPs) and update its quarterly stress test exercise.



Source: Banco de Portugal

30. Efforts by banks to restructure troubled loans are progressing. Following the BdP's Instruction on the identification and mandatory marking of loans that are restructured due to financial difficulties of the client, banks are required to submit, as of September 2012, quarterly reports on the amount of restructured loans, allowing the BdP to closely follow their evolution. Moreover, the BdP, as part of the OIP exercise, has assessed banks' progress in implementing the Instruction's requirements and provided specific recommendations that the banks are currently implementing. In addition, the BdP is planning to conduct a thematic review of banks' operational capacity in the area of loan restructurings, ensuring that banking system can effectively support the balance sheet adjustment of the private sector by timely engaging troubled debtors whose financial viability is in jeopardy.

31. The mission took stock of ongoing discussions with the European Commission on the aided banks' restructuring plans. State aid recipients have already shed a significant proportion of their assets since the onset of the crisis and further reductions are foreseen in the banks' current FCPs. While the ongoing restructuring process for the state-aid recipients can contribute to the aided banks' long-term viability, staff and the authorities stressed the importance of ensuring that any future downsizing



Sources: Banks' FCPs; and IMF staff estimates.

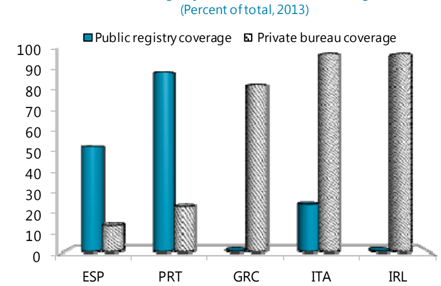
remains in line with the macro-financial assumptions embedded in the FCPs and does not unduly constrain domestic credit supply—particularly to inherently viable companies in the tradable sector—nor trigger material erosion of banks' capital buffers and profitability prospects.

32. In parallel, a number of government-sponsored initiatives are being put in place or considered, especially for SMEs:

- **Guaranteed credit lines.** To date, about €12 billion in government-guaranteed credit lines have been disbursed to SMEs through the PME Invest and Crescimiento initiatives. The government is undertaking a comprehensive review of these schemes to ensure they are effectively targeted to viable and productive companies, in line with international best practice. In this context, it has conducted an external audit of the National Guarantee System (NGS), which has helped identify preliminary policy recommendations aiming at making these schemes more efficient and minimizing risks for the state. A detailed implementation plan of the final recommendations is currently being finalized, with a focus on further enhancing pricing mechanisms and investment selection processes as well as the NGS risk management capabilities and governance structure. Moreover, specific modalities to tie government-sponsored support to successful completion of a corporate restructuring process are being considered to effectively support viable firms in financial difficulties. In parallel, the authorities are establishing a new quarterly monitoring framework including key balance sheet indicators of the firms benefiting from the credit lines.

- **Measures to improve access to capital markets by SMEs.** Notwithstanding recent successful placements in domestic and international bond markets by large corporations, prospects for SMEs issuing debt securities remain poor. In response, the government is exploring new measures to align the tax treatment of commercial paper to other debt instruments and promote their securitization through pooled SME issuances, in line with successful experiences in other periphery countries. Detailed proposals by relevant entities are expected by end-May, with a first draft of the necessary amendments of the rules governing the commercial paper market to be prepared by end-June subject to a review of any potential tax implications. The authorities are also considering other forms of government-guaranteed support, including a €220 million venture capital line.

Public Registry and Private Bureau Coverage
(Percent of total, 2013)



Sources: World Bank Doing Business Indicators; and IMF staff estimates.

In order to increase the efficiency and use of existing government initiatives, including effective channeling of EU structural funds, the government is assessing possible modalities to centralize resources and rationalize these initiatives, focusing on few, targeted and successful ones. These efforts will also aim at minimizing any fiscal burden and risks for the state.

33. The BdP is stepping up its efforts to broaden information sharing on credit and firms' balance sheet indicators, leveraging on its comprehensive public databases. The data coverage of the Central Credit Registry (CCR), is being further enhanced to include additional financial products and supplementary classifications, e.g. on guaranteed and restructured loans. Subject to the authorization of the Portuguese Data Protection Authority, financial institutions would also be able to access historical information on their potential new clients. In parallel, the BdP is assessing available options to allow access to other available data sources, such as the Central Balance Sheet Database (CBSD). These initiatives are expected to provide further support to the BdP regular supervisory activities, but can also play a critical role in reducing information asymmetries, especially for SMEs, and help diversify funding availability from banks and other investors.

34. Staff encouraged the authorities to closely monitor the performance of the new debt restructuring tools. Following the positive initial data on the utilization of the fast track in-court restructuring mechanism, the authorities are planning to launch a survey of key stakeholders, to be completed by July 2013, about the usefulness and appropriateness of the new corporate debt restructuring tool, with the aim to identify any remaining gaps or bottlenecks. In parallel, the BdP will continue to conduct quarterly assessments of the household debt restructuring regimes. Finally, the Ministry of Economy, in consultation with the BdP, will henceforth monitor, on a quarterly basis, selected financial and debt restructuring indicators, with a view to assessing progress realized in the various debt restructuring processes. A first monitoring report will be issued by end-June 2013.

BOOSTING COMPETITIVENESS AND GROWTH

A. Recent Structural Developments

35. Structural reforms to foster competition and remove bottlenecks to growth and job creation are advancing broadly as planned. The government recently submitted to Parliament a draft framework law governing regulatory agencies, which will strengthen the regulators' independence, as well as their financial, administrative and management autonomy. The new framework for regulators and ongoing service sector reforms in line with EU directives should help increase competition in the nontradable sectors. A second ten-percent cut in port user administrative fees was introduced in January. In addition, following adoption of a new Ports Work Law—aimed at lowering wage costs and making the use of labor more flexible—the authorities are now seeking effective transmission of lower labor costs to end-users of port services by engaging with concessionaires (MEFP ¶29). Other steps are also being taken to reduce companies' operating costs, including the ongoing cuts in administrative burdens and licensing. On the labor market front, however, delays have been encountered in the next step of the planned severance pay reform, reflecting political and social pressure to water down the agreement reached at the time of the sixth review.[16]

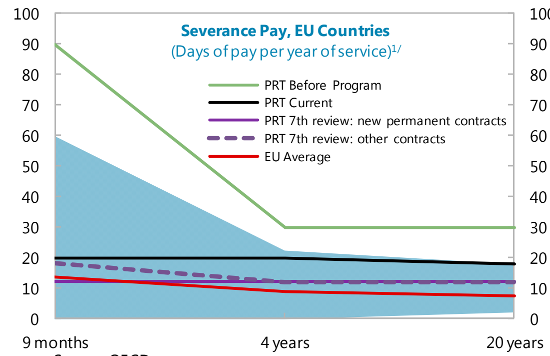
36. Reforms to improve the efficiency of the judicial system continue to progress well. The authorities have increased the pace of resolution of the backlogged enforcement cases. Two landmark pieces of legislation—the Code of Civil Procedure to speed up the court procedure and

[16] The authorities have submitted to Parliament a law that further reduces severance payments to 12 days of salary per year of service for all tenures.

the Bill for a new judicial roadmap to streamline the court structure—are now being debated in Parliament, and are scheduled to enter into force in the fall of 2013 and in early 2014, respectively. The authorities have also started preparatory steps for implementation of these two bills.

B. Policy Discussions

37. Structural reforms discussions focused on the following areas:



Source: OECD.
1/ Shaded area represents area between max and min.

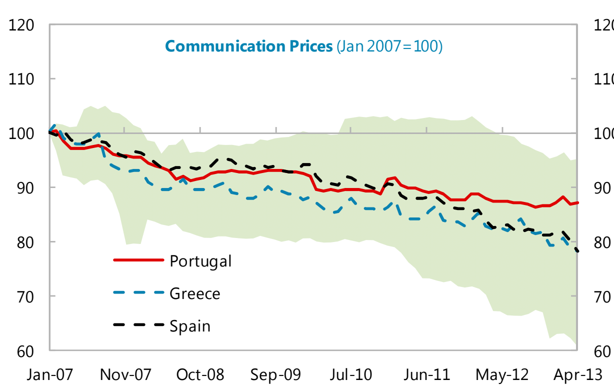
- *Labor market.* Faced with significant pressure to modify the draft law on severance pay, the authorities emphasized that there was room to amend the reform slightly while still achieving the same objectives. A compromise was reached which entails reducing severance payments to 12 days per year of service for all new permanent labor contracts—in line with the initial objective—and, for the existing permanent contracts and all fixed-term contracts, to 18 days per year of service for the first three years of the contract, and to 12 days per year of service for subsequent years (MEFP ¶28). This approach, the authorities argued, would provide incentives for enterprises to hire via permanent contracts. While staff regretted the softening of the reform—in an area where more ambitious reform may still be necessary to foster more wage flexibility—the average severance payment will still be brought down significantly closer to the EU average (see chart). The authorities committed to enact the reform by October 2013 (*structural benchmark*).

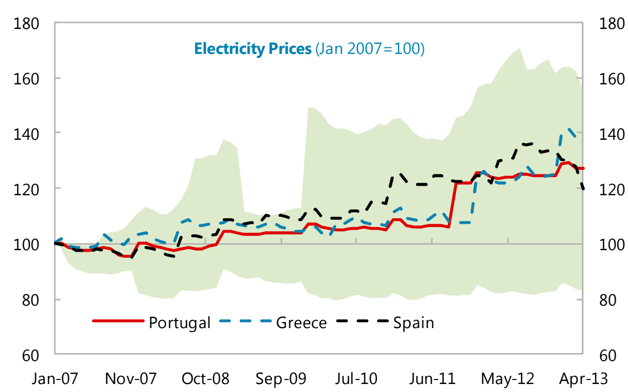
- *Corporate Income Tax (CIT).* The mission discussed with the authorities the preparatory work for a comprehensive reform of the corporate income tax. The main objective is to improve the international competitiveness of the CIT by simplifying the overly complex tax structure, reducing compliance and administrative costs, and gradually lowering the tax rate (MEFP ¶11). The reform will also envisage reducing policy-induced debt bias. A detailed and fully quantified proposal will be developed over the next few months, in consultation with the EC/ECB/IMF staff, leading to a draft law by end-June 2013. The authorities are also investigating possible short-term CIT incentives—consistent with the fiscal targets—to jump start investment.

- *Debt enforcement/judicial reform*. With the main judicial reform projects on track, discussions specifically focused on incentivizing efficient debt enforcement. In this regard, the authorities will refine and strengthen the enforcement agents' fee system and the framework for supervision and monitoring (CACAJ), including by revising the fee structure to provide proper incentives and by setting up a strengthened and independent entity to effectively monitor and supervise the enforcement agents. These two instruments are scheduled to be adopted by end-June 2013 (MEFP ¶34)

38. The government also needs to consider alternative policy options to generate more significant reductions in production costs, particularly nontradable sector prices. A set of important labor and product market reforms is now in place (Appendix IV) but, as noted above, progress on price-competitiveness has so far been modest. Sustaining the structural reform effort and getting the details of implementation right is therefore important, and staff strongly cautioned the authorities against any complacency—a non-negligible risk in view of the recent improvement in financial market conditions and the heightened social dissatisfaction. Stronger policy options would need to be considered if nominal rigidities, particularly in nontradable prices, persist, delaying the needed rebalancing of incentives toward producing tradables.

39. The evolution of prices in some network industries exemplifies the challenge facing the authorities. In the context of the monetary union, because raising productivity takes time, improving competitiveness requires reducing production costs including wages and non tradable prices. And on the latter front, network industries such as electricity and communications, because their prices cascade through the production process, can have an important bearing containing or even reducing input costs for the tradable sector. But the evolution of consumer prices in these sectors do not yet reflect the current depressed demand conditions (text charts). To some degree, this reflects past policy decisions, including for example the increase in VAT in mid-2011 or binding purchasing contracts in the electricity sector. Still, concrete steps that need to be considered in these sectors include tackling more decisively any explicit and implicit policies that limit market entry, hinder competition, and guarantee high rates of returns to incumbent firms. The authorities agreed with these objectives but pointed to the long-term character of some of the contracts in these sectors. But more intrusive regulatory approaches coupled with a reexamination of existing contracts in network industries may be unavoidable.





Sources: Eurostat; and IMF staff calculations.
1/ Shaded area represents area between max and min.

FINANCING AND RISKS

40. With the recent successful bond issues, near-term financing needs are manageable. Having ended 2012 with a comfortable stock of deposits (some €15 billion), the authorities have adequate resources to meet expected financing needs for the next 12 months or so. Further bond issuance s—or stepped-up net Treasury bill issuance—will serve to increase cash buffers; and prospects for this are good. The recent strong results of the five and ten-year bond issues and reasonable markets yields have also strengthened the credibility of the authorities' strategy for gradual market re-access.

41. Further support from European partners will remain important in helping overcome remaining medium-term financing challenges. The January bond issue featured a shift in the investor base towards hedge funds and active fund managers rather than pension fund and large institutional investors, likely reflecting the sub-investment grade rating. Although the proportion of real money accounts increased at the May bond issue, this is a reminder that financing Portugal's large medium-term needs could still be challenging. In light of this, the final green light by the European authorities to extend EFSF/EFSM maturities by 7 years on average will be particularly welcome.[17] Such a meaningful rescheduling has helped create a window that will facilitate further issuance of longer-term bonds in the next few years. Eligibility to the ECB's Outright Monetary Transaction (OMT) program would also go some way in helping improve the monetary transmission mechanism in Portugal and secure durable market access. Of course, OMT should not be seen as an alternative to market financing, but at the same time the latter is not entirely independent of OMT eligibility.

42. Exceptional access remains justified. Notwithstanding the recent progress on the financing front for both private and public sectors, exceptional access under the program remains critical to address Portugal's funding needs (Criterion 1). Staff considers public debt to be sustainable over the medium term, but sustainability cannot be asserted with high probability. Nonetheless, exceptional access continues to be justified on the basis of systemic international spillover risks given euro area fragility (Criterion 2). With the first successful foray in January 2013, expectation of market access within the period that Fund resources are outstanding has improved markedly. However, significant uncertainty remains over whether issuance can be sustained at the necessary scale. Commitments by the euro area leaders to support Portugal until full market access is regained—provided the authorities persevere with strict program implementation—gives additional assurances that that financing will be available to repay the Fund (Criterion 3).[18] Implementation capacity and prospects for program success remain reasonably strong, given the solid track record to date, including a majority in Parliament (Criterion 4).

43. Capacity to repay the Fund remains adequate. The Fund's exposure to Portugal rises to substantial levels, reaching 16.3 percent of GDP in 2014, with debt service expected to peak in 2018, at 5.7 percent of exports of goods and services, or 2.7 percent of GDP. Export strength has partially compensated the increased burden on the economy that emanates from the euro weakness and downward revisions to nominal GDP. Despite fiscal and political setbacks, program implementation capacity remains strong, and the rapid closure of the external imbalances also provides assurance that adequate resources will be available to repay the Fund.

[17] The maturity extension was made contingent on the 7th review. Staff's baseline projections do not incorporate the extension.

[18] This commitment was reaffirmed at the Eurogroup meeting on March 16, 2013.

44. Downside risks to the attainment of the program's objectives are nevertheless significant. The materialization of downside risks to the macro-fiscal outlook noted above may require prompt implementation of corrective measures to preserve confidence gains achieved to date. On the fiscal front, the unavoidable cuts are set to turn the PER into one of the most difficult components of Portugal's program. The government is reaching out to stakeholders to build up consensus around the reforms before finalization. Political support will be critical. Even then, and notwithstanding the authorities' efforts to ensure that the PER respects constitutional principles, the exercise would still face legal risks. On the financing front, renewed stress in euro area financial markets or materialization of fiscal risks could further delay market re-access, and room for maneuver is limited in view of the high debt burden and significant medium-term financing needs.

STAFF APPRAISAL

45. Program implementation is on track, against difficult economic conditions and significant legal challenges. Reflecting the authorities' strong policy and reform effort to date, fiscal adjustment is advancing and external imbalances are being corrected at a faster pace than expected. Coupled with improved market conditions at the euro area level since last summer, this has allowed Portugal to re-access the international bond market for the first time since early 2011, providing a significant boost to the authorities' strategy to regain full market access. Although the recent Constitutional Court ruling has complicated policy making considerably, the authorities have reacted quickly to address the fiscal consequences and continue to advance the PER. Nonetheless, weak business and consumer confidence, the stifling private sector debt burden, and strong headwinds from activity in the euro area are weighing on growth and employment. While a modest economic recovery is still envisaged later this year, the recession is now set to be deeper and unemployment to peak at a higher level than previously envisaged. This is exacerbating social and political tensions and, in turn, testing the government's resolve to continue with adjustment policies and reforms.

46. The markedly weaker economic outlook provides a strong case for recalibrating the program's fiscal targets. As in the past, the program's fiscal parameters are being adjusted to ensure that it continues to strike the right balance between advancing the required adjustment to bring public finances back to a sustainable path and avoiding undue strains on the economy and employment.

47. But the scope for more financing going forward is very limited. Reflecting both the weaker growth path as well as related adjustments to the fiscal targets, the debt trajectory has ratcheted up since the beginning of the program—with debt now set to peak at 124 percent of GDP on current policies and outlook. Moreover, the risk of a higher still debt peak is high given the significant downside risks to the current growth projections as well as the possibility that some contingent liabilities could migrate to the government's balance sheet. Coupled with the fact that the pace of adjustment has now been eased, this implies that the scope to deviate from the current fiscal deficit path is minimal without raising debt sustainability concerns. One of the counter arguments to this is that financing conditions and markets' debt tolerance level have improved, creating fiscal space that should be exploited in this hour of need. However, markets' tolerance for higher debt levels in Portugal has waxed and waned, as evidenced over the few years. Basing policies on the assumption that the recent improvement in sentiment will endure would be most imprudent.

48. Sustaining the fiscal consolidation effort in the coming months is thus imperative. In this context, early implementation of the measures identified in the context of the PER is critical. This includes prompt implementation of the required legislation to advance the expenditure reforms. Moreover, while modifications to the proposed PER reform package could still be made, these would need to be accompanied by offsetting permanent measures of equivalent yield and quality. In particular, it is difficult to envisage that a comprehensive expenditure reform package would not tackle key public expenditure weaknesses. And, in view of Portugal's large public service and relatively high public sector wages and pensions compared to peers, sustainable spending adjustment will require addressing these areas.

49. This strong adjustment effort also needs to be buttressed by sustained fiscal structural reforms. Ensuring that all government entities respect the new expenditure commitment control system is also paramount in view of the potential risks posed by local elections later this year. More generally, further progress on the public financial reform agenda—particularly tighter control over PPPs and strengthening of the medium-term fiscal framework for all general government entities—continued strengthening of the revenue administration—with particular emphasis on reducing compliance risks—and reforms of state-owned enterprises are important to limit fiscal risks.

50. Continued vigilance is warranted to secure financial stability as the deleveraging process advances. The banking sector has been successfully recapitalized, in parallel to major enhancement to the legal and regulatory frameworks. Nevertheless, while liquidity buffers have also improved, access to credit remains difficult for SMEs. In these conditions, efforts to increase the efficiency of the numerous government initiatives to assist viable companies in funding their activities are necessary. Promoting rapid restructuring of troubled loans by the banks is also important to ensure that they actively support a smooth private sector balance sheet adjustment while protecting viable firms.

51. A more competitive economy—a must to underpin a sustainable recovery—requires addressing nominal rigidities forcefully. Within the constraints of the monetary union, fostering a more competitive economy will need to be achieved through a combination of measures to raise productivity—which takes time—and reduce input costs, including wages, for the tradable sector. As noted above, some of the reforms that will contribute to these objectives are in place or ongoing. But pay-off to these reforms can take a while, as demonstrated by the limited wage flexibility and only moderate improvement in price-competitiveness indicators so far. The risk is thus quite high that the necessary adjustment will take place through recessionary channels rather than a rapid supply response. In light of this, staff urges the authorities to take stock of remaining labor market rigidities. There is also a strong need to explore alternative policy options to further lower production costs and compress excessive profit margins in the nontradable sector. The planned comprehensive reform of the corporate income tax could also help foster investment and competitiveness, but has to be done in a fiscally neutral manner.

52. Program success also hinges on continued external support and effective crisis management policies at the euro-area level. Strong implementation of the adjustment program is key for addressing Portugal's deep-seated economic problems. At the same time, risks are considerable and Portugal remains vulnerable to shocks stemming from other euro area countries or from policy failures at the regional level. Domestic efforts therefore need to be complemented by institutional reforms and strong crisis management policies at the euro-area level to support Portugal's path toward a durable return to market financing. The commitment by European leaders to support Portugal until market access is restored, as long as the program is on track, continues to provide a valuable financing assurance. In addition, the envisaged lengthening of the maturities of EFSF and EFSM loans to smooth the debt redemption profile will also support the government's return to full market financing during 2013. Finally, recourse to the ECB's Outright Monetary Transactions would help address credit market segmentation and restore an appropriate monetary policy transmission.

53. Staff recommends completion of the seventh review and the modifications of end-June PCs.

Box 1. Reforms to the Legal Toolkit for Corporate Debt Restructuring

The authorities have undertaken important steps to enhance the legal toolkit for corporate debt restructuring. Specifically:

Out of Court Guidelines. In September 2011, the authorities adopted Guidelines on the Extrajudicial Recovery of Debtors to promote the use of out of court debt restructuring. These voluntary Guidelines intend to facilitate corporate debtors to restructure their debts in good faith out of court by providing guidance on how to achieve consensual debt restructuring. The Guidelines are in line with international best practices, such as the INSOL Global Principles for Multi-Creditor Work-outs. Since only recently adopted, it needs to be seen how widely such Guidelines are being used.

SIREVE. Since September 2012, a formal out of court regime to facilitate debt restructuring tailored to SMEs through mediation by IAPMEI, the so-called SIREVE, has been in force. This regime is formalized in a law and for instance involves a standstill for participating creditors. Also, the tax and social security authorities are required to participate in the negotiations. There is no cram down (on dissenting creditors by a court) and only participating creditors are bound by an agreement. Given that this regime has only been recently adopted, there are many pending SIREVE cases but only a few cases have so far emerged successfully.

Insolvency Code and PER. The Insolvency Code is a modern unitary law that provides for rehabilitation of viable firms and liquidation of non-viable firms. The Code was amended effective May 2012 (the "May 2012 Amendment") to, in particular, introduce/strengthen:

- **Fast track in-court approval**. The May 2012 Amendment provides, in line with international best practice, for a rapid restructuring within short deadlines of up to three months, including a "fast track" court approval process by which pre-arranged restructuring plans can be approved rapidly by the court (so called PER) if they are supported by the requisite majority of creditors (cram down). Since its introduction, there have been many successful restructurings under the PER.
- **Priority financing**. The Code provides for priority for new financing, if envisaged under the restructuring plan in an insolvency administrator supervised process. The May 2012 Amendment further strengthened the priority of new financing by protecting it from certain legal challenges.

Other initiatives. The authorities also addressed other disincentives for debt restructuring. For instance, in September 2011, the authorities unified the public creditors' legal framework for debt restructuring by enabling the tax authorities to participate in debt restructuring at the same terms as the social security authorities (i.e., agreeing to up to 150 installments).

Table 1. Portugal: Selected Economic Indicators

(Year-on-year percent change, unless otherwise indicated)

				Projections					
	2010	2011	2012	2013	2014	2015	2016	2017	2018
Real GDP	1.9	-1.6	-3.2	-2.3	0.6	1.5	1.8	1.8	1.8
Total domestic demand	1.8	-5.8	-6.8	-3.9	0.1	1.3	1.6	1.5	1.5
Private consumption	2.5	-3.8	-5.6	-3.3	0.1	1.0	1.1	1.1	1.1
Public consumption	0.1	-4.3	-4.4	-4.2	-2.0	-1.9	-0.5	0.0	1.2
Gross fixed investment	-3.1	-10.7	-14.5	-7.6	2.5	4.9	5.2	4.0	3.5
Private	-8.3	-5.5	-11.7	-8.4	3.7	6.2	6.2	3.9	3.7
Government	27.1	-32.5	-31.2	-1.9	-6.2	-4.9	-3.3	5.0	1.2
Exports	10.2	7.2	3.3	0.9	4.4	4.9	5.1	5.1	5.1
Imports	8.0	-5.9	-6.9	-3.9	3.1	4.4	4.7	4.5	4.5
Contribution to Growth									
Total domestic demand	2.0	-6.3	-7.0	-4.0	0.0	1.2	1.5	1.4	1.4
Private consumption	1.7	-2.6	-3.7	-2.1	0.1	0.6	0.7	0.7	0.7
Public consumption	0.0	-0.9	-0.9	-0.9	-0.4	-0.4	-0.1	0.0	0.2
Gross fixed investment	-0.7	-2.1	-2.6	-1.2	0.4	0.8	0.8	0.7	0.6
Foreign balance	-0.1	4.7	3.9	1.8	0.6	0.3	0.3	0.4	0.4
Savings-investment balance (percent of GDP)									
Gross national savings	9.8	10.6	14.1	14.8	14.9	15.8	17.2	18.1	18.9
Private	16.8	15.4	18.8	18.4	17.2	16.7	17.5	18.2	18.6
Public	-7.0	-4.9	-4.7	-3.6	-2.2	-0.9	-0.4	-0.1	0.4
Gross domestic investment	20.2	17.8	16.0	14.5	14.8	15.9	16.8	17.3	17.7
Private	16.3	15.2	14.1	12.6	13.1	14.2	15.2	15.6	16.0
Public	3.9	2.6	1.9	1.9	1.8	1.7	1.6	1.7	1.7
Resource utilization									
Potential GDP	0.7	-0.2	-0.9	-1.0	-0.1	0.2	0.4	0.9	0.9
Output Gap (% of potential)	-0.3	-1.6	-3.9	-5.1	-4.5	-3.2	-1.8	-0.9	0.0
Employment	-1.5	-1.5	-4.2	-3.9	-0.5	0.4	0.6	0.6	0.6
Unemployment rate (%) 1/	10.8	12.7	15.7	18.2	18.5	18.1	17.5	16.9	16.3
Prices									
GDP deflator	0.6	0.5	-0.1	1.8	1.3	1.1	1.7	1.7	1.8
Consumer prices (harmonized index)	1.4	3.6	2.8	0.7	1.0	1.5	1.5	1.5	1.5
Compensation per worker (whole economy)	2.0	-0.6	-2.6	3.1	0.0	0.0	0.8	1.0	1.0
Labor productivity	3.5	0.0	1.1	1.6	1.1	1.1	1.2	1.2	1.2
Unit labor costs (whole economy)	-1.5	-0.6	-3.6	1.5	-1.0	-1.1	-0.4	-0.2	-0.2
Money and credit (end of period, percent change)									
Private sector credit	-0.3	-1.5	-6.5	-4.7	-2.0	-0.1	1.0	1.5	1.8
Broad money	-1.3	-1.3	-6.2	-0.7	1.9	2.7	3.5	3.5	3.6
Interest rates (percent)									
Short-term deposit rate	1.7	3.5	3.0	2.5	2.7	3.0	3.5	3.8	3.8
Government bond rate, 10-year	5.4	10.2	10.5	6.0	6.0	5.5	5.0	5.0	5.0
Fiscal indicators (percent of GDP)									
General government balance 2/	-9.9	-4.4	-6.4	-5.5	-4.0	-2.5	-1.9	-1.6	-1.1
Primary government balance	-7.0	-0.4	-2.0	-1.1	0.4	1.8	2.4	2.8	3.2
Structural balance	-9.0	-6.5	-4.0	-3.2	-1.6	-1.1	-1.1	-1.2	-1.1
Structural primary balance (percent of potential GDP)	-6.2	-2.6	0.3	1.0	2.5	3.1	3.1	3.2	3.2
General government debt	93.2	108.0	123.6	122.9	124.2	123.1	120.5	117.7	114.7
External sector (percent of GDP)									
Trade balance (goods)	-11.1	-8.3	-5.2	-3.2	-2.7	-2.5	-2.5	-2.4	-2.2
Trade balance (G&S)	-7.2	-3.8	0.1	2.3	3.2	3.5	3.8	4.2	4.5
Current account balance	-10.6	-7.0	-1.5	0.3	0.1	0.0	0.4	0.7	1.3
Net international investment position	-107.2	-104.9	-116.5	-115.5	-111.8	-107.5	-102.2	-96.6	-90.7
REER based on ULC (1999=100)	108.1	106.9	105.4	108.2	107.0	105.4	104.4	103.8	102.5
(rate of growth)	-1.4	-1.2	-1.3	2.7	-1.1	-1.5	-0.9	-0.7	-1.2
REER based on CPI (1999=100)	107.8	108.7	107.2	106.5	105.9	105.8	105.7	105.5	105.3
(rate of growth)	-2.1	0.8	-1.3	-0.6	-0.6	-0.1	-0.1	-0.1	-0.2
Nominal GDP (billions of euro)	172.9	171.1	165.4	164.5	167.5	172.0	178.1	184.4	191.1

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

1/ The unemployment rate series contains a structural break in 2011.

2/ EDP notification concept.

Table 2a. General Government Accounts 1/

(Billions of euros)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
					Projections 2/					
Revenue	66.7	72.0	76.9	67.8	70.0	70.5	71.6	73.9	76.2	78.9
Taxes	36.6	38.3	40.4	38.1	39.7	40.1	41.4	43.1	44.6	46.3
Taxes on production and imports	21.5	23.0	23.4	22.5	21.7	22.3	23.2	24.2	24.9	25.8
Current taxes on income, wealth, etc. and capital taxes	15.1	15.3	17.0	15.5	18.0	17.8	18.2	18.9	19.7	20.5
Current taxes on income, wealth, etc.	15.1	15.2	17.0	15.3	18.0	17.8	18.2	18.9	19.7	20.5
Capital taxes	0.0	0.1	0.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	21.0	21.3	20.9	19.2	19.7	20.1	19.6	20.0	20.6	21.0
Grants and other revenue	9.1	12.4	15.7	10.5	10.6	10.3	10.6	10.7	11.0	11.6
Property income	1.3	1.2	1.1	1.1	1.2	1.2	1.2	1.2	1.3	1.4
Sales of goods and services	4.1	4.4	4.4	4.6	5.2	5.3	5.4	5.5	5.6	6.0
Other current revenue	2.4	2.0	2.5	2.9	2.3	2.3	2.4	2.4	2.5	2.7
Capital transfers and investment grants	1.2	4.8	7.6	1.9	1.9	1.5	1.5	1.6	1.7	1.6
of which: Pension funds transfer	0.0	2.8	6.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure 3/	83.9	89.0	84.5	78.4	79.0	77.2	75.9	77.3	79.2	81.0
Expense	82.2	86.2	83.9	79.9	80.2	78.6	77.5	79.0	80.9	82.8
Compensation of employees	21.4	21.2	19.4	16.3	17.3	15.6	14.6	14.4	14.7	15.1
Use of goods and services	8.4	8.9	8.0	7.5	7.2	7.2	7.0	7.3	7.2	7.2
Consumption of fixed capital	3.6	3.8	3.9	4.2	4.3	4.3	4.5	4.6	4.8	4.9
Interest (ESA95)	4.8	4.9	6.9	7.3	7.2	7.3	7.4	7.7	8.2	8.3
Subsidies	1.3	1.3	1.2	1.0	0.9	0.9	0.9	0.9	0.9	1.0
Social benefits	37.0	37.9	37.6	37.4	39.3	39.0	39.0	39.8	41.2	42.2
Grants and other expense	5.7	8.2	6.8	6.2	4.0	4.2	4.1	4.1	4.0	4.1
Other current expense	4.3	4.9	4.4	3.8	4.0	4.0	3.7	3.8	3.7	3.8
Capital transfers	1.4	3.3	2.4	2.3	0.0	0.3	0.4	0.3	0.3	0.3
Net acquisition of nonfinancial assets	1.7	2.8	0.5	-1.5	-1.3	-1.4	-1.6	-1.7	-1.7	-1.7
Gross fixed capital formation	5.3	6.6	4.4	2.7	3.0	2.9	2.8	2.9	3.0	3.1
(-) Consumption of fixed capital	-3.6	-3.8	-3.9	-4.2	-4.3	-4.3	-4.5	-4.6	-4.8	-4.9
Acquisitions less disposals of other nonfinancial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-11.9	-10.4	-3.1	-7.9	-5.9	-3.8	-1.4	-0.5	0.1	1.0
Net lending (+)/borrowing (–) (ESA95)	-17.1	-17.0	-7.5	-10.6	-9.0	-6.7	-4.3	-3.4	-3.0	-2.2
Net lending (+)/borrowing (–) (EDP notification)	-17.1	-17.1	-7.5	-10.6	-9.0	-6.7	-4.3	-3.4	-3.0	-2.2
Net lending (+)/borrowing (–) (program) 4/	-17.1	-17.1	-6.9	-7.8	-9.0	-6.7	-4.3	-3.4	-3.0	-2.2
Net acquisition of financial assets	1.1	4.9	14.2	4.8	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	-0.5	0.7	10.2	1.2	...	...	...	...	...	...
Debt securities	0.4	-0.1	0.4	6.4	...	...	...	...	...	...
Loans	-0.2	1.3	0.4	1.2	...	...	...	...	...	...
Equity and investment fund shares	1.0	1.6	-0.3	-1.1	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	-0.1	-0.4	-0.2	-0.2	...	...	...	...	...	...
Other accounts receivable	0.4	1.8	3.7	-2.6	...	...	...	...	...	...
Net incurrence of liabilities	18.2	21.9	21.8	15.5	...	...	...	...	...	...
SDRs	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	-0.5	-0.8	-3.1	-1.4	...	...	...	...	...	...
Debt securities	16.2	17.8	-11.2	-6.8	...	...	...	...	...	...
Loans	2.0	3.8	35.5	27.1	...	...	...	...	...	...
Equity and investment fund shares	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Other accounts payable	0.5	1.1	0.5	-3.5	...	...	...	...	...	...
Memorandum items:										
Primary balance	-12.3	-12.1	-0.6	-3.3	-1.8	0.6	3.1	4.3	5.2	6.2
Interest (EDP notification)	4.8	4.9	6.9	7.3	7.2	7.3	7.4	7.7	8.2	8.3
Debt at face value (EDP notification)	139.9	161.1	184.7	204.5	202.1	208.1	211.7	214.6	217.1	219.3
Nominal GDP	168.5	172.9	171.1	165.4	164.5	167.5	172.0	178.1	184.4	191.1

Sources: Portuguese statistical authorities; and IMF staff projections.
1/ GFSM 2001 presentation.
2/ Projections assume no structural fiscal effort after 2015. In contrast, the authorities assume additional effort in order to achieve the European "fiscal compact" objective (structural deficit of less than 0.5 percent of GDP). Compared with the baseline, adherence to the "fiscal compact" would lower the debt-to-GDP ratio by three percentage points by 2020.
3/ Historical data include expenditure commitments that have given rise to arrears of the general government.
4/ Excludes the impact of several large transactions that were booked differently at the time the original deficit targets were set. In 2011, those were €600 million in bank restructuring costs (IMF Country Report 12/77). In 2012, those were ANA concession (€1,200 million), increase in the share capital of CGD (€750 million), reclassfied operations of Sagestamo (€750 million), and valuation changes of BPN (€100 million). See MEFP, paragraph 4.

Table 2b. General Government Accounts [1/]

(Percent of GDP)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
					Projections 2/					
Revenue	39.6	41.6	45.0	41.0	42.6	42.1	41.6	41.5	41.4	41.3
Taxes	21.7	22.2	23.6	23.0	24.2	23.9	24.1	24.2	24.2	24.2
Taxes on production and imports	12.7	13.3	13.7	13.6	13.2	13.3	13.5	13.6	13.5	13.5
Current taxes on income, wealth, etc. and capital taxes	9.0	8.9	9.9	9.4	11.0	10.6	10.6	10.6	10.7	10.7
Social contributions	12.5	12.3	12.2	11.6	12.0	12.0	11.4	11.2	11.2	11.0
Grants and other revenue	5.4	7.2	9.2	6.3	6.5	6.1	6.1	6.0	6.0	6.1
Property income	0.8	0.7	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Sales of goods and services	2.4	2.5	2.6	2.8	3.2	3.1	3.1	3.1	3.0	3.1
Other current revenue	1.4	1.2	1.5	1.7	1.4	1.4	1.4	1.4	1.3	1.4
Capital transfers and investment grants	0.7	2.8	4.5	1.2	1.1	0.9	0.9	0.9	0.9	0.8
of which: Pension funds transfer	0.0	1.6	3.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure 3/	49.8	51.5	49.4	47.4	48.0	46.1	44.1	43.4	43.0	42.4
Expense	48.8	49.9	49.1	48.3	48.8	46.9	45.1	44.4	43.9	43.3
Compensation of employees	12.7	12.2	11.4	9.9	10.5	9.3	8.5	8.1	8.0	7.9
Use of goods and services	5.0	5.2	4.7	4.6	4.4	4.3	4.1	4.1	3.9	3.8
Consumption of fixed capital	2.1	2.2	2.3	2.5	2.6	2.6	2.6	2.6	2.6	2.6
Interest (ESA95)	2.9	2.8	4.0	4.4	4.4	4.4	4.3	4.3	4.4	4.4
Subsidies	0.7	0.7	0.7	0.6	0.5	0.5	0.5	0.5	0.5	0.5
Social benefits	22.0	22.0	22.0	22.6	23.9	23.2	22.6	22.4	22.3	22.1
Grants and other expense	3.4	4.7	4.0	3.7	2.5	2.5	2.4	2.3	2.2	2.1
Other current expense	2.5	2.8	2.6	2.3	2.4	2.4	2.2	2.2	2.0	2.0
Capital transfers	0.9	1.9	1.4	1.4	0.0	0.2	0.2	0.1	0.1	0.1
Net acquisition of nonfinancial assets	1.0	1.6	0.3	-0.9	-0.8	-0.8	-0.9	-1.0	-0.9	-0.9
Gross fixed capital formation	3.1	3.8	2.6	1.6	1.8	1.7	1.6	1.6	1.6	1.6
(-) Consumption of fixed capital	-2.1	-2.2	-2.3	-2.5	-2.6	-2.6	-2.6	-2.6	-2.6	-2.6
Acquisitions less disposals of other nonfinancial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-7.1	-6.0	-1.8	-4.8	-3.6	-2.2	-0.8	-0.3	0.0	0.5
Net lending (+)/borrowing (–) (ESA95)	-10.2	-9.9	-4.4	-6.4	-5.5	-4.0	-2.5	-1.9	-1.6	-1.1
Net lending (+)/borrowing (–) (EDP notification)	-10.2	-9.9	-4.4	-6.4	-5.5	-4.0	-2.5	-1.9	-1.6	-1.1
Net lending (+)/borrowing (–) (program) 4/	-10.2	-9.9	-4.0	-4.7	-5.5	-4.0	-2.5	-1.9	-1.6	-1.1
Net acquisition of financial assets	0.6	2.8	8.3	2.9	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	-0.3	0.4	6.0	0.7	...	...	...	...	...	...
Debt securities	0.2	0.0	0.2	3.9	...	...	...	...	...	...
Loans	-0.1	0.7	0.3	0.7	...	...	...	...	...	...
Equity and investment fund shares	0.6	0.9	-0.2	-0.7	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	-0.1	-0.2	-0.1	-0.1	...	...	...	...	...	...
Other accounts receivable	0.3	1.0	2.2	-1.6	...	...	...	...	...	...
Net incurrence of liabilities	10.8	12.7	12.7	9.4	...	...	...	...	...	...
SDRs	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	-0.3	-0.5	-1.8	-0.9	...	...	...	...	...	...
Debt securities	9.6	10.3	-6.5	-4.1	...	...	...	...	...	...
Loans	1.2	2.2	20.8	16.4	...	...	...	...	...	...
Equity and investment fund shares	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Other accounts payable	0.3	0.6	0.3	-2.1	...	...	...	...	...	...
Memorandum items:										
Primary balance	-7.3	-7.0	-0.4	-2.0	-1.1	0.4	1.8	2.4	2.8	3.2
Structural balance (Percent of potential GDP)	-9.2	-9.0	-6.5	-4.0	-3.2	-1.6	-1.1	-1.1	-1.2	-1.1
Structural primary balance (Percent of potential GDP)	-6.4	-6.2	-2.6	0.3	1.0	2.5	3.1	3.1	3.2	3.2
Interest (EDP notification)	2.8	2.9	4.0	4.4	4.4	4.4	4.3	4.3	4.4	4.4
Debt at face value (EDP notification)	83.0	93.2	108.0	123.6	122.9	124.2	123.1	120.5	117.7	114.7

Sources: Portuguese statistical authorities; and IMF staff projections.

1/ GFSM 2001 presentation.

2/ Projections assume no structural fiscal effort after 2015. In contrast, the authorities assume additional effort in order to achieve the European "fiscal compact" objective (structural deficit of less than 0.5 percent of GDP). Compared with the baseline, adherence to the "fiscal compact" would lower the debt-to-GDP ratio by three percentage points by 2020.

3/ Historical data include expenditure commitments that have given rise to arrears of the general government.

4/ Excludes the impact of several large transactions that were booked differently at the time the original deficit targets were set. In 2011, those were €600 million in bank restructuring costs (IMF Country Report 12/77). In 2012, those were ANA concession (€1,200 million), increase in the share capital of CGD (€750 million), reclassfied operations of Sagestamo (€750 million), and valuation changes of BPN (€100 million). See MEFP, paragraph 4.

Table 3. General Government Stock Positions
(Billions of euros)

	2008	2009	2010	2011	2012
Net financial worth	-93.1	-108.7	-111.2	-93.5	-129.0
Financial assets	45.7	48.6	58.5	73.7	83.1
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0
Currency and deposits	7.3	6.8	7.7	18.0	19.2
Debt securities	1.5	1.9	1.8	2.2	8.6
Loans	3.0	2.8	4.1	4.6	5.8
Equity and investment fund shares	25.8	28.7	34.4	34.7	38.0
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	0.0
Financial derivatives and employee stock options	-0.1	0.0	0.1	0.4	0.4
Other accounts receivable	8.1	8.5	10.3	13.8	11.2
Liabilities	138.8	157.2	169.7	167.2	212.2
Special Drawing Rights (SDRs)	0.0	0.0	0.0	0.0	0.0
Currency and deposits	19.5	18.9	18.1	15.0	13.6
Debt securities	98.1	114.3	120.5	85.2	105.4
Loans	15.7	17.4	22.5	58.6	85.3
Equity and investment fund shares	0.0	0.0	0.0	0.0	0.0
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	0.0
Financial derivatives and employee stock options	0.0	0.0	0.0	0.9	1.2
Other accounts payable	5.6	6.5	8.5	7.6	6.7
Memorandum items:					
Gross debt (at market value)	138.8	157.2	169.6	166.3	211.0
Gross debt at face value	128.7	146.5	169.7	192.3	211.2
Gross debt at face value (EDP notification)	123.1	139.9	161.1	184.7	204.5
Other economic flows - financial assets	...	1.8	5.0	1.1	4.6
Other economic flows - liabilities	...	0.3	-9.5	-24.2	29.5

Sources: Portuguese statistical authorities; and IMF staff calculations.

Table 4. Portugal: General Government Financing Requirements and Sources [1/]

(Billions of euros)

	2010	2011	2012	2013	2014	2015	2016	2017	2018
Gross borrowing need	58.4	59.3	66.1	38.2	37.0	35.3	38.2	28.9	38.1
Overall balance	17.0	7.5	10.6	9.0	6.7	4.3	3.4	3.0	2.2
Amortization	31.0	40.7	38.0	29.1	30.9	31.8	35.3	26.4	35.9
M&LT	7.7	12.8	18.2	9.7	17.6	16.2	12.0	9.3	14.3
Residents	0.7	3.9	11.5	4.6	8.3	9.0	5.6	4.5	7.5
Of which within general government	0.0	0.4	3.2	0.9	1.6	1.6	0.7	0.6	0.6
Non-residents	7.1	8.9	6.7	5.1	9.3	7.2	6.5	4.8	6.7
ST	23.3	27.9	18.8	19.4	13.3	13.3	13.3	13.3	13.3
Residents	6.4	16.9	17.0	18.5	10.1	8.0	5.9	5.9	5.9
Of which within general government	1.1	3.3	4.7	3.2	...	...	...	...	...
Non-residents	16.9	11.0	1.8	0.9	3.2	5.3	7.3	7.3	7.3
EU and IMF 2/	0.0	0.0	1.0	0.0	0.0	2.3	9.9	3.8	8.3
Other 3/	11.4	17.4	28.8	0.2	-0.6	-0.8	-0.5	-0.5	1.0
Of which within general government	6.3	10.8	19.0	...	...	...	...	...	...
Other (net) 3/	10.4	11.0	17.5	0.1	-0.6	-0.8	-0.5	-0.5	0.0
Of which within general government	4.6	3.9	6.9	...	...	...	...	...	...
Gross financing sources	58.4	23.9	38.0	28.3	29.1	35.3	38.2	28.9	38.1
Privatization receipts	0.7	0.6	2.2	3.7	0.0	0.0	0.0	0.0	0.0
Market access	59.0	36.8	35.5	17.7	29.1	35.3	38.2	28.9	38.1
M&LT	31.0	18.0	16.1	4.4	15.8	22.1	24.9	15.6	24.8
Residents	15.9	13.7	14.7	2.2	6.8	7.8	8.8	6.2	9.3
Of which from general government	3.0	6.1	6.2	...	...	...	...	...	...
Non-residents	15.1	4.3	1.5	2.2	9.0	14.3	16.1	9.4	15.5
ST	27.9	18.8	19.4	13.3	13.3	13.3	13.3	13.3	13.3
Residents	16.9	17.0	18.5	10.1	8.0	5.9	5.9	5.9	5.9
Of which from general government	3.3	4.7	...	...	...	...	...	...	...
Non-residents	11.0	1.8	0.9	3.2	5.3	7.3	7.3	7.3	7.3
Use of deposits 4/	-1.3	-13.5	0.3	6.9	0.0	0.0	0.0	0.0	0.0
Of which intra-government	-0.6	-3.2	2.9	...	...	...	...	...	...
Financing under the program 2/	0.0	35.3	28.5	9.9	7.9	0.0	0.0	0.0	0.0
European Union	...	22.2	20.4	6.5	5.2	...	...	...	...
IMF	...	13.1	8.2	3.4	2.7	...	...	...	...
Net placement (market access-amortization)	28.0	-3.9	-2.5	-11.4	-1.8	3.5	2.9	2.5	2.2
Residents	25.8	9.9	-5.2	-10.8	-3.6	-3.3	3.3	1.6	1.8
M&LT	15.3	9.8	3.1	-2.4	-1.5	-1.2	3.3	1.6	1.8
ST (net increase)	10.5	0.1	-8.4	-8.4	-2.1	-2.1	0.0	0.0	0.0
Non-residents	2.2	-13.8	-2.9	-0.7	1.8	9.1	9.6	4.6	8.7
M&LT	8.0	-4.6	-5.2	-2.9	-0.3	7.1	9.6	4.6	8.7
ST (net increase)	-5.9	-9.2	2.3	2.3	2.1	2.1	0.0	0.0	0.0

Source: Portuguese authorities and Fund staff estimates.

1/ The coverage of this table has been expanded to fully reflect all general government (including local and regional governments and SOES) financing operations. However, data are on a non-consolidated basis (with intra-government flows presented where available). On a consolidated basis, they are smaller, by the amount of intra-government transactions.

2/ Changes to IMF disbursements compared to initial programmed amounts reflect EUR/SDR exchange rate variations. Program financing from the EU includes the EUR 1.1 billion EFSF prepaid margin and EUR 0.1 billion in issuance costs (2011) and the roll-over of a EUR 1 billion short-term loan (2012).

3/ Includes use of Bank Solvency Support Facility and other net financial transactions, net financing from retail government securities programs, as well as adjustments for cash-accrual differences and consistency between annual projections and preliminary quarterly accounts.

4/ Changes in government deposits (including deposits in BSSF).

Table 5. Portugal: Balance of Payments, 2010–2018

	2010	2011	2012	2013	2014	2015	2016	2017	2018
				Projections					
				(Billions of euro)					
Current account	-18.3	-12.0	-2.6	0.5	0.2	-0.1	0.7	1.4	2.5
Balance of goods and services	-12.5	-6.5	0.1	3.9	5.3	6.0	6.8	7.7	8.7
Trade balance	-19.2	-14.2	-8.6	-5.3	-4.5	-4.4	-4.4	-4.3	-4.2
Exports fob	37.4	43.1	45.5	46.0	48.6	51.6	55.0	59.0	63.3
Imports fob	56.6	57.3	54.1	51.4	53.0	56.0	59.4	63.3	67.5
Services, net	6.7	7.7	8.7	9.2	9.8	10.4	11.2	12.0	12.9
Exports	17.6	19.2	19.1	19.5	20.6	21.9	23.4	25.0	26.7
Imports	10.9	11.5	10.4	10.4	10.8	11.5	12.2	13.0	13.8
Of which:									
Tourism	4.6	5.2	5.7	5.9	6.3	6.7	7.2	7.7	8.2
Exports	7.6	8.1	8.6	8.8	9.4	9.9	10.6	11.4	12.1
Imports	3.0	3.0	2.9	2.9	3.1	3.2	3.5	3.7	3.9
Income, net	-7.9	-8.5	-6.4	-7.0	-8.7	-9.7	-9.7	-9.8	-9.7
Current transfers, net	2.2	3.0	3.8	3.6	3.6	3.6	3.6	3.5	3.5
Private remittances, net	2.2	2.4	2.8	2.8	2.7	2.7	2.7	2.8	2.9
Official transfers, net	0.0	0.6	1.0	0.9	0.9	0.9	0.9	0.7	0.6
Capital account	1.9	2.1	3.9	2.4	2.4	2.4	2.4	2.4	2.4
Financial account	15.6	-24.2	-29.4	-12.8	-10.5	-2.3	-3.0	-3.8	-4.8
Direct investment	7.7	-2.7	5.4	5.1	1.6	1.6	1.6	0.5	0.4
Portuguese investment abroad	5.7	-10.7	-1.5	-1.5	-1.6	-1.6	-1.7	-2.8	-3.0
Foreign investment in Portugal	2.0	8.0	6.9	6.6	3.2	3.2	3.3	3.3	3.4
Portfolio investment, net	-9.7	-4.6	-20.9	-16.5	-4.3	10.0	12.1	5.0	9.5
Financial derivatives	0.4	0.5	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other investment, net	18.2	-18.6	-13.9	-1.5	-7.9	-14.0	-16.8	-9.4	-14.8
Reserve assets	-1.0	1.2	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	0.8	0.1	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	...	33.9	27.7	9.9	7.9	...	...	...	...
European Union	...	20.9	19.4	6.5	5.2	...	...	...	...
IMF	...	13.1	8.2	3.4	2.7	...	...	...	...
Memorandum items:									
Net international investment position 1/	-185.2	-179.4	-192.8	-189.9	-187.3	-185.0	-181.9	-178.1	-173.3
Direct investment, net	-33.6	-30.6	-34.8	-39.9	-41.5	-43.0	-44.6	-45.1	-45.5
Portfolio investment, net	-52.1	-31.7	-25.3	-8.8	-4.5	-14.5	-26.6	-31.6	-41.1
Financial derivatives	-1.1	-2.4	-3.6	-3.7	-3.8	-3.8	-3.9	-4.0	-4.0
Other investment, net	-114.1	-131.2	-146.2	-154.7	-154.7	-140.8	-124.0	-114.6	-99.8
Reserve assets	15.7	16.5	17.2	17.2	17.2	17.2	17.2	17.2	17.2
Nominal GDP	172.9	171.1	165.4	164.5	167.5	172.0	178.1	184.4	191.1
				(Percentage of GDP)					
Current account	-10.6	-7.0	-1.5	0.3	0.1	0.0	0.4	0.7	1.3
Current account (including capital transfers)	-9.4	-5.8	0.8	1.7	1.6	1.3	1.7	2.0	2.5
Of which: Balance of goods and services	-7.2	-3.8	0.1	2.3	3.2	3.5	3.8	4.2	4.5
Net international investment position 1/	-107.2	-104.9	-116.5	-115.5	-111.8	-107.5	-102.2	-96.6	-90.7
Direct investment, net	-19.5	-17.9	-21.0	-24.3	-24.8	-25.0	-25.1	-24.5	-23.8
Portfolio investment, net	-30.1	-18.5	-15.3	-5.3	-2.7	-8.4	-14.9	-17.2	-21.5
Financial derivatives	-0.7	-1.4	-2.2	-2.3	-2.3	-2.2	-2.2	-2.2	-2.1
Other investment, net	-66.0	-76.7	-88.4	-94.1	-92.3	-81.8	-69.6	-62.2	-52.2
Reserve assets	9.1	9.6	10.4	10.4	10.3	10.0	9.6	9.3	9.0

Sources: Bank of Portugal; and IMF staff calculations.

1/ End-of-period data.

Table 6. Portugal: External Financing Requirements and Sources, 2010-2018
(Billions of euros)

	2010	2011	2012	2013	2014	2015	2016	2017	2018
GROSS FINANCING REQUIREMENTS	186.0	210.5	179.3	158.3	160.1	142.3	139.7	129.7	132.8
Current account deficit	18.3	12.0	2.6	-0.5	-0.2	0.1	-0.7	-1.4	-2.5
Medium- and long-term debt amortization	28.8	29.6	29.2	25.5	35.5	26.3	20.9	21.8	25.4
Public sector	7.1	8.9	6.7	5.1	9.3	7.2	6.5	4.8	6.7
Banks	18.5	16.7	18.6	13.8	17.6	13.2	9.3	14.1	14.7
Other private	3.3	4.1	3.9	6.5	8.7	5.9	5.1	2.9	4.0
Short-term debt amortization	138.9	168.9	147.6	133.3	124.9	113.7	109.6	105.6	102.2
Public sector	40.3	71.0	63.6	67.0	64.4	54.3	45.9	33.4	30.8
Central Bank	23.4	59.9	61.0	66.1	61.2	49.0	38.6	26.1	23.5
General government and SOEs	16.9	11.1	2.7	0.9	3.2	5.3	7.3	7.3	7.3
Banks	79.5	76.6	57.4	47.7	43.7	43.5	44.6	46.3	48.2
Other private	19.1	21.3	26.6	18.6	16.8	15.9	19.1	25.8	23.2
EU and IMF 1/	0.0	0.0	0.0	0.0	0.0	2.3	9.9	3.8	7.5
SOURCES OF FINANCING	186.0	176.6	151.7	148.4	152.3	142.3	139.7	129.7	132.8
Capital account (net)	1.9	2.1	3.9	2.4	2.4	2.4	2.4	2.4	2.4
Foreign direct investment (net)	7.7	-2.7	5.4	5.1	1.6	1.6	1.6	0.5	0.4
Inward	2.0	8.0	6.9	6.6	3.2	3.2	3.3	3.3	3.4
New borrowing and debt rollover	194.1	161.4	140.5	140.9	145.8	145.0	140.4	130.9	137.7
Medium and long-term borrowing	25.2	14.7	7.2	16.0	32.1	35.5	34.8	28.6	36.9
General Government	15.1	4.3	1.5	2.2	8.9	14.2	16.1	9.6	15.6
Banks	3.7	2.0	2.6	8.7	15.4	14.1	11.8	15.5	16.5
Other private	6.4	8.4	3.1	5.2	7.8	7.1	6.9	3.5	4.8
Short-term borrowing	168.8	146.7	133.3	124.9	113.7	109.6	105.6	102.2	100.8
Public sector	71.0	62.8	67.0	64.4	54.3	45.9	33.4	30.8	29.8
Central Bank	59.9	61.0	66.1	61.2	49.0	38.6	26.1	23.5	22.5
General government	11.0	1.8	0.9	3.2	5.3	7.3	7.3	7.3	7.3
Banks	76.6	57.4	47.7	43.7	43.5	44.6	46.3	48.2	50.1
Other private	21.3	26.6	18.6	16.8	15.9	19.1	25.8	23.2	20.9
Other (includes asset operations)	-17.7	15.8	1.9	0.0	2.5	-6.7	-4.6	-4.0	-7.8
Of which: Net errors and omissions	0.8	0.1	0.5	0.0	0.0	0.0	0.0	0.0	0.0
FINANCING GAP	0.0	33.9	27.7	9.9	7.9	0.0	0.0	0.0	0.0
European Union (2/3 of total) 1/	...	20.9	19.4	6.5	5.2	...	...	...	...
IMF (1/3 of total)	...	13.1	8.2	3.4	2.7	...	...	...	...
ROLLOVER RATES									
General government	109.2	30.5	25.6	88.8	113.9	172.9	169.6	139.7	163.2
Private	89.7	79.5	67.6	85.7	95.3	108.1	116.4	101.5	102.4
Banks	81.9	63.6	66.2	85.0	96.1	103.6	108.0	105.5	105.9
Other private	124.1	138.0	71.3	87.4	93.3	120.0	135.0	93.1	94.4

Source: Bank of Portugal and staff estimates.
1/ Net of intra-year EFSF treasury bill issuance and amortization and EFSF pre-paid margin.

Table 7. Portugal: Selected Financial Indicators of the Banking System, 2008-2012Q4

(Percent)

	2008	2009	2010	2011	2012Q1	2012Q2	2012Q3	2012Q4
Capital Adequacy								
Regulatory capital to risk-weighted assets	9.4	10.5	10.3	9.8	10.7	12.3	12.3	12.6
Regulatory Tier 1 capital to risk-weighted assets	6.6	7.9	8.3	8.6	9.5	11.0	11.1	11.3
Capital to assets[1/]	5.8	6.5	6.7	5.3	5.8	6.2	6.6	6.7
Asset composition and quality								
Nonperforming loans to total gross loans[2/]	3.6	4.8	5.2	7.5	8.0	9.2	9.8	9.8
Nonperforming loans to total gross loans[3/]	3.5	4.8	5.1	…	…	…	…	…
Sectoral distribution of loans								
Residents	83.7	83.6	83.3	84.0	83.2	82.4	82.5	83.3
Deposit-takers	6.2	5.8	5.3	6.5	6.8	7.3	6.3	7.7
Central bank	1.3	1.2	0.5	0.9	0.4	0.4	0.7	1.1
Other financial corporations	3.6	3.7	3.9	2.9	2.7	2.7	2.7	2.4
General government	1.6	1.7	2.9	2.6	3.2	2.7	2.7	2.2
Nonfinancial corporations	31.6	31.5	30.7	31.0	30.6	30.0	30.3	30.2
Other domestic sectors	39.5	39.6	39.9	40.1	39.6	39.2	39.8	39.8
Nonresidents	16.3	16.4	16.7	16.0	16.8	17.6	17.5	16.7
Earnings and profitability								
Return on assets	0.3	0.4	0.5	-0.3	0.5	0.1	0.0	-0.3
Return on equity	5.7	7.3	7.5	-5.5	8.2	2.5	0.3	-5.4
Interest margin to gross income	59.5	53.8	52.3	57.5	51.3	47.9	46.6	46.7
Noninterest expenses to gross income	58.0	58.3	58.9	63.9	58.2	55.0	57.0	59.6
Liquidity								
Liquid assets to total assets[4/]	12.8	13.2	19.0	13.8	11.2	12.7	13.9	14.8
Liquid assets to short-term liabilities[4/]	67.7	84.5	86.2	85.3	90.5	101.5	131.0	140.0
Loans to deposits[5/]	…	161.5	157.8	140.2	136.9	136.3	133.3	127.9
Foreign-currency-denominated liabilities to total liabilities[6/]	5.8	5.1	5.1	4.1	3.9	3.9	4.0	4.2

Sources: Bank of Portugal.

1/ On accounting basis; consolidated.

2/ New NPL ratio in line with international practices. On a consolidated basis.

3/ New NPL ratio in line with international practices. On a consolidated basis, excluding institutions under intervention.

4/ Three-month residual maturity.

5/ Loans to customers (net of impairments) and securitized non-derecognized credit to customers divided by resources from customers and other loans.

6/ Includes 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 8. Portugal Monetary Survey, 2011-2018

(Millions of euros, unless otherwise indicated; end of period)

	Dec-11	Dec-12	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18
		Projections						
Aggregated Balance Sheet of Monetary Financial Institutions (MFIs) 1/								
Assets	472,496	442,721	421,590	410,707	413,049	421,899	428,454	434,624
Cash	1,606	1,605	973	978	990	1,002	1,015	1,027
Claims on Bank of Portugal	5,692	8,136	2,299	1,895	845	377	168	75
Claims on other FIs	53,526	46,870	45,148	40,253	39,623	40,253	39,623	40,253
Claims on non MFIs	307,347	296,034	280,808	273,789	273,098	276,821	281,135	285,817
General government	32,309	38,759	35,564	33,513	33,075	34,398	35,075	35,328
Central government (excluding SOEs)	19,544	27,212	23,846	21,242	20,341	21,615	22,351	22,520
loans	467	567	567	487	407	328	248	228
securities	19,078	26,645	23,279	20,755	19,933	21,288	22,103	22,292
Bonds	10,307	16,078	14,724	13,448	13,666	15,021	15,836	16,025
Tbills	8,770	10,567	8,555	7,307	6,267	6,267	6,267	6,267
Regional and local government (excl SOEs)	6,408	5,686	5,874	5,874	5,874	5,874	5,874	5,935
SOEs	6,365	5,870	5,844	6,397	6,860	6,908	6,850	6,873
Private sector	275,038	257,275	245,244	240,276	240,023	242,424	246,060	250,489
Claims on non-residents	96,585	88,380	90,676	92,073	96,729	101,619	104,622	105,559
Other assets	7,740	1,696	1,686	1,718	1,764	1,826	1,891	1,893
Liabilities	472,496	442,721	421,590	410,707	413,049	421,899	428,454	434,624
Liabilities to Bank of Portugal	46,928	53,724	48,884	36,686	26,243	13,749	11,148	10,141
Liabilities to other FIs	60,888	46,542	46,206	47,349	46,608	52,084	54,345	57,062
Deposits of non MFIs	176,290	170,955	165,684	170,929	176,288	180,377	181,899	183,445
General government	12,279	13,218	6,218	6,218	6,218	6,218	6,218	6,218
Private sector	164,011	157,737	159,466	164,711	170,070	174,159	175,681	177,227
Securities other than capital	53,345	46,342	39,987	34,838	34,651	36,981	36,351	36,322
Liabilities to non-residents	105,130	89,474	83,892	83,473	85,560	88,982	92,541	96,243
Other	-10,690	-14,376	-15,195	-14,746	-13,970	-13,740	-13,516	-13,740
Capital and reserves	40,606	50,061	52,133	52,177	57,669	63,466	65,685	65,151
Money and Credit								
Broad Money (M3)	172,547	161,855	160,652	163,715	168,127	174,064	180,230	186,802
Intermediate money (M2)	169,872	156,877	155,883	158,854	163,136	168,896	174,879	181,256
Narrow money (M1)	67,504	65,785	64,289	65,515	67,280	69,656	72,124	74,754
Private sector credit	275,038	257,275	245,244	240,276	240,023	242,424	246,060	250,489
Public sector credit	32,309	38,759	35,564	33,513	33,075	34,398	35,075	35,328
				(Percent of GDP)				
Broad Money	100.9	97.9	97.8	97.8	97.8	97.8	97.8	97.8
Private sector credit	160.8	155.6	149.2	143.5	139.6	136.1	133.5	131.1
Public sector credit	18.9	23.4	21.6	20.0	19.2	19.3	19.0	18.5
				(Percentage change)				
Broad Money	-1.3	-6.2	-0.7	1.9	2.7	3.5	3.5	3.6
Private sector credit	-1.5	-6.5	-4.7	-2.0	-0.1	1.0	1.5	1.8
Public sector credit	-4.5	20.0	-8.2	-5.8	-1.3	4.0	2.0	0.7
Memo items:								
ECB access (% assets)	9.9	12.1	11.6	8.9	6.4	3.3	2.6	2.3
Credit to deposits (%)	146.1	148.9	141.2	132.3	129.1	124.9	124.2	124.1
Loan to deposits (%) 2/	140.6	145.0	143.4	137.0	135.0	131.6	131.7	131.2
Wholesale market funding (% assets) 3/	29.5	26.9	25.5	24.9	25.1	25.8	25.9	26.2

Sources: Bank of Portugal and staff estimates.

1/ Excludes Bank of Portugal.

2/ Loan to deposit ratio for banking system as a whole based on monetary statistics.

3/ Includes foreign interbank borrowing and securities issued.

Table 9. Portugal: External Debt Sustainability Framework, 2008-2018

(Percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Debt-stabilizing non-interest current account 6/
Baseline: External debt	200.8	223.8	231.0	231.2	235.0	231.5	223.3	219.1	211.6	204.3	198.4	-0.8
Change in external debt	5.3	22.9	7.2	0.2	3.8	-3.5	-8.3	-4.2	-7.5	-7.4	-5.9	
Identified external debt-creating flows (4+8+9)	5.1	13.3	0.4	13.6	9.6	3.7	-2.0	-4.3	-5.2	-4.8	-5.2	
Current account deficit, excluding interest payments	4.7	4.8	5.3	0.5	-5.4	-6.5	-6.5	-6.6	-6.9	-7.3	-8.0	
Deficit in balance of goods and services	9.5	7.0	7.2	3.8	-0.1	-2.3	-3.2	-3.5	-3.8	-4.2	-4.5	
Exports	33.2	28.7	31.8	36.4	39.1	39.9	41.3	42.7	44.0	45.5	47.1	
Imports	42.7	35.7	39.0	40.2	39.0	37.5	38.1	39.2	40.2	41.4	42.6	
Net non-debt creating capital inflows (negative)	-4.5	-1.8	-4.6	4.2	0.2	-1.4	-0.5	-1.0	-1.0	-0.4	-0.3	
Automatic debt dynamics 1/	4.9	10.2	-0.3	8.9	14.9	11.7	5.0	3.3	2.7	2.9	3.1	
Contribution from nominal interest rate	7.9	6.1	5.3	6.5	7.0	6.2	6.4	6.6	6.5	6.6	6.7	
Contribution from real GDP growth	0.0	6.0	-4.2	3.6	7.6	5.5	-1.4	-3.3	-3.9	-3.7	-3.6	
Contribution from price and exchange rate changes 2/	-3.0	-1.8	-1.4	-1.2	0.3	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	0.2	9.7	6.8	-13.4	-5.9	-7.2	-6.2	0.1	-2.2	-2.5	-0.7	
External debt-to-exports ratio (in percent)	605.2	780.1	726.4	635.7	601.5	580.7	540.9	512.8	480.8	448.7	421.3	
Gross external financing need (in billions of Euros) 4/				210.5	179.3	158.3	160.1	142.3	139.7	129.7	132.8	
in percent of GDP				123.1	108.4	96.2	95.6	82.7	78.5	70.4	69.5	
Scenario with key variables at their historical averages 5/						231.5	231.8	238.2	243.3	248.2	255.3	1.4
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	0.0	-2.9	1.9	-1.6	-3.2	-2.3	0.6	1.5	1.8	1.8	1.8	
GDP deflator in Euros (change in percent)	1.6	0.9	0.6	0.5	-0.1	1.8	1.3	1.1	1.7	1.7	1.8	
Nominal external interest rate (in percent)	4.1	3.0	2.4	2.8	2.9	2.6	2.8	3.0	3.1	3.2	3.4	
Growth of exports (Euros, in percent)	2.8	-15.3	13.7	13.2	3.8	1.5	5.5	6.3	6.7	7.1	7.2	
Growth of imports (Euros, in percent)	7.8	-18.1	12.2	1.8	-6.1	-4.4	3.5	5.6	6.2	6.5	6.6	
Current account balance, excluding interest payments	-4.7	-4.8	-5.3	-0.5	5.4	6.5	6.5	6.6	6.9	7.3	8.0	
Net non-debt creating capital inflows	4.5	1.8	4.6	-4.2	-0.2	1.4	0.5	1.0	1.0	0.4	0.3	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency--not used here), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).
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; 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, deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 10. Government Debt Sustainability Framework, 2008-2030

(Percent of GDP, unless otherwise indicated)

Table 10. Portugal: Government Debt Sustainability Framework, 2008-2030

(Percent of GDP, unless otherwise indicated)

	Actual				Projections								
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2020	2025	2030	Debt-stabilizing primary balance 9/
1 Baseline: General Government debt 1/	71.6	83.0	93.2	108.0	123.6	122.9	124.2	123.1	120.5	108.5	94.0	82.1	0.2
Of which: foreign-currency denominated	1.2	1.2	1.5	9.6	14.8	16.9	18.3	17.5	15.4	4.8	1.1	0.9	
2 Change in public sector debt	3.3	11.5	10.2	14.8	15.7	-0.8	1.4	-1.2	-2.5	-3.2	-2.7	-2.2	
3 Identified debt-creating flows (4+7+12)	2.5	11.7	7.4	5.0	8.8	3.9	1.7	-0.7	-2.3	-3.3	-2.7	-2.2	
4 Primary deficit	0.6	7.3	7.0	0.4	2.0	1.1	-0.4	-1.8	-2.4	-3.4	-3.3	-2.8	
5 Revenue and grants	41.1	39.6	41.6	45.0	41.0	42.6	42.1	41.6	41.5	42.4	42.3	41.8	
6 Primary (noninterest) expenditure	41.7	46.9	48.7	45.3	43.0	43.6	41.7	39.8	39.1	39.0	39.0	39.0	
7 Automatic debt dynamics 2/	2.0	4.4	0.8	5.0	8.1	5.1	2.1	1.1	0.2	0.1	0.6	0.6	
8 Contribution from interest rate/growth differential 3/	2.0	4.3	0.8	5.0	8.1	5.1	2.1	1.1	0.2	0.1	0.6	0.6	
9 Of which contribution from real interest rate	2.0	2.2	2.3	3.6	4.6	2.2	2.8	2.9	2.3	2.3	2.5	2.2	
10 Of which contribution from real GDP growth	0.0	2.1	-1.6	1.5	3.5	2.9	-0.7	-1.8	-2.2	-2.1	-1.9	-1.6	
11 Contribution from exchange rate depreciation 4/	0.0	0.1	0.1	0.0	...	...	...	...	...	...	...	...	
12 Other identified debt-creating flows	-0.1	0.0	-0.4	-0.4	-1.3	-2.2	0.0	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	-0.1	0.0	-0.4	-0.4	-1.3	-2.2	0.0	0.0	0.0	0.0	0.0	0.0	
14 Residual, including net acquisition of financial assets and changes in deposits (2-3) 5/	0.8	-0.3	2.8	9.7	6.8	-4.7	-0.4	-0.4	-0.3	0.1	0.0	0.0	
Public sector debt-to-revenue ratio 1/	174.1	209.7	223.8	240.1	301.6	288.6	295.2	295.6	290.5	255.8	222.3	196.5	
Gross financing need 6/	17.3	36.3	44.0	25.9	27.9	16.2	21.3	23.0	23.4	0.0	0.0	0.0	
Billions of U.S. dollars	40.5	89.3	100.5	58.4	58.4	33.6	44.9	49.5	51.8	0.0	0.0	0.0	
Scenario with key variables at their historical averages 7/				108.4	123.5	121.4	125.1	128.8	132.7	149.6	172.0	195.6	1.4
Scenario with no policy change (constant primary balance at 2011 level excluding one-offs)				108.4	131.5	133.6	138.9	143.0	146.3	161.1	180.9	204.3	0.3
Key Macroeconomic and Fiscal Assumptions Underlying Baseline													
Real GDP growth (percent)	0.0	-2.9	1.9	-1.6	-3.2	-2.3	0.6	1.5	1.8	2.0	2.0	2.0	
Average nominal interest rate on public debt (percent) 8/	4.6	3.9	3.5	4.3	3.9	3.5	3.6	3.6	3.7	4.2	4.7	4.7	
Average real interest rate (using in GDP deflator, percent)	3.0	3.0	2.9	3.8	4.1	1.7	2.4	2.4	2.0	2.2	2.7	2.7	
Inflation rate (GDP deflator, percent)	1.6	0.9	0.6	0.5	-0.1	1.8	1.3	1.1	1.7	2.0	2.0	2.0	
Growth of real primary spending (deflated by GDP deflator, percent)	0.9	9.2	5.7	-8.3	-8.1	-0.9	-3.9	-3.1	0.0	1.9	2.0	2.0	
Primary deficit	0.6	7.3	7.0	0.4	2.0	1.1	-0.4	-1.8	-2.4	-3.4	-3.3	-2.8	

Sources:

1/ General government gross debt (ESA 95 definition).

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

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

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ Includes change in deposits, support to financial sector, recognition of implicit contingent liabilities, reclassifications, unidentified financial transactions, and cash-accrual adjustments.

For 2011, includes accumulation of deposits (6 percent of GDP) and BSSF funds (0.6 percent of GDP). For 2012, includes accumulation of BSSF funds (4.2 percent of GDP) and non-BSSF bank recapitalization (1.6 percent of GDP)

For 2013, includes use of deposits (-5.9 percent of GDP) and acquisition of financial assets (0.3 percent of GDP). For projections, this line includes exchange rate changes.

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

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

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

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table 11. Portugal: Access and Phasing Under the Extended Arrangement, 2011-2014

Review	Review date[1/]	Action	Purchase	
			In millions of SDRs	in percent of quota
	May 20, 2011	Board approval of Extended Arrangement	5,611	544.9
First review	September 12, 2011	Observation of end-June 2011 performance criteria; completion of first review	3,467	336.7
Second review	December 19, 2011	Observation of end-September 2011 performance criteria; completion of second review	2,425	235.5
Third review	April 4, 2012	Observation of end-December 2011 performance criteria; completion of third review	4,443	431.5
Fourth review	July 16, 2012	Observation of end-March 2012 performance criteria; completion of fourth review	1,197	116.2
Fifth review	October 24, 2012	Observation of end-June 2012 performance criteria; completion of fifth review	1,259	122.3
Sixth review	January 16, 2013	Observation of end-September 2012 performance criteria; completion of sixth review	724	70.3
Seventh review	March 15, 2013	Observation of end-March 2013 performance criteria; completion of seventh review	574	55.7
Eighth review	June 15, 2013	Observation of end-March 2013 performance criteria; completion of eighth review	806	78.3
Ninth review	September 15, 2013	Observation of end-June 2013 performance criteria; completion of ninth review	873	84.8
Tenth review	December 15, 2013	Observation of end-September 2013 performance criteria; completion of tenth review	803	78.0
Eleventh review	March 15, 2014	Observation of end-December 2013 performance criteria; completion of eleventh review	760	73.8
Twelfth review	May 15, 2014	Observation of end-March 2014 performance criteria; completion of twelfth review	800	77.7
Total			23,742	2,305.7

Source: Fund staff projections.

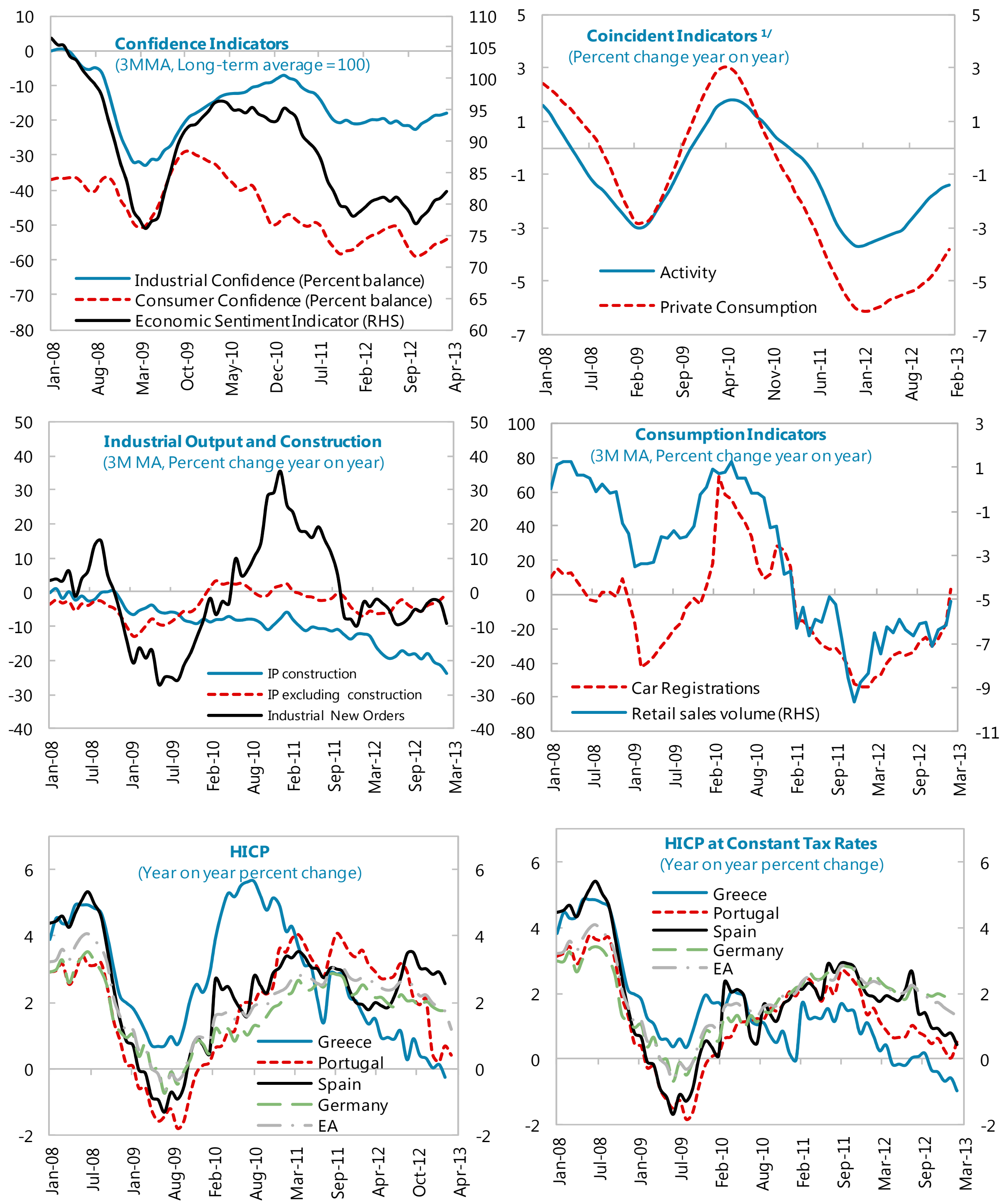
1/ For completed reviews the dates refer to Board dates and for future reviews the dates refer to expected availability dates

Table 12. Portugal: Indicators of Fund Credit
(Millions of euros, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Disbursements	13,052	8,216	3,403	2,712	…	…	…	…	…
(in percent of quota)	1,117	670	289	229	…	…	…	…	…
(Projected debt service to the Fund, based on existing and prospective drawings)									
Total	14	152	342	848	1,544	3,615	4,622	5,171	5,138
Interest and charges	14	152	342	848	1,005	965	845	688	503
Repayments	0	0	0	0	539	2,650	3,777	4,483	4,635
Total debt service, in percent of									
Exports of goods and services	0.0	0.2	0.5	1.2	2.1	4.6	5.5	5.7	5.3
GDP	0.0	0.1	0.2	0.5	0.9	2.0	2.5	2.7	2.6
(Projected level of credit outstanding based on existing and prospective drawings)									
Outstanding stock	13,052	22,777	25,355	27,247	26,834	24,318	20,673	16,303	11,668
in percent of quota	1,117.1	1,857.4	2,154.2	2,305.7	2,260.3	2,038.2	1,723.3	1,351.6	967.3
in percent of GDP	7.6	13.8	15.4	16.3	15.6	13.7	11.2	8.6	6.0
Memorandum Items (in billions of euros)									
Exports of goods and services	62	65	66	69	73	78	84	90	96
GDP	171	165	164	168	172	178	184	189	194

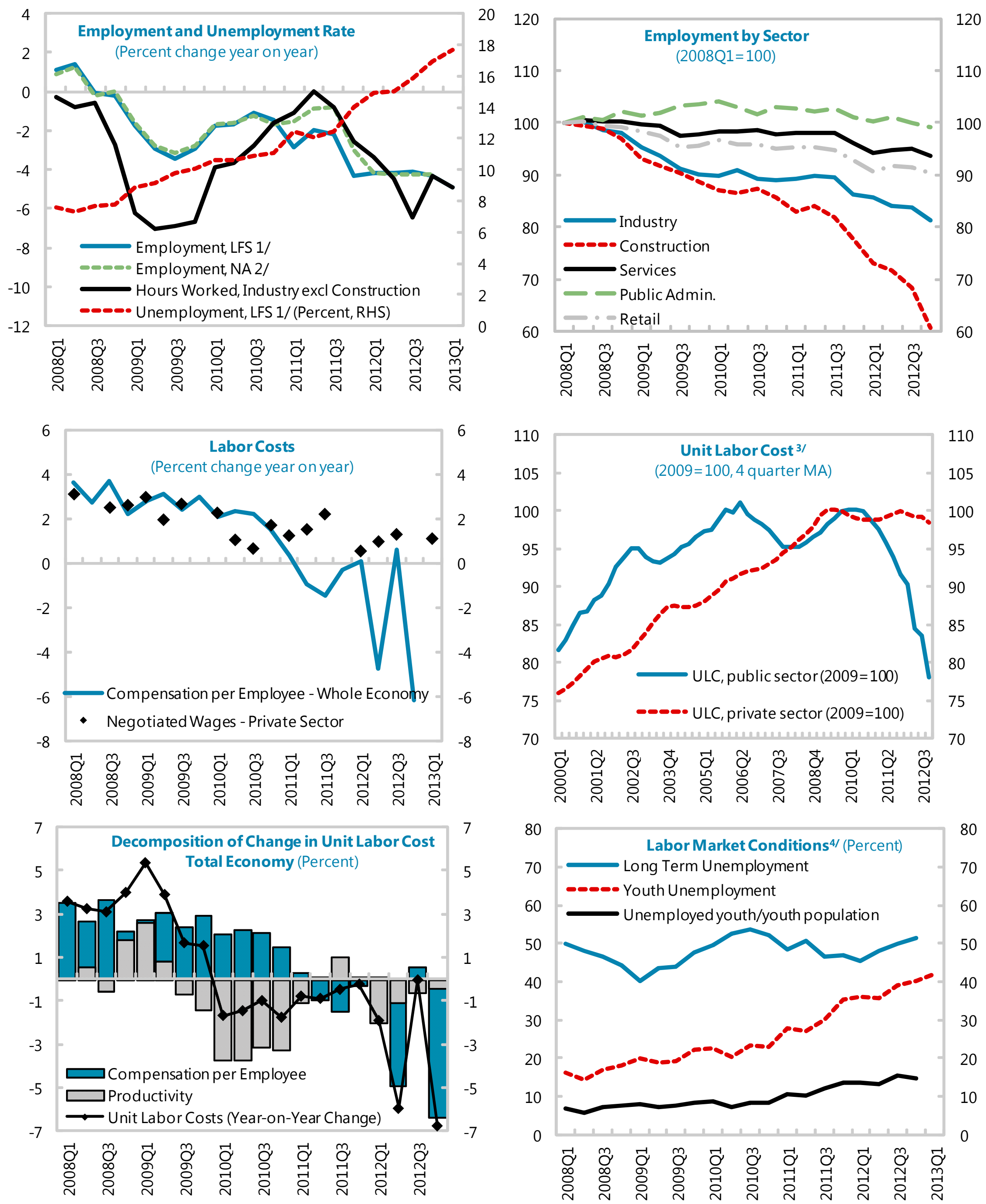
Source: Fund staff projections. Exchange rate forecasts against the SDR as per WEO assumptions.

Figure 1. Portugal: High Frequency Indicators



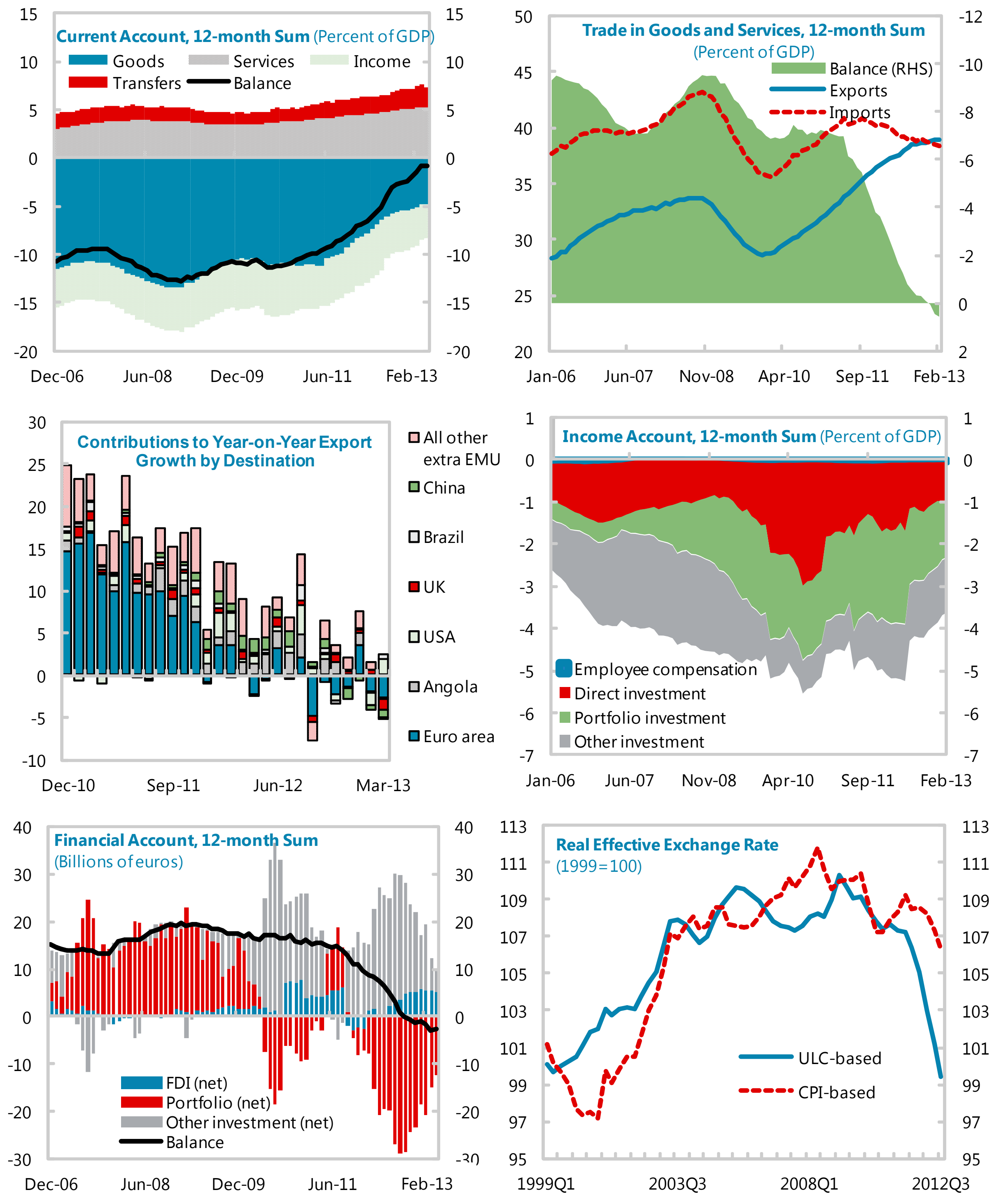
Source: Statistical Office of the European Communities; European Commission; Bank of Portugal; and Fund staff calculations.
1/ Calculated by the Bank of Portugal.

Figure 2. Portugal: Labor Market Indicators



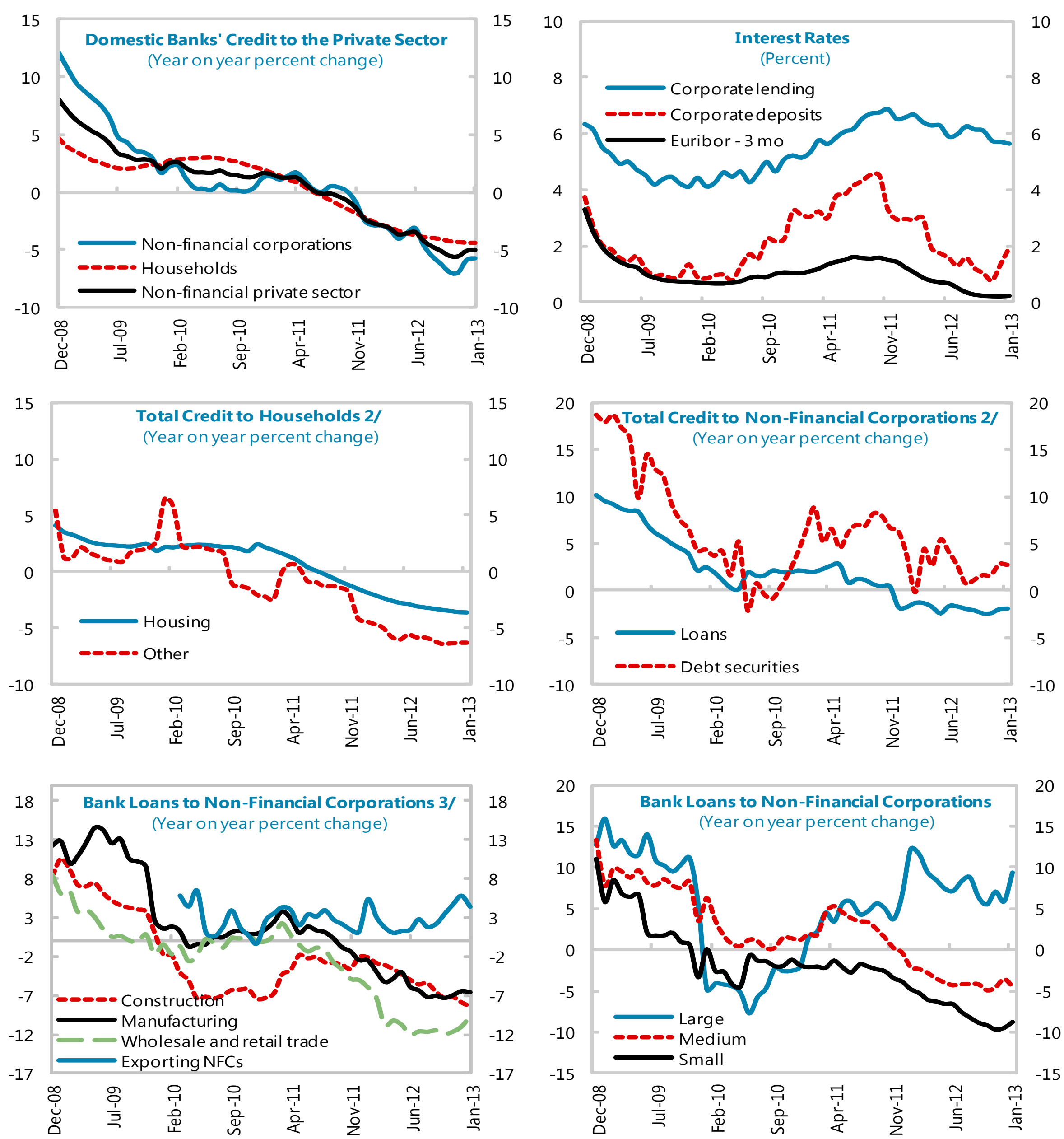
Source: Statistical Office of the European Communities; European Commission; Bank of Portugal; and Fund staff calculations.
1/ Labor Force Survey
2/ National Accounts
3/ Esitmated. Productivity is defined as the gross value added divided by number of employment.
4/ Long term unemployment rate as percent of total unemployed; youth unemployment rate as percent of youth labor force.

Figure 3. Portugal: Balance of Payments Developments



Sources: INE; Banco de Portugal; Eurostat; and IMF staff calculations.

Figure 4. Portugal: Financing of the Economy, 2008-January 2013 1/



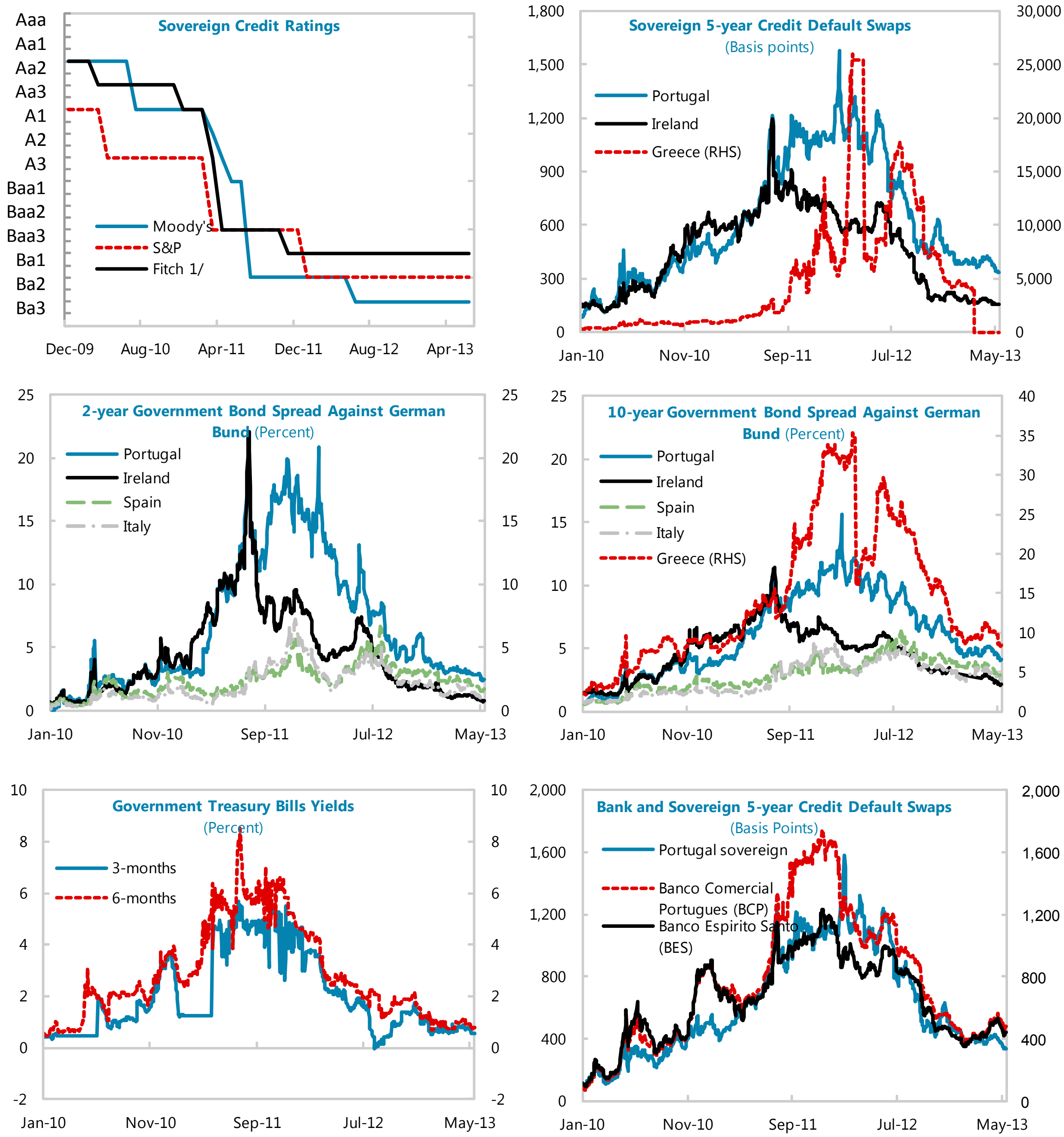
Source: Banco de Portugal.

1/ Credit and loan figures are adjusted for securitisation operations and monthly transactions (calculated using the outstanding amounts corrected of reclassifications, write-offs/write-downs, exchange rate changes and price revaluations). Whenever relevant, figures are additionally adjusted for credit portfolio sales, as well as for other operations with no impact on non-financial corporations' effective financing.

2/ Total credit granted to residents by resident and non-resident entities is reported on a consolidated basis and includes loans, debt securities and trade credits.

3/ Private-owned exporting companies, defined as: a) companies that export more than 50% of the turnover; or b) companies that export more than 10% of the turnover and the total amount exceeds 150 thousand euro (with both criteria met in the last 3 years.

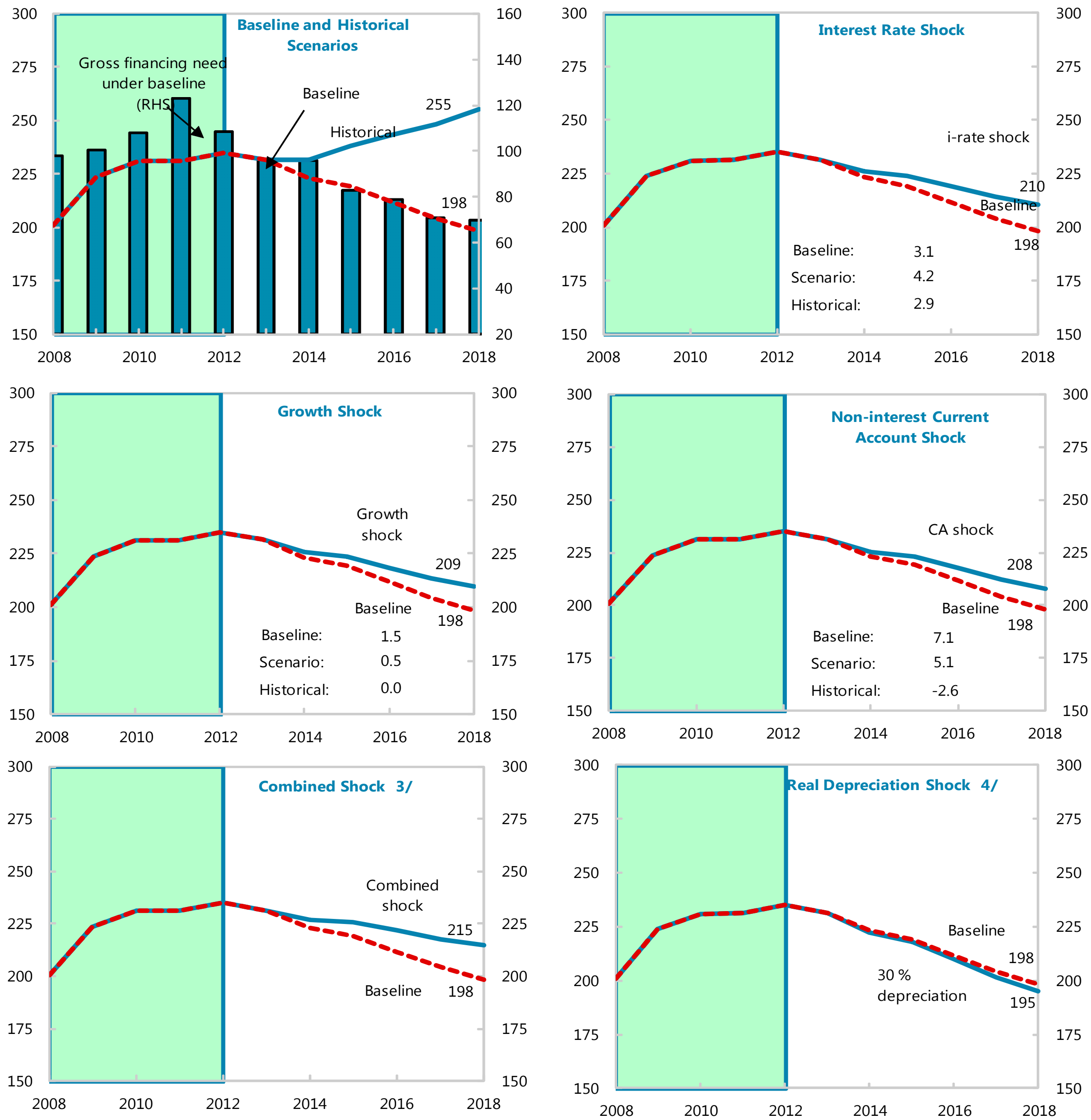
Figure 5. Portugal: Financial Indicators



Sources: Bloomberg; and IMF staff calculations.
[1/] Rating used is the LT Foreign Currency Issuer Default

Figure 6. Portugal: External Debt Sustainability[1/2/]

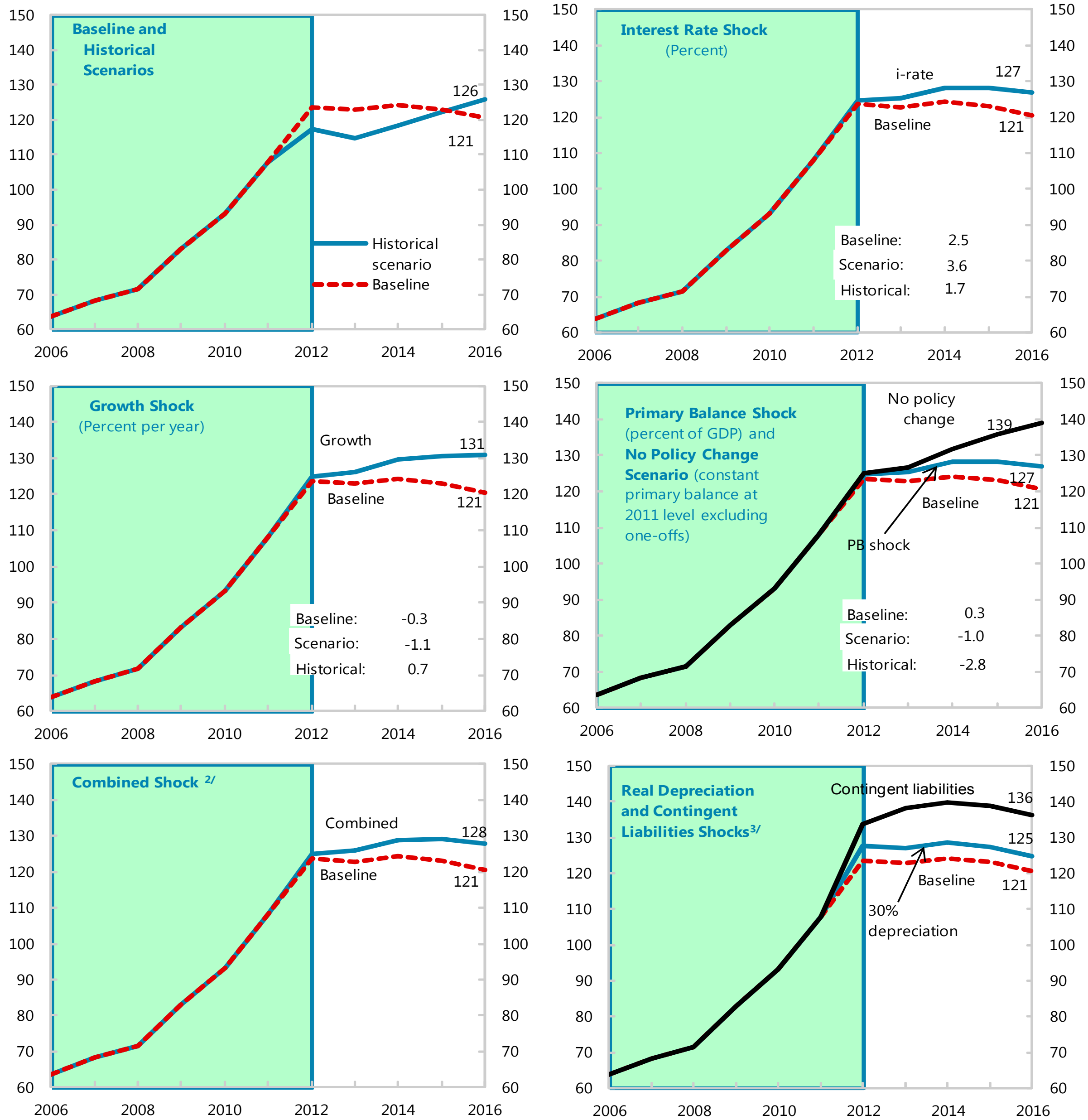
(External Debt in Percent of GDP)



Sources: International Monetary Fund, Country desk data, and IMF staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks, except the interest rate shock which is a permanent one standard deviation shock. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to growth rate, and current account balance, and 1/2 standard deviation shock to the real interest rate.
4/ One-time real depreciation of 30 percent occurs in 2013

Figure 7. Portugal: Government Debt Sustainability: Bound Tests[1/]

(Percent of GDP)



Sources: International Monetary Fund; country desk data; andIMF staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Appendix I. Public Expenditure Review Measures

Public Expenditure Review Measures

(in millions of euros, unless specified otherwise)

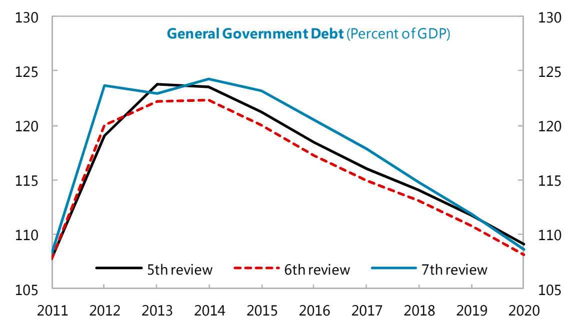
	2013	2014 1/	Total
Wage bill	777	1,395	2,172
Special mobility (requalification)	48	119	167
Convergence public-private working rules	176	365	541
Mutual agreements (voluntary separation)	0	252	252
Single wage and supplement scale	0	445	445
Termination of fixed-term contracts	74	214	288
Attrition	479	0	479
Pensions	0	1,378	1,378
Increase in retirement age	0	270	270
Equality between public sector and private sector schemes	0	672	672
Sustainability contribution	0	436	436
Intermediate consumption	334	520	854
Savings from the line ministries	284	470	754
Other	50	50	100
Other	300	-4	296
Total	**1,411**	**3,289**	**4,700**
in percent of 2013 GDP	*0.9*	*2.0*	*2.9*
Memorandum item			
Upfront costs (severance payments) 2/	0	507	

1/ Incremental with respect to 2013.
2/ This is a one-off cost.

Appendix II. Public Debt Sustainability Analysis (DSA)

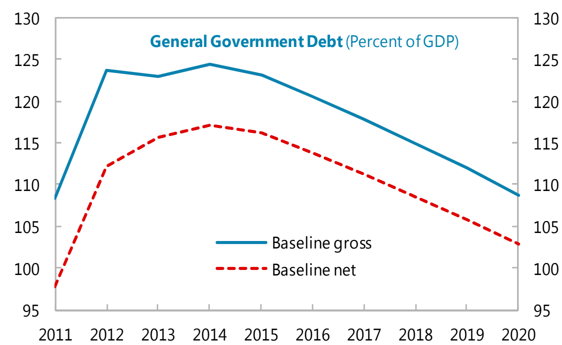
This appendix updates the analysis presented at the time of the sixth review (IMF Country Report No.13/18). The results are broadly unchanged: Portugal's debt trajectory remains sustainable under baseline assumptions, but is vulnerable to plausible shocks. Nevertheless, debt dynamics could become unsustainable under a combined shock scenario.

Under the revised baseline, debt is projected to peak at close to 124 percent of GDP in 2014. The two-percentage-point increase in debt peak vis-à-vis the sixth review is largely due to the slower pace of fiscal adjustment going forward and the recession that turned out to be more severe than originally anticipated. Overall, the revised baseline is very close to the debt paths projected during the two previous reviews.[1]



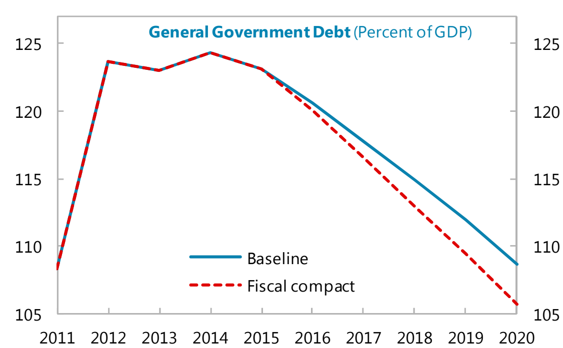
Sources: Portugal authorities; and IMF staff estimates.

The projected reduction in the gross debt-to-GDP ratio in 2013 reflects a number of one-off transactions rather than an underlying improvement in the public sector's net worth. Those transactions are asset exchanges: the sale of foreign assets of the social security fund, the use of government's cash holdings, and the transfer of the shares of CGD—a public bank—to Parpública, a state-owned holding company that is outside of the perimeter of the general government. The last transaction will allow the government to settle some of its debt to Parpública in kind. Portugal's debt net of government deposits—which is a better approximation of the net worth of the public sector—is projected to rise smoothly to its peak in 2014 and then decline.[2]



Sources: Portugal authorities; and IMF staff estimates.

The authorities' medium-term fiscal strategy envisages a structural deficit of ½ percent of GDP starting in 2016, in line with the Fiscal Compact objective. Compared with staff's baseline,



Sources: Portugal authorities; and IMF staff estimates.

---

[1] The baseline does not incorporate the envisaged EFSF/ESM maturity extension.

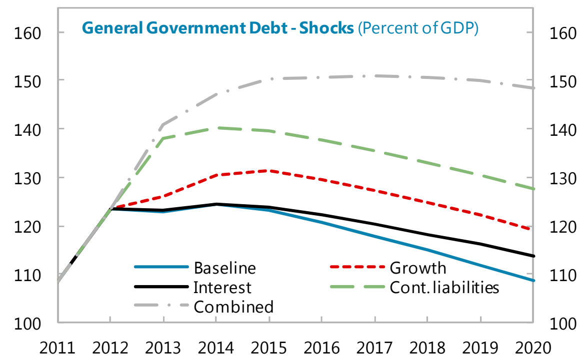
[2] By the same token, the €3.8 billion increase in gross debt in the first quarter of 2013 reflects to a large extent an increase in government deposits.

it implies an additional primary structural effort of some 0.6 percent of GDP in 2016 and the permanently lower deficits (by ½ percentage points of GDP) in the medium term, resulting in the debt-to-GDP ratio that is three percentage points of GDP lower by 2020.

The baseline remains highly sensitive to shocks, especially if a combination of them were to materialize:

- A *growth shock* that lowers the output by cumulative 5 percentage points in 2013 – 15 would raise the debt peak by 7 points to 131½ percent of GDP.

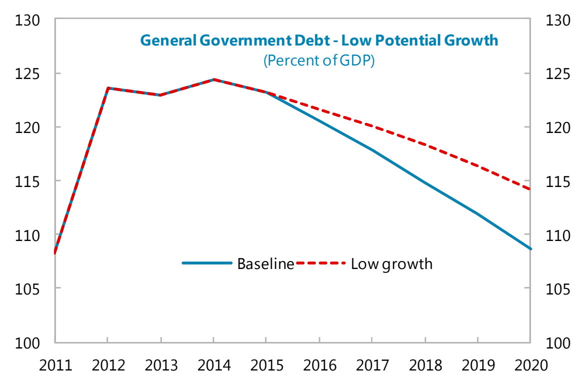
- An *interest rate spike* of 400 bps on all debt in 2013 – 15 would not have a large immediate effect, but it would slow down the rate of debt decline in the medium term, so that by 2020 the debt-to-GDP ratio is 5 points higher compared with the baseline.



Sources: Portugal authorties; and IMF staff estimates.

- *A reduction in potential growth* (from two to one percent in real terms) will have an impact that is numerically similar to the impact of an interest rate spike noted above.

- Realization of *contingent liabilities* (15 percent of GDP, in line with earlier staff work – see IMF Country Reports 12/77 and 13/18) would immediately push debt close to 140 percent of GDP; debt would fall below 120 percent of GDP only in 2023.



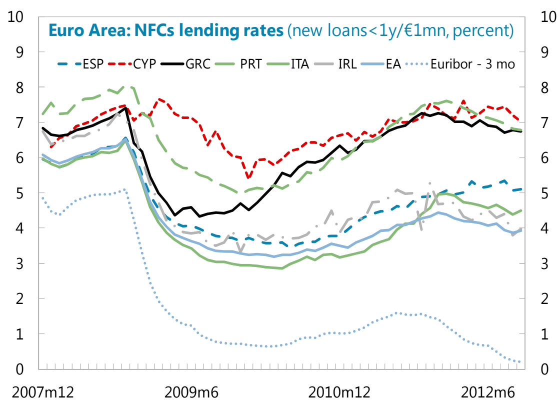
- A *combined shock* that incorporates all of the scenarios mentioned above (except a reduction in potential growth) would lead to debt above 140 percent of GDP through 2024, a clearly unsustainable outcome.

Appendix III. Determinants of Lending Rates in Portugal[1]

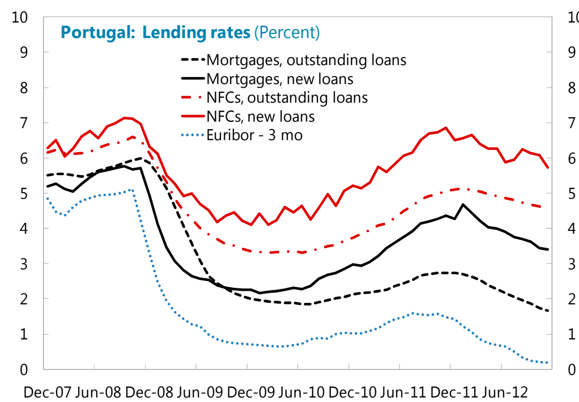
Portugal is facing among the most difficult credit conditions in the euro area. This note aims to identify the key sources of the high lending rates in the country and the underlying credit segmentation in the region. Most of the short-term factors behind the high cost of credit are common to all periphery countries, although amplified by Portugal's specific developments and characteristics. Specifically, the sharper sovereign debt crisis and banks' funding pressures are some of the key determinants of the higher lending rates in Portugal compared to other countries in the region. Weak domestic conditions and profitability are also found to put additional pressure on Portuguese lending rates in the context of over-leveraged private sector balance sheets.

STYLIZED FACTS

Despite a recent stabilization, credit conditions remain exceptionally tight in Portugal. In particular, the lending rates applied by Portuguese banks to new corporate loans have significantly increased since the onset of the crisis, increasingly diverging from the policy rate and Euro area average.



Sources: ECB, and staff estimates.



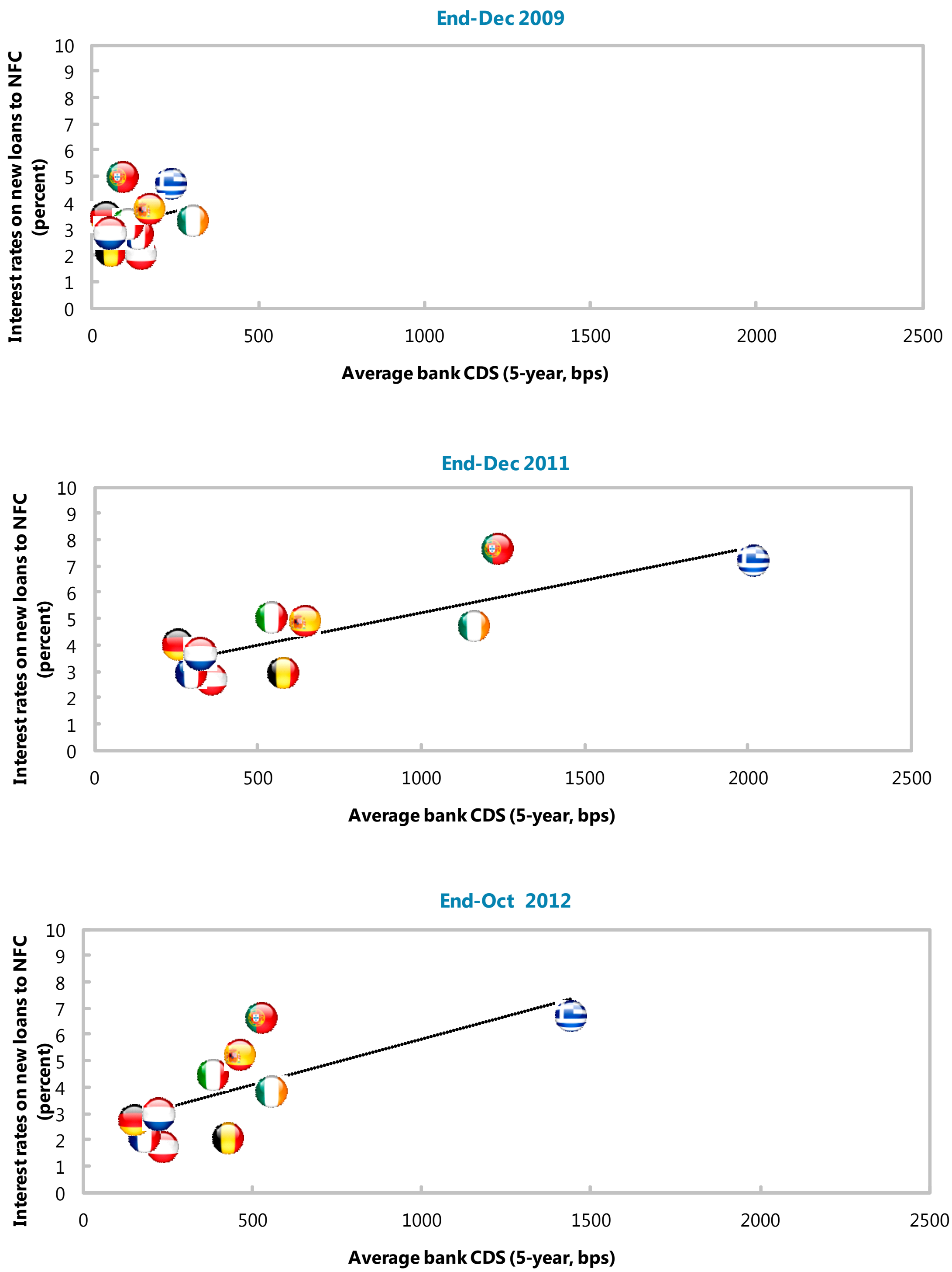
Sources: BdP, Bloomberg, and staff estimates.

Most of the factors behind these particularly difficult credit conditions are common to all periphery countries, although they are amplified in Portugal due to country-specific developments and characteristics:

- ***Sovereign debt crisis.*** The sudden increase in the sovereign default risk translated in lower ratings and loss of market access also for the Portuguese banks. In this crisis environment, banks' private funding costs—a primary component of the marginal cost of lending—have remained elevated despite historically low policy rates.

[1] Prepared by Manuela Goretti. Min Kyu Song provided research assistance.

Figure AII.1. Euro Area: Banks' Market Conditions and Lending Rates



Sources: ECB, Bloomberg, and staff estimates.

However, while, since the onset of the crisis, deposit rates have declined and market conditions have started to improve, the impact on lending rates has so far been limited, suggesting that other factors are at play.

- ***Recession and regulatory requirements.*** Weak domestic conditions are also weighing on banks' lending and pricing decisions. Banks' profit margins are being squeezed by (i) high impairment levels and provisions as a result of corporate bankruptcies and high unemployment; and (ii) low returns from the long-term legacy portfolios—mostly mortgages—with a fixed spread over the Euribor. This adds to the higher capital adequacy requirements in the wake of the crisis coupled with high cost of capital (including from the of high remuneration rates on the hybrid instruments injected by the state in some banks as part of the capital augmentation exercise).

- ***Corporate debt overhang and banks' restructuring.*** All of these factors are amplified by the ongoing and necessary re-tooling of banks' lending strategy as they shift their business to new clients in the tradable sectors and deleverage from the highly indebted segments of the economy (see Selected Issues Chapter on Corporate deleveraging, 2012 Article IV Consultation). Although sizable cost reductions are ongoing and, as part of broader restructuring, banks are diversifying the instruments offered to retail customers, the impact on profitability is only gradual, leading banks to buttress their profit margins through high lending rates on new loans.

EMPIRICAL ANALYSIS

A panel-data approach is used to test the key determinants of corporate lending rates in Portugal and other Euro area countries during the crisis.[2] The ECB database is used as the main data source for interest rates and banks' indicators, given the greater comparability and coverage across countries, complemented by market and IMF databases. The sample covers Euro area countries over the period 2003M1–2012M10, subject to data availability. [3]

The panel results over the full sample period confirm evidence of significant, yet partial, pass-through from market rates to retail rates (see first column of table below). The 3-month Euribor accounts for about 70 percent of the banks' rates on new loans to non-financial corporations, followed by the 10-year sovereign yield, as a measure of aggregate credit risk at country level. The unemployment rate also enters significantly in the full-sample regression and is used to capture developments in domestic economic conditions faced by banks. [4] Results are also not significantly

[2] The pass-through of market interest rates to retail interest rates in Portugal and other Euro area countries has been widely tested in the empirical literature, although mostly for the pre-crisis period. See, for example, de Bondt (2005), Gropp et al. (2007), Gambacorta (2004), Antao (2009), Castro-Santos (2010).

[3] Greece and Cyprus are de facto excluded from the analysis due to data shortcomings.

[4] Robustness tests on bank-specific indicators like NPLs, banks' provisions in percent of total assets, and returns on equity bear comparable estimates, although data coverage and definitions differ across countries.

different if a dynamic panel-data approach, applying the GMM two-step system estimator by Roodman (2009), is used to control for endogeneity in the short-term dynamics. [5]

Determinants of Bank Lending Rates to Non-Financial Corporations

	Fixed effects					GMM 1/		
	Full sample (2003M1-2012M10)	Pre-crisis (2003M1-2008M8)	Global/debt crisis (2008M9-2012M10)	Debt crisis (2010M1-2012M10)		Full sample (2003M1-2012M10)	Pre-crisis (2003M1-2008M8)	Debt crisis (2010M1-2012M10)
EA Const.	1.51***	1.9***	0.74***	-0.08	EA Const.	0.51	2.71	0.56
Euribor	0.69***	0.75***	0.78***	0.7***	Euribor_1	0.75***	0.71***	0.71***
Sov. Yield	0.13***	0.03***	0.1***	0.1***	Sov. Yield_1	0.14**	0.03	0.14*
Unemp.	0.02***	-0.01	0.11***	0.21***	Unemp._1	0.12	-0.10	0.12**
R-sq (overall)	0.68	0.70	0.53	0.27	AR(1) test	-2.85***	-2.41**	-1.96**
R-sq (within)	0.90	0.96	0.87	0.67	AR(2) test	-2.72***	-1.73*	-1.58
Obs.	1282	691	591	414	Obs.	1281	690	414

Notes: ***, **, * indicate significance at 1, 5, and 10 percent level. 1/ Dynamic panel data with GMM two-step system estimator.

Consistent with the stylized facts, the panel results identify significant non-linearities in the determinants of lending rates since the onset of the crisis (see other columns of table above). In particular, in the pre-crisis period, lending rates are mostly driven by the short-term policy rate, with a significantly lower weight played by sovereign yields. As the sovereign debt crisis in the Euro area deepens (the 2010M1-2012M10 subsample in the table), short-term dynamics are increasingly affected by developments in sovereign yields and domestic conditions, which explain most of the higher lending spreads in Portugal and other crisis countries (Figure AII.2).

Nevertheless, in the case of Portugal, the results also point to significant long-run differences in lending rates, as captured by the country fixed effect compared to the Euro area constant. Banks' structural characteristics, like concentration and limited presence of foreign banks, [6] as well as the higher degree of leverage (as captured by the banks' loan to deposit ratio or by the corporate debt overhang) explain some of Portugal's long-run risk premium (estimated in the order of 100 basis points compared to the Euro area average. Capital and lending conditions as well as cost measures, instead, have only a marginal contribution in reducing the country fixed effect. Nevertheless, these results are subject to important data shortcomings, in terms of coverage and cross-country comparability. [7]

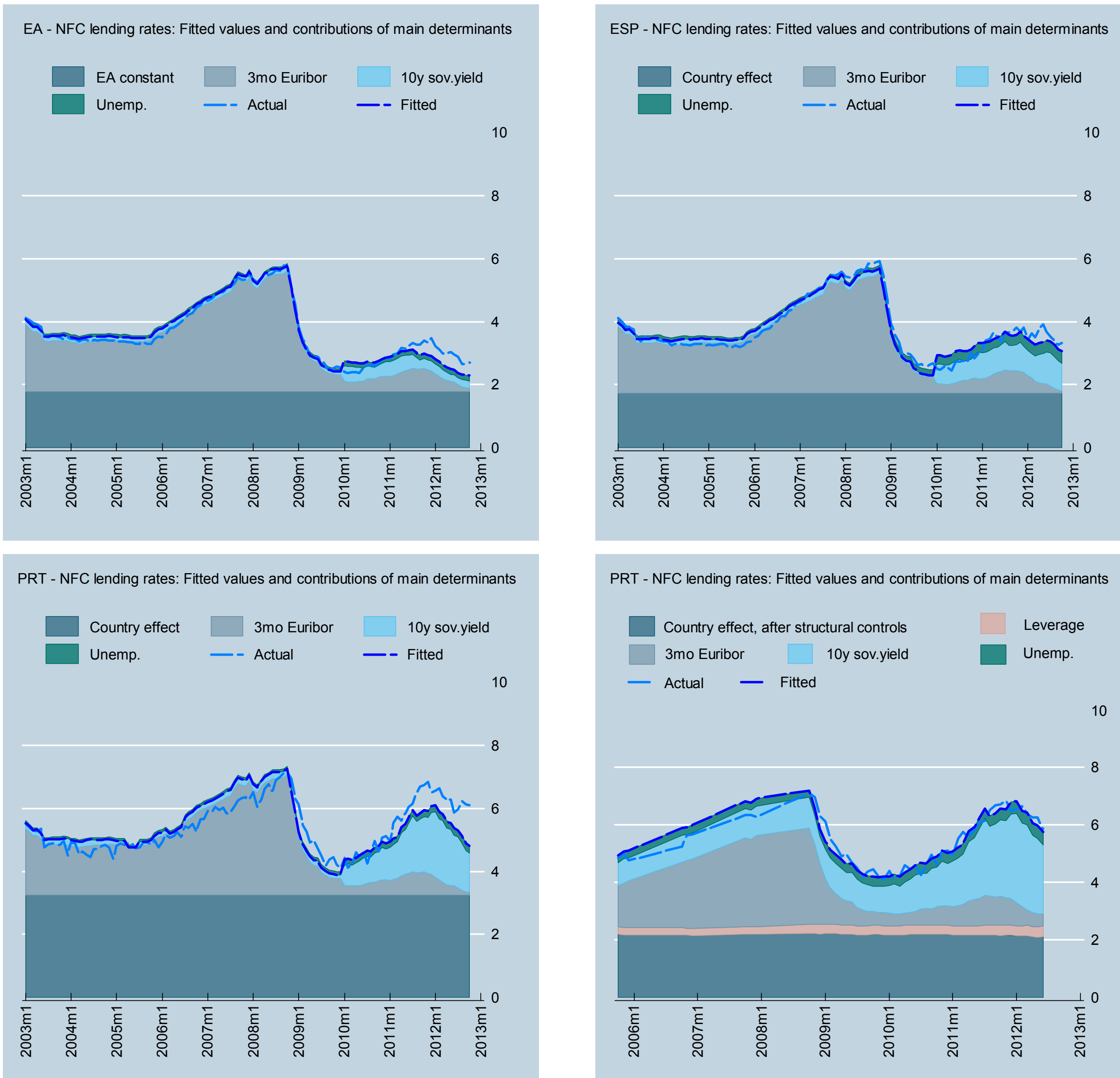
[5] The results in Figure 2 do not use the GMM fitted values mainly to present country and Euro area-wide fixed effects. Moreover, to avoid any break in the series, the fitted values in Figure 2 are estimated over the full sample period with interactive dummies to control for the debt crisis period.

[6] The market share of the top 5 banks in the system, as well as the Herfindahl index from the ECB database, are used as measures of concentration of the banking system. The presence of foreign banks is captured by the market share of foreign subsidiaries in percent of total assets in the banking system.

[7] As noted by the BdP, the weighting scheme used in the MIR statistics on interest rates on new loans does not take into account the term of the operations, so that national differences in the aggregated figures may result from different maturity structures in the different countries. Moreover, the concept of new operation in the MIR statistics does not include interest rates set in the context of debt restructuring operations and on overdrafts.

Results for lending rates on household housing and consumption are not reported for brevity, also given the lower loan activity, but indicate a greater role of the Euribor and domestic conditions in banks' pricing decision, with a much lower contribution from sovereign rates.

Figure AII.2. Euro Area: Contributions of Main Determinants of NFC Lending Rates



Sources: ECB, Bloomberg, FSI, IFS, and staff own calculations.

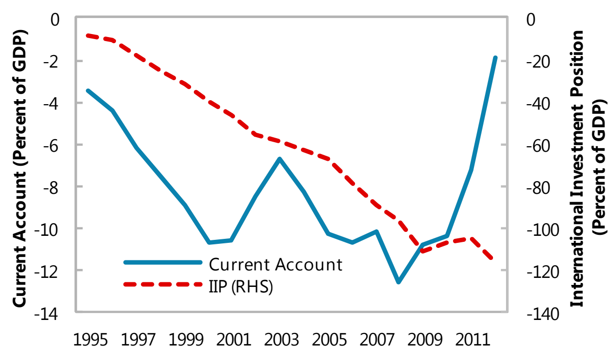
Appendix IV. Structural Reforms and External Competitiveness: Where Do Things Stand?[2]

While the economy's flow adjustment, both on the fiscal and external side, is progressing well, there are indications that the relative price adjustment needed to correct Portugal's external competitiveness gap is lagging. And, in the medium term, it is progress on restoring external competitiveness that will determine Portugal's economic fortunes. This note summarizes the main structural reform measures adopted under the program and gauges their impact on external competitiveness to date. The assessment of the impact of reforms is, however, a challenging exercise. For one, in many cases, reforms have only recently been adopted and have yet to be implemented fully. And even where the reforms have been in place for some time, with growth constrained by the slump in domestic demand and a corporate credit squeeze, the reforms may not yet yield the favorable relative price and productivity responses that may occur once present macroeconomic tensions recede. Finally, further structural rigidities may still need to be identified and addressed before the reforms introduced so far can effectively bear fruits. Accordingly, the discussion below has to be considered partial and preliminary.

Background

In the run-up to the global financial crisis in 2008 a significant and growing external competitiveness gap was evident in Portugal (text charts). Since 2000, the external current account deficit remained at unsustainably high levels of around 10 percent of GDP, notwithstanding the marked slowdown in economic growth and rising unemployment. The large and persistent external imbalance coupled with internal activity running below capacity level suggests that currency overvaluation had become fairly significant and entrenched over time.

Current Account & International Investment Position
(Percent of GDP)



Sources: INE; AMECO; Banco de Portugal; and IMF staff estimates.

To restore external competitiveness, structural reforms—in combination with fiscal adjustment and financial sector measures—need to make Portugal's tradable sectors significantly more attractive for investment and production. In particular, the tradable sectors need to become more attractive for locating investments than the non-tradable sectors. Conceptually, structural reforms can promote external competitiveness through two main channels:

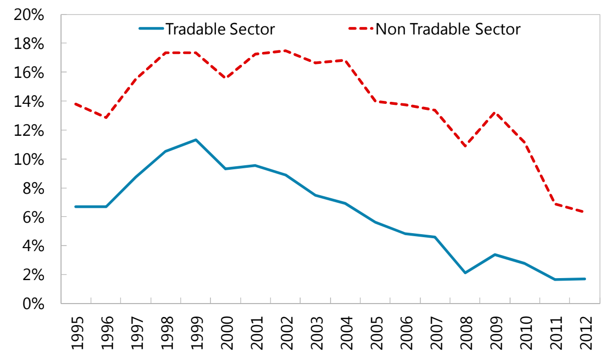
[1] Prepared by Albert Jaeger, Yanliang Miao, and Stephane Roudet.

[2] Prepared by Albert Jaeger, Yanliang Miao, and Stephane Roudet.

- Containing or reducing the cost of factor inputs in the tradable sectors, i.e. reforms can reduce unit costs by lowering the prices of inputs (or at least slow their rate of increase relative to a counterfactual without reforms). With prices of tradable goods and services largely set by foreign competition, lower input prices increase profit mark-ups in the tradable sectors, boosting activity in these sectors.

- Increasing the productivity of factor inputs across all sectors, i.e. structural reforms can reduce unit costs by raising output per unit of factor inputs in both tradable and non-tradable sectors, which, in general, should boost tradable sector mark-ups.

Tradable and Non Tradable Sector Markups
(Percent)



Sources: INE; Eurostat; and IMF staff estimates.

Estimates of profit mark-ups in the tradable and non-tradable sectors are consistent with the hypothesis of a large and growing external competitiveness gap (text chart and table).3 In particular, mark-ups across sectors received a boost during the late-1990s from declining capital cost, but afterwards through the next ten years mark-ups eroded gradually. At the same time, tradable sector mark-ups remained significantly below non-tradable sector mark-ups, a discrepancy that seems to be responsible for past flows of resources, particularly FDI, toward the non-tradable sectors. The breakdown of the different cost components for labor, capital, and intermediate inputs suggests that tradable sector mark-ups got squeezed during 1995-2010 mainly by negative growth of capital and intermediate input productivities.

Key Structural Reforms under the Program

The program's structural reform agenda has accordingly focused on enhancing external competitiveness—including through an adjustment in relative prices. In this context, labor and product market reforms have been designed with the objective of lessening nominal rigidities to facilitate adjustment and foster a reallocation of resources toward the tradable sector, reducing tradable sector input costs to enhance its competitiveness, and boosting overall productivity. Other reforms aim at making the business environment more conducive to investment and growth.

A. Labor Market Reforms

- Circa 2011, Portugal had one of the highest levels of ***employment protection*** for workers with permanent labor contracts in Europe. This was costly to employers and led to a highly segmented labor market with a high share of fixed-term workers with little incentive to invest

[3]For concepts and methodology regarding mark-up calculations, see Box 1 in the 2012 Article IV consultation report.

in human capital. It also constrained economic flexibility by reducing the shift of resources to more dynamic sectors. To address these weaknesses, a substantial reduction in severance pay has been effected; and a further reduction is to be legislated for implementation later this year. These two steps will bring severance compensation closer to the EU average. New definitions of individual dismissals have also been enacted to give more discretion to firms in separations processes.

- Tight restrictions on ***working time and work organization*** relative to EU average constrained companies' choices to deploy labor in a more efficient manner. Labor Code revisions were introduced to facilitate working time flexibility. The number of holidays and annual leave days was reduced, as well as the amount of additional required payments for overtime.

- The ***wage setting and bargaining system*** was governed by very strong multi-year increases in the minimum wage and sectoral collective agreements which were extended to sectors without little regard to the cost positions of non-affiliated firms. Wage bargaining has been reformed to define clear criteria for extension and to ensure better representation before collective agreement extension. In particular, collective agreements reached by associations with less than 50 percent of total work force will not be extended to all firms in the sectors - unless they specifically exclude micro and small enterprises.. Multi-year tripartite agreement on minimum wage increases were halted; minimum wage frozen for the duration of program.

- As the ***unemployment benefit system*** was one of the most generous in Europe for those covered by the system—entailing significant disincentives, particularly for low-wage workers to seek re-employment for the duration of the benefit—an u*nemployment benefit reform delinked the benefit from the worker's age, shortened the duration of the benefit, and introduced a declining profile and a cap.*

- ***Active labor market policies*** were reoriented toward programs focused on training and reinsertion to facilitate reallocation of the labor force to the tradable sectors. Education reform now also puts more emphasis on vocational training.

B. Product Market Reforms

Major changes in the overall legal framework are being legislated to enhance competition and contain excessive mark-ups and rents in the non-tradable sectors. A new ***Competition Law***, approved by Parliament, has harmonized the competition framework with EU law. It has strengthened the powers of the Competition Authority (PCA) to open investigations related to anti-trust and merger control, improves its ability to produce evidence essential to successfully prosecute competition cases, and strengthens the enforcement regime by separating criminal from administrative procedures. In addition, a new specialized Competition Court has been established to allow for more effective enforcement of competition principles.

- A ***Framework Law for Regulators*** has also been submitted to parliament. It will strengthen the regulators' independence, as well as their financial, administrative and management autonomy. The privatization program is also aimed at raising efficiency while reducing state involvement in the economy. On this latter point, certain special rights of the state ("golden shares") in publicly held companies have been abolished.

- In addition to the overall legal framework for competition and regulation, reforms aiming at reducing competitive distortions in specific sectors are in the work:

- ***Telecommunications***. High mobile termination rates, which put small operators at a disadvantage, have been reduced. A successful spectrum auction was conducted—it did not attracting new entrants but broadened access of all operators to existing networks. Transposition of the EU Regulatory Framework for Electronic Communications into national legislation will also ensure more efficiency in the sector.

- ***Electricity***. The transposition of the EU's Third Energy Package is close to completion, the effect of which will be to strengthen the National Regulator Authority's independence and foster competition in the gas and electricity sectors. The authorities' strategy to invite the main players to the negotiating table in an attempt to re-negotiate legacy contracts[4] has not yielded results in some areas. Rent-reducing measures will alleviate some of the still substantial pressures on end-user prices.

- ***Services***. Progress toward full compliance with the EU service directive and reforms of regulated professions will facilitate the establishment and cross-border provision of services and remove unjustified restrictions to access and activity exercise in regulated professions.

- ***Transportation***. A landmark Port Work reform was enacted—with expected effects on labor costs and efficiency in ports. SOEs in the transport sector are being reformed with a view to generating efficiency gains.

C. Other Reforms of Business Environment

- A host of reforms geared toward making the business environment more conducive to investment and growth are also being implemented. With a large backlog of court cases, an area of priority is reforms to improve the ***efficiency of the judicial system.*** But reforms have focused not only on implementing targeted measures to expedite resolution of backlog cases, but also on establishing a cost-effective and swift enforcement regime, modifying the Code of Civil Procedure to streamline court procedures, developing plans to reduce the number of court districts and close underutilized courts, and strengthening the arbitration and mediation framework to support out of court settlements.

[4] High rates of return granted to generators in the standard and special regimes are recovered from electricity consumers and represent a significant share of the total electricity payment and weighing on input costs in energy-intensive industries. These policy costs are not currently fully compensated by electricity tariffs. The associated debt ("tariff deficit") to distributors is expected to rise steadily, potentially posing risks to cash flows or crowding out credit as the debt is securitized with banks.

- Landmark revisions to the ***urban rental legislation*** have also been adopted to liberalize the rental market. The new legislation phases out, albeit with a long transitory period of 5 years, the old system of open-ended leases signed before 1990 under which rents were frozen and contracts could not be terminated by landlords. The legislation also provides for more flexibility in the choice of contract duration and updating of rents, sets incentives for renovation of the housing stock and provides for a new, rapid extrajudicial eviction procedure in cases of contract violation. These reforms should help revive the moribund rental housing market and facilitate labor mobility.

- The **Public administration reform** aims at a more efficient state to increase the productivity and quality of public services is under way. This will include improving training and raising qualification levels of public employees and introducing better human resource management policies across all administrations.

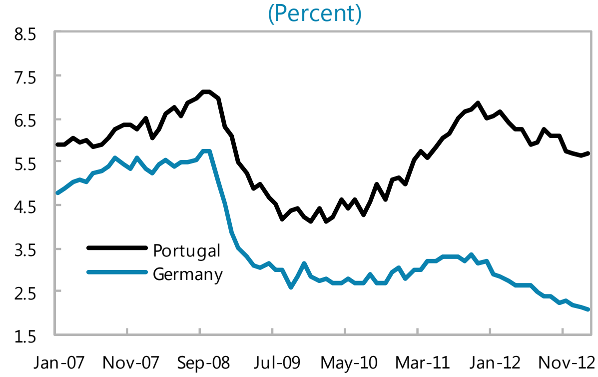
The present explicit and implicit barriers to the establishment, operation, and expansion of firms create substantial uncertainty, are also being lifted to encourage investment and spur job growth. Several initiatives are advancing to reduce excessive licensing procedures, regulations, and other administrative burdens.

Outcomes

To gauge recent progress in improving external competitiveness, the rest of this note considers the recent evolution in a range of indicators: (i) profit mark-ups in the tradable and non-tradable sectors; (ii) effective exchange rates; (iii) sectoral price developments, particularly in the non-tradable sectors; and (iv) export performance indicators. These outturns should not be attributed solely to the reforms that have been adopted to date, but may also reflect present highly contractionary macroeconomic conditions.

A. Recent Mark-Up Developments

Interest Rates on New Loans to Firms
(Percent)



Source: European Central Bank.

During 2010-12, developments in the mark-ups paint a mixed picture. Overall, mark-ups in both the tradable and non-tradable sectors have declined, reflecting the deep recession. But within this overall picture, one encouraging sign is that mark-ups in the non-tradable sectors have shrunk much faster, narrowing the gap between the two sectors' mark-ups to the level observed in the mid-1990s. Decomposing the cumulative changes in mark-ups suggests the following main drivers behind recent downward pressures on the profitability of tradable sectors:

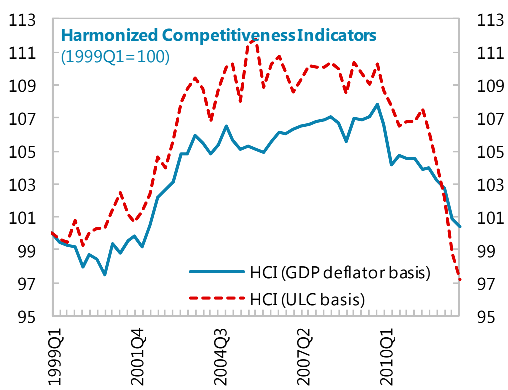
- Falling unit labor costs supported tradable sector mark-ups, but only moderately, reflecting slow labor productivity growth combined with limited nominal wage declines.

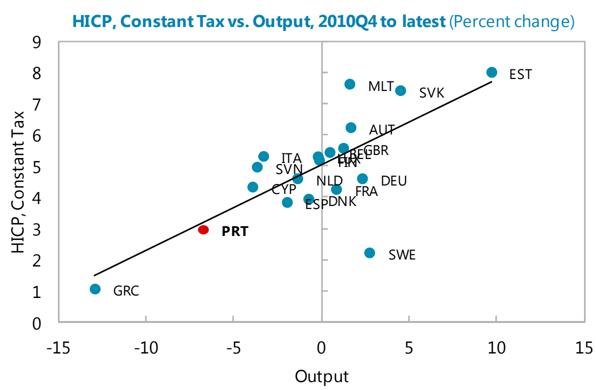
- At the same time, rising costs of capital have compressed significantly mark-ups, reflecting increasing corporate credit cost.

- Finally, rising intermediate input costs also reduced tradable sector mark-ups, reflecting mainly increases in the prices of intermediate inputs, which were mainly the result of higher import cost, particularly for energy. At the same time, there is evidence that falling unit costs of intermediate inputs from the non-tradable sectors have helped boost tradable sector mark-ups, a remarkable turnaround from earlier trends.

B. Effective Exchange Rates

The nominal effective exchange rate (NEER) has decreased by around 10 percent from its peak in late 2009, broadly mirroring the depreciation of the euro against other currencies. The CPI based real effective exchange rate (REER), however, has been broadly unchanged over the program period, mainly reflecting higher tax-policy induced inflation relative to trading partners. Adjusting for taxes and controlling for economic cycles, the evolution of inflation in 2011-12 in Portugal seems broadly in line with developments in output observed across the European countries.[5]

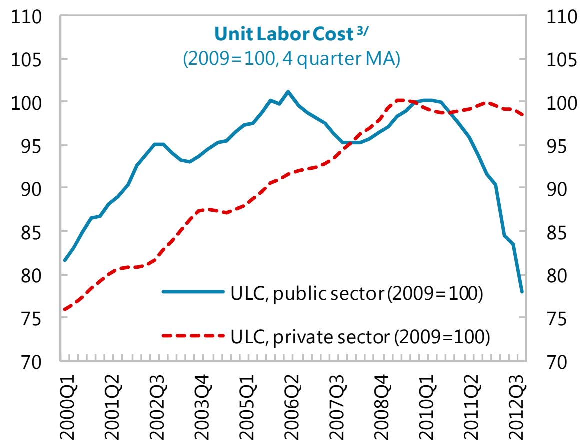


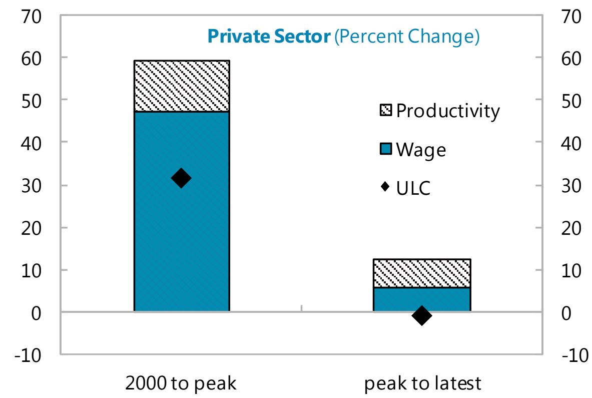


Sources: European Central Bank; Eurostat; and IMF staff calculations.

The GDP deflator and unit labor cost (ULC) based REERs showed a relatively larger decline (around 10 percent) than their CPI based counterparts since late 2009. Compared to the CPI-REER, GDP deflators grew at a much more moderate pace reflecting lower government consumptions and the reduction in public wages. The latter also contributed to lower labor cost. The economy-wide unit labor cost (ULC) whole declined by 3½ percent in 2012 (to about 5½ percent below its 2009 peak). But the reduction in the private sector ULC was more modest, helping reverse only around a third (7 percentage points) of the 25 percent increase in ULC since 2000. And this gain has been driven mostly by productivity increases through job shedding rather than reductions in nominal wages.

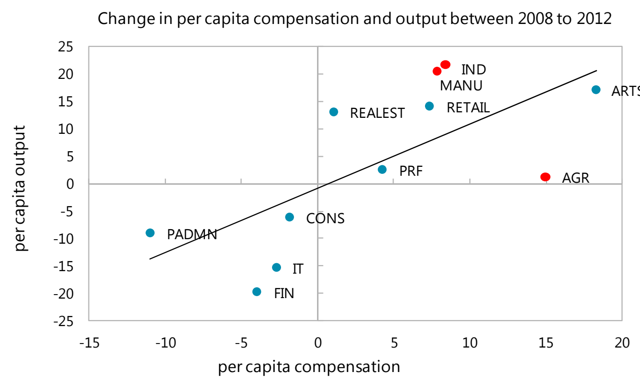
[5] Trading partners here refer to all countries in the Euro Area plus Denmark, Sweden, and the U.K.



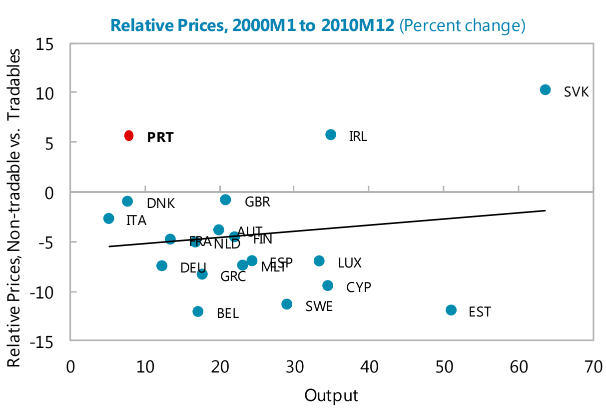


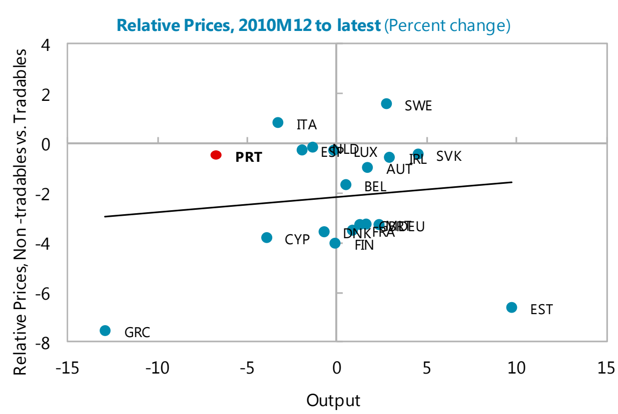
C. Sectoral Developments

By and large, the evolution of wages across sectors mirrors the evolution of output. Tradable sectors, like industry and manufacturing, have seen significant increases in productivity and in compensation. The decline in compensation in public administration reflects the cut to wages and salaries introduced under the program. In other sectors, despite sharp falls in output, the decline in compensation has been limited.



A breakdown of the economy-wide CPI into tradable and non-tradable components suggests that the main culprit was the limited adjustment in the relative price of non-tradables vis-à-vis trading

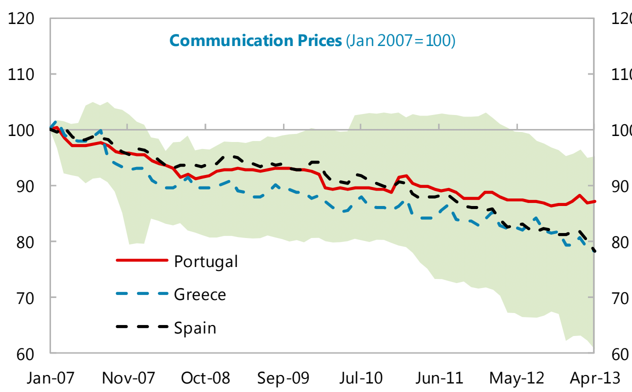


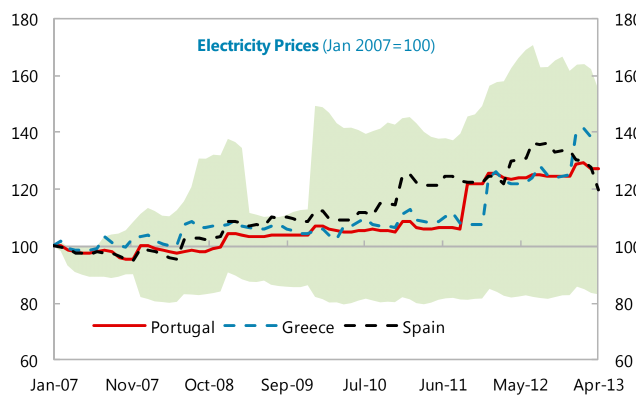


partners.[1]

The changes in tradable prices, both before and during the program period, were comparable to those in main trading partners after adjusting for the changes in output. The adjustment in non-tradable prices is, however, lagging behind that being seen in trading partners.

A good example of this is the evolution of prices in some network industries. Because the price of network services such electricity and communications cascade through the production process their evolution can have an important bearing tradable prices in particular sector. And here there are few signs of consumer prices paying heed to the current deep recession. Admittedly, this partly reflects policy decisions, including for example the increase in VAT in mid-2011 and/or binding purchasing contracts in the electricity sector. Still, some of these effects have been just as prevalent in other countries in the periphery, and even then prices have moderated somewhat more in those cases.





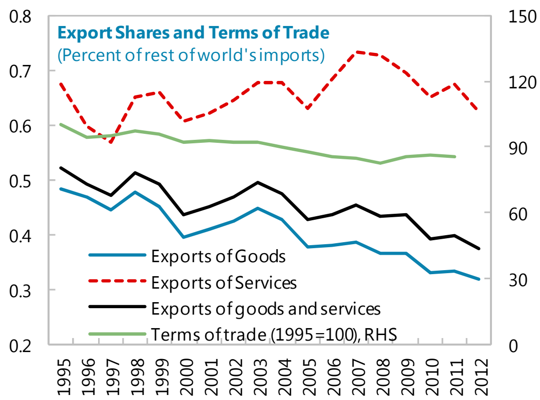
Sources: Eurostat; and IMF staff calculations.
1/Shaded area represents area between max and min.

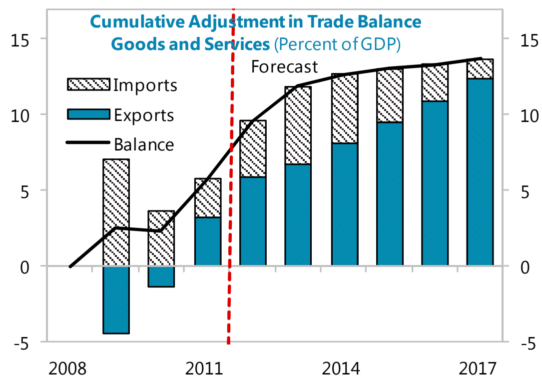
D. Export Indicators

In contrast to the limited improvement in direct measures of competitiveness, the external current account deficit—the variable of concern when it comes to competitiveness—has narrowed very rapidly. The deficit has narrowed from some 10 percent of GDP in 2010 to less than 2 percent of GDP in 2012. Exports of goods and services represented around 60 percent of the external adjustment in 2009-12. For the first time since World War II, the trade balance has swung into a surplus on a 12-month cumulative basis.

But as solid as the recent export performance has been, it may have also been inflated by the ongoing import compression. Since 2011, fuel exports have increased by around some €2 billion reflecting the diversion of oil products hitherto consumed domestically abroad. And in terms of export market shares, despite robust exports growth and diversification into non-European markets, the overall trend continues to be one of gradual decline for goods and broad stability in services.

[1] The 12 main components of the CPI are broken down into tradables and non-tradables by the tradability of final consumption goods. Tradables include food, clothing, alcohol and tobacco, hotel, and the electricity and furnishing sub-categories from the housing component.





Sources: IMF, *World Economic Outlook;* Banco de Portugal; and IMF staff estimates.

E. Assessment

Portugal's external competitiveness was eroded over a prolonged time period, a cumulative process that ultimately led to the sudden stop in capital inflows in early 2011. In the main, the deterioration of external competitiveness reflected weak productivity growth, particularly for capital and intermediate inputs.

To restore external competitiveness, the structural reforms introduced under the program will have to make Portugal's tradable sectors significantly more attractive for investment and production. The available evidence suggests that there has been some progress in containing unit labor cost, more so in the tradable than in the non-tradable sectors. To some extent the more favorable trend in unit labor cost may already reflect the impact of labor market reforms, although the large increase in unemployment is likely a key driver as well. More wage adjustment still may be needed to improve competitiveness, particularly as reforms take time to bear fruits on the productivity front. Moreover, earlier pressures on tradable sector mark-ups from rapidly rising unit costs of intermediate inputs have reversed during 2010-12, likely reflecting a combination of the effects of structural reforms but also slack in the non-tradable sectors. However progress on these two fronts has been more than undone by rising unit costs of capital, reflecting the fragmentation of credit costs across the euro area. Other indicators tracking effective exchange rates, a variety of price indicators, and export indicators broadly support these conclusions.

However, this broad assessment of limited progress on restoring external competitiveness needs to be tempered by several considerations. First, some of the structural reforms, particularly regarding increasing competitive pressures in product markets may need considerable time to bear fruit. Second, some of the structural reforms, particularly in the areas of public administration and courts, still need to be fully implemented. Finally, with domestic demand in a depressed state and given the high credit costs faced by Portuguese companies, these macroeconomic tensions may first have to recede for structural reforms to yield the hoped-for results, particularly in terms of increasing the productivity of labor, capital, and intermediate inputs.

Appendix V. Portugal: Letter of Intent

Lisbon, June 12, 2013

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Ms. Lagarde:

1. The attached Memorandum of Economic and Financial Policies (MEFP) describes the progress made in recent months towards the objectives laid out in our program supported by the Extended Arrangement. It also updates previous MEFPs and highlights the policy steps to be taken in the months ahead.

2. We continue to advance the policies necessary to eliminate the macroeconomic imbalances that engendered the economic crisis:

- Despite weak economic conditions, the end-December and end-March deficit and debt performance criteria were met. The two end-December 2012 structural benchmarks on the regional and local finance laws and the implementation of the Large Taxpayer Unit were completed on time. We also timely submitted to Parliament amendments to the law governing banks' access to public capital, a structural benchmark for end-January 2013.

- As a condition for completion of this review, we have identified measures to close the fiscal gap created as a result of an unfavorable Constitutional Court ruling regarding a number of provisions in the 2013 budget.

3. Steady program implementation and important policy actions at Euro area level have successfully strengthened market prospects, setting the path for Portugal's gradual return to the international bond markets. Nevertheless, the economic outlook remains fragile, with weaker external and domestic conditions posing sizable challenges to fiscal performance, despite our corrective actions. As a result, we are recalibrating the fiscal targets under the program in a delicate balancing act between the output and social costs of adjustment and the need to secure fiscal consolidation and debt sustainability.

4. To support the still sizable fiscal efforts ahead, we have identified measures to strengthen the sustainability, effectiveness, and social equity of the expenditure programs and functions of the government. These measures underpin the medium-term fiscal framework—including fully-specified measures to meet the 2014 deficit target—which was adopted and published by the Council of

Ministers as a *prior action* for completion of this review. By the end of the legislative session (July 15, 2013), we will finalize all the key legislative changes required to implement the public expenditure review (PER), through approval by the Council of Ministers or submission to Parliament if needed, as specified in the attached MEFP. In parallel, we are conducting a comprehensive reform of the corporate income tax, to simplify and rationalize existing schemes in support of investment and employment. Moreover, we are making important progress in strengthening our budget controls, streamlining the public administration, and curbing tax evasion to ensure an equitable distribution of the fiscal adjustment.

5. We are committed to preserving financial sector stability and supporting a balanced and orderly deleveraging in the economy. The capital and liquidity conditions of the banking system have significantly strengthened, under the vigilant supervision of Banco de Portugal (BdP). Nevertheless, the challenges posed by the ongoing balance sheet adjustment call for renewed work to promote adequate funding conditions for the most productive and innovative segments of the economy, while ensuring prompt restructuring of viable firms in financial difficulties. We are exploring the setting-up of a mechanism to securitize high-quality mortgage credit with a supranational guarantee. Moreover, we are promoting new initiatives in support of viable SMEs, focused on developing their access to financial markets, retargeting existing government-sponsored initiatives, and facilitating information sharing.

6. We strive to push further ahead our ambitious structural agenda to bolster price and cost competitiveness and set the basis for a strong and durable recovery. Significant steps are underway to improve the dynamism and efficiency of the labor market, reduce costs for exporters, addressing the excessive rents in the energy sector and port costs, and further improve our business environment.

7. On the basis of the strength of the policies defined in this letter, and in light of our performance under the program, we request the completion of the seventh review under the Extended Arrangement and the eighth purchase under the arrangement in the amount of SDR 574 million.

8. The eight review mission by the IMF, the European Commission, and the ECB staff is expected to take place by mid-July 2013.

9. We remain confident that the policies described in the current and previous MEFPs are adequate to achieve the objectives under the program. We stand ready to take additional measures should they be needed to meet the objectives of the economic program and will consult with the IMF, the European Commission, and the ECB, in advance of any necessary revisions to the policies contained in this letter and attached Memorandum.

10. This letter is copied to Messrs. Dijsselbloem, Rehn, and Draghi.

Sincerely yours,

/s/	/s/
Vítor Gaspar	Carlos da Silva Costa
Minister of State and Finance	Governor of the Banco de Portugal

Attachments: 1. Memorandum of Economic and Financial Policies (MEFP)
2. Technical Memorandum of Understanding (TMU)

Attachment I. Memorandum of Economic and Financial Policies

June 12, 2013

1. **Macro-financial adjustment**. Strong program implementation is gradually correcting the sizable macro-financial imbalances accumulated in the pre-crisis period. Fiscal consolidation is underway, with significant progress achieved in reducing structural deficits in both 2011 and 2012. The current and capital account turned positive in 2012, reversing a long-run pattern of external deficits and starting to reduce the large external debt. Financial stability has been preserved, with Portuguese banks benefiting from strengthened capital and liquidity buffers. We have implemented ambitious structural reforms that will improve competitiveness and support employment creation over the medium term. Market confidence has improved markedly, allowing successful issuances at 5 and 10 year maturities in January and May 2013, respectively, well ahead of program schedule. Political support from the European partners is contributing to the success of the program. Important steps are still needed in the period ahead to strengthen debt sustainability and market prospects, while supporting a strong and durable recovery.

2. **Activity.** Economic conditions remain difficult, with unemployment higher and output lower than previously envisaged. The economy contracted by 3¼ percent last year and unemployment rose to 17¾ percent in the first quarter of this year. The outlook for 2013 remains difficult. In the main, this reflects the headwinds from the deeper euro area recession. The effect of this has been to slow export growth—an important source of support for overall economic activity—in recent months. With a smaller contribution to output from exports and the recovery in private investment delayed somewhat, we now expect output to contract by 2¼ percent in 2013 (compared to 1 percent at the time of the sixth review). As before, the recession is expected to trough this year, but with recovery only starting in the fourth quarter of the year, one quarter later than previously expected. Reflecting weak domestic demand and the effect of tax measures dissipating, we expect the headline inflation to average around ¾ percent this year. Unemployment is expected to peak at 18½ percent in 2014.

3. **External Adjustment.** The current account deficit narrowed faster than expected in 2012, to below 2 percent of GDP from 6.5 percent of GDP in 2011, implying a total adjustment since 2009 of some 9 percentage points of GDP. Sustained demand from non-EU destinations has supported robust exports growth for the year as a whole, despite the negative impact from the strike of port workers in late 2012 and the marked slowdown in activity in major EU trading partners. We expect the adjustment to continue, with the current account reaching a balanced position this year. Portugal's market share in most export markets has been improving. But the improvement in competitiveness indicators has been gradual. Additional challenges would arise if the slowdown of our main trading partners deepens. We therefore reaffirm our commitment to structural reforms to bolster competitiveness and ensure durable external adjustment, reducing external indebtedness.

Fiscal Policy

4. **2012 Budget Outturns**. The government deficit for program purposes reached 4.7 percent of GDP in 2012 —6.4 percent of GDP excluding the one-off transaction related to the ANA concession and including the increase in the share capital of CGD (as capital expenditure), the reclassified operations of the public entity Sagestamo, and changes in the valuation of the assets of BPN SPVs. This compares with a deficit target of 5 percent of GDP and is consistent with a structural primary adjustment of some 2.8 percentage points of GDP. The end-year general government cash deficit performance criterion was accordingly met. Compliance with the program objective was achieved on account of a significant tightening of budget execution—particularly intermediate consumption and capital expenditure—in the last few months of the year, to offset broad-based tax revenue shortfalls (in the order of ½ percent of GDP) due to weaker economic activity. Significant expenditure savings were also realized on the wage bill, as the reduction in the number of employees exceeded our targets. Domestic arrears declined by €700 million in the fourth quarter, but increased slightly in February; still, the stock of domestic arrears, as defined in the TMU, declined by €1 billion between September 2012 and February 2013.

5. **2013-15 Fiscal Path**. The deterioration in the macroeconomic outlook and a negative carry-over from 2012 have opened a fiscal gap of over 1 percent of GDP in 2013. Taking into consideration the financing constraints and implications for debt as well as the output and social costs of adjustment, we are recalibrating fiscal policy to contain the deficit to 5½ percent of GDP in 2013 and 4 percent of GDP in 2014. We estimate that permanent measures of about 2.9 percent of 2013 GDP will be necessary to achieve the revised fiscal objectives—with the equivalent of 0.9 percent of GDP frontloaded to the second half of 2013. These measures will be drawn from the ongoing public expenditure review (PER). The fiscal consolidation needed to achieve our commitment under the Excessive Deficit Procedure—of reducing the deficit to below 3 percent of GDP—would then be completed by 2015, with a targeted deficit of 2½ percent of GDP.

6. **Supplementary Budget for 2013**. On April 5, the Constitutional Court declared unconstitutional some key provisions of the 2013 budget: (i) the cuts in the 14th monthly payment to public wage earners and pensioners; and (ii) a new contribution on illness and unemployment benefits. The Court ruling opened a fiscal gap of about €1.3 billion (0.8 percent of GDP). In light of this, we have identified a series of measures that add-up to this amount and will allow us to meet our revised fiscal objective for 2013. These include mainly (i) expenditure compression in line ministries, (ii) a reprogramming of EU structural funds, and (iii) a minimum threshold for applying the contribution on illness and unemployment benefits. These measures have been included in a supplementary budget and submitted to Parliament at the end of May (*prior action*). Some of these savings are of temporary nature, but we are committed to replacing them with permanent savings from the PER starting in 2014. In addition, some of our Public Expenditure Review measures (PER—see below) will be frontloaded.

7. **Public Expenditure Review**. We have completed our major initiative to review and ensure the sustainability, effectiveness, and social equity of the expenditure programs and functions of the

state. This comprehensive exercise, which was launched in the second half of 2012, has identified measures to underpin fiscal adjustment in the years ahead. On this basis, the Council of Ministers has adopted and published a medium-term (2013-17) fiscal framework (DEO), which will form the basis for the 2014 budget. Fully-specified measures to meet the revised 2014 deficit target have been approved by the Council of Ministers and made public (*prior action* for completion of the review). By the end of the legislative session (July 15), all the key legislative changes, as described below, required to implement the public expenditure review will be finalized, and approved by the Council of Ministers or submitted to Parliament if needed.

8. **Expenditure Reforms.** Savings will be generated mainly by limiting outlays on the public wage bill and pensions—which account for almost 60 percent of primary spending and where Portugal spends relatively more in comparison to peer countries—as well as sector-specific reforms. To do so, the ongoing reform of the state implements measures that increase equity and efficiency in the provision of social transfers and public services. The total package of measures for 2014 will amount to €4.7 billion (net of reduced income tax and social contribution collections). The underlying reforms will be organized around three main pillars:

- A well-targeted *wage bill reform* will generate at least one-third (€2.2 billion) of the savings. The overall objective will be to (i) reduce the size of the public sector workforce—addressing excessive employment in particular sub-sectors—while tilting its composition toward high-skilled and better-trained civil servants; (ii) ensure convergence of the public sector work rules and regulations towards private sector legal regimes (including regarding working hours, working time arrangements, and holiday entitlements); (iii) increase beneficiaries' contributions to ensure self-sustainability of public sector health subsystem; and (iv) simplify the remuneration policy by implementing a single wage scale, streamlining the wage supplement scale, and reducing fringe benefits. The reduction in the workforce, which will be facilitated by increasing the working hours to 40-hours per week, will be achieved through a combination of policies, including lower replacement of retirees, voluntary separations, and enhanced use of the redesigned mobility pool. These reforms will be implemented through a series of legislative and regulatory amendments. In particular, we will submit to Parliament a new draft public administration labor law by the end of the legislative session (July 15) that will aim at aligning current public employment regime to the private sector rules, including for working hours and holiday time, and termination of tenure (*structural benchmark*). We will also submit a draft law on the redesigned mobility pool by end-June (*structural benchmark*). The single wage scale and wage supplement reforms will be made effective by January 1, 2014 through the adoption of a specific law.

- A comprehensive *pension reform* will also be a significant source of savings. It will be based on equity principles with preservation of minimum socially-acceptable income levels, thus protecting those who earn the lowest pensions. Specifically, the reform will take into consideration the need to reduce the current differences between the civil servants' regime and the general social security regime, aiming at enhancing the fairness of the overall pension system. Moreover, while reforms implemented over the past two decades have contributed to long-term sustainability, the amount of pension benefit payments for which the government is currently liable makes the system excessively costly under the current circumstances reassessing the need to take into account demographic developments. Accordingly, the reform will be based on two main elements: (i) an effective increase by one-year in the statutory retirement age to 66 years (implemented by adjusting the demographic sustainability factor); (ii) aligning the rules and benefits of the public sector pension funds, CGA, to the general pension regime by changing one of the replacement rate parameters from about 90 to about 80 percent for all applicable beneficiaries. Each of these reforms will be implemented through modifications to the relevant laws. The necessary legislative proposals will be submitted to Parliament by the end of the legislative session (July 15) (*both structural benchmarks*). In addition and if strictly necessary, a third measure we are also considering is a sustainability contribution on pensions that effectively lowers pension replacement rates to more affordable levels. This measure, however, may need to be replaced by identified measures of equivalent value and quality, as discussed below.

- *Other savings* will be generated through a combination of sector-specific reforms, which mainly include targeted dismissals of personnel and intermediate consumption cuts. Additional cutbacks in SOE and PPP expenditure will be generated through further negotiation and operational restructuring (see ¶15 and ¶17). In the education sector for example, rationalization of the school network and a convergence of the key indicators, namely class size, towards peer levels will be at the core of our reforms. In the health sector, savings will come from further reforms in the hospitals network.

Following the ongoing consultations with social and political partners, some of the above listed measures may be replaced by others of an equivalent value and quality, following discussion with EC/ECB/IMF staff, in time to allow for the finalization of all legislative changes required to implement the public expenditure review by July 15, 2013.

9. **Legal safeguards.** We will take a number of steps aimed at mitigating legal risks from future potential Constitutional Court rulings. First, expenditure reforms will be designed with the principle of public/private sector and intergenerational equity in mind as well as the need to address the sustainability of social security systems. Second, legislation underpinning the expenditure reforms will be duly justified on compliance with the fiscal sustainability rules in the recently-ratified European Fiscal Compact which now ranks higher than ordinary legislation. Third, the government will rely as much as possible on general laws—rather than on one-year budget laws—consistent with the structural nature of the reforms. This also opens the possibility of prior constitutional review of said laws, thus allowing early reaction on the part of the government in case these reforms raise constitutional issues.

10. **Debt Path.** Under this revised fiscal path, debt is set to peak at close to 124 percent of GDP in 2014. This projection is contingent on the government implementing two planned measures: (i) a partial reallocation of the Social Security portfolio from foreign assets to government securities; and (ii) the transfer of its CGD shares to Parpública.

11. **CIT Reform.** We have launched a far-reaching reform of the Portuguese corporate income tax (CIT). Our goal is to boost investment and growth by simplifying the CIT system through the redefinition of the tax base, the gradual lowering of the rate, the reduction of multiple surcharges, and the rationalization of the incentive schemes. We will also focus on enhancing legal stability, lowering compliance costs and aiming at reducing litigation. In addition, the reform will improve the international competitiveness of the tax and strengthen the territorial approach through measures that include, but are not limited to, the adoption of a universal participation exemption regime, while keeping track with internationally accepted standards. The reform will also envisage reducing policy-induced debt bias. We will work on a detailed and fully quantified proposal over the next months, in consultation with the EC/ECB/IMF staff. We will prepare a first draft law by end-June 2013, which will be sent for public discussion, ahead of its submission to Parliament. In order to stimulate productive investment in 2013, the Government will grant a CIT credit limited to 20 percent of investment expenses or €1 million (corresponding to a maximum eligible investment of €5 million). This measure will be applicable to eligible investments made between June 1, 2013 and December 31, 2013.

Containing Fiscal Risks

12. **Public Financial Management.** We have made significant progress in advancing our Public Financial Management reform. Parliament approved legislation transposing the EU economic and governance fiscal framework into the Budgetary Framework Law (BFL) and further changes are expected by year end to streamline budgetary procedures. We have published a comprehensive tax expenditure report, in line with international standards and greatly expanding public information in this domain, which from now on will accompany the budget proposal to support policy decision making. We remain committed to continue reducing the stock of outstanding arrears (€ 3.1 billion in December 2012) and haltering its accumulation. In particular, we are working closely with the enforcement authorities in order to effectively sanction public officials who do not comply with the commitment law. In the health sector, we will proceed with a second settlement program—in the value of € 432 million—following the same procedures envisaged in the March 2012 strategy document. All resources under this program will be applied to settle debt overdue above 60 days.

13. **Revenue Administration.** We will keep focusing our efforts on curbing tax evasion to support the achievement of the 2013 revenue targets. Key steps to support this effort have been made, notably the full functionality of the new Large Taxpayer Unit and the successful implementation of the VAT invoicing reform. We will establish a Risk Management Unit to speed up the phasing in of a modern compliance risk model, under the aegis of the new Compliance Council. Strengthening the PIT compliance management is a top priority, given the high reliance of the 2013 fiscal targets on this tax. To this end, we will accelerate the pilot projects on the High Net Wealth Individuals and the Self-employed Professionals, and strengthen the control of the monthly PIT withholding information. We have completed the property revaluation process, successfully bringing the property tax base closer to market values. Finally, we are advancing in our efforts to modernize tax litigation. The task force of judges has increased the pace of its work on high-value tax cases,

and remains committed to clearing the remaining cases in courts. The State has registered a positive win/loss balance in terms of merit-based decisions in 2012.

14. **Public Administration**. Streamlining the public administration continues to be a top priority and a key component of the PER. We have achieved strong results in 2012, reducing the number of public employees by 4.6 percent, well above the 2 percent target. We have put in place a new framework increasing flexibility of the working hours, geographical mobility, and regulating the mutual agreement on contract termination, which will support the PER efforts. Finally, drawing on the survey on foundations, we have taken key steps towards streamlining this sector and reducing its budgetary support.

15. **State-Owned Enterprises.** Cost-reduction efforts and voluntary redundancy programs have successfully brought the state-owned enterprises (SOEs) sector as a whole back to operating balance ahead of schedule, with even more problematic firms in the infrastructure and transport sectors showing results well ahead of expectations. We retain formal cost-cutting objectives for those firms still showing operating deficits, while other firms are required to continue improving operating balances with a view to reducing debt burdens and financial costs. We continue to manage the high debt burdens of some firms, and treasury support has remained within the envelope of budgeted transfers.

16. **Privatization**. The sale of the airport operator, ANA, represents another milestone in our privatization program. Following high quality proposals from several bidders, the financial transaction is expected to be successfully completed by end-July, allowing us to fully meet our revenue objectives for the full privatization program. The sale of the airline, TAP, did not go through due to inadequate financial assurances by the final bidder. The firm remains in good financial health and we expect to re-launch the process this year. We will launch the privatization process for the rail cargo firm, CP Carga, in the second half of the year, for completion by year end. With changes in the legal framework for postal services underway, we expect to launch the privatization process for the postal company CTT in the second quarter, and receive binding offers by end-2013. We have prepared a strategic plan for the water and waste sector, with a view to introducing private capital and management in the system. Binding offers for the sale of the waste management business will be sought by the end of the year. Opening water concessions to private capital and management is in course and will take longer.

17. **Public-Private Partnerships.** We are taking bold steps to achieve a fiscally-responsible PPP model. We continue to advance in staffing our newly-created PPP unit in order to bring it into fully operational status. We are also taking steps toward enhancing fiscal transparency and improving reporting in this area. Additional renegotiation commissions have been appointed in order to extend the Government's effort to other road concessions, the relevant meetings being expected to start until the end of 2Q2013. Preliminary agreements have been reached with the majority of the private partners', which set forth the terms under which the concession contracts will be reformed, as well as the expected public savings arising thereof. These agreements constitute a crucial milestone in the renegotiation process and offer solid prospects for reaching the revised savings goal of €300 million in 2013. The results of the renegotiation process are paramount to achieve the fiscal savings

envisaged in the budget, leading to a relevant contribution of this sector to fiscal consolidation. The ongoing revision of the regulatory framework is also part of the strategy to achieve road sector sustainability by reviewing downwards the service levels and capturing additional savings on other roads and concessions to the state. Finally, the PPP unit has started supporting similar negotiation efforts in the autonomous region of Madeira and is bringing expertise to the committee for the re-appraisal of the Lisboa Oriental PPP hospital.

18. **Regional and Local Governments.** The draft Regional and Local Finance Laws submitted to Parliament last-December 2012 (*structural benchmark*) aim at improving our inter-governmental fiscal framework, notably by applying the same principles of the Budgetary Framework Law to sub-national governments. The establishment of a coordination council between the central and sub-national governments is expected to enhance the exchange of information in order to support budgetary planning. The €1 billion credit line to support local governments' arrears settlement is being implemented, following the necessary procedures to validate the claims. The regional government of Madeira has made progress in budget consolidation and PFM reforms, justifying the release of the disbursements under its adjustment program with the central government, but we remain vigilant to budget risks.

Safeguarding Financial Stability

19. **Capital Augmentation Exercise.** Following the successful completion of the capital augmentation exercise, all banks have met the 10 percent Core Tier 1 target set under the program. In addition, the results of the recent On-site Inspections Program, focused on assets related to the construction and commercial real estate sectors, and the latest round of stress tests have confirmed the continued resilience of the participating banks, including under adverse conditions. We remain committed to providing further support to the banking sector, in the event new capital needs were to arise. While we will continue to encourage banks to seek private solutions, resources from the Bank Solvency Support Facility (BSSF) remain available to support viable banks if needed. The resources in the BSSF will solely be utilized to provide public support, if needed, to the banking system. State aid will remain subject to strict conditionality, in line with EU rules, aimed at avoiding subsidizing private shareholders and preventing migration of private liabilities to the public sector balance sheet, while ensuring adequate lending to the real economy, with special focus on SMEs, particularly within the sectors of tradable goods and services.

20. **Funding and Liquidity Conditions.** Non-standard measures by the ECB to restore the proper transmission of monetary policy have helped ease liquidity pressures and improve market conditions, supporting an important first step in the gradual return of banks to international bond markets. Better funding conditions, stable customer deposits, and additional resources from the recent capital exercise, together with orderly balance-sheet deleveraging, have also allowed Portuguese banks to start reducing their reliance on Eurosystem liquidity, including through partial early repayment of the 3-year LTROs. Exceptional liquidity support is still playing a pivotal role in absorbing remaining funding constraints and mitigating the lingering risk of excessive credit

contraction, while strengthened collateral buffers provide an important shield against potential adverse shocks. Moreover, following the successful creation of a platform for interbank unsecured lending to facilitate the functioning of the domestic interbank market, the BdP has launched in early May a new platform for secured transactions.

21. **Credit Conditions and Orderly Deleveraging.** Despite the improvement in market sentiment and liquidity conditions, the credit situation remains difficult. While to date the sustained decline in bank credit is broadly in line with demand conditions and the necessary private sector deleveraging, lending rates on new business remain elevated across all segments of the economy. Moreover, while large corporations have been increasing access to funding alternatives through capital markets, this is currently not feasible for the smaller firms. In the context of this difficult credit environment, banks' funding and capital plans should keep ensuring that the deleveraging process takes place in an orderly manner to achieve a stable market-based funding position, while adequate and sustainable financing is provided to the economy. In particular, we will continue to ensure that the pace and composition of the deleveraging, as also envisaged under the restructuring plans of the aided banks, remains consistent with the program's macroeconomic framework and objectives. We presented an initial proposal for a mechanism to securitize banks' high quality mortgage credit as a contribution to this objective and to reinforce long-term viability of the Portuguese banking sector.

22. **Initiatives to Support Funding to SMEs.** The Ministry of Finance, together with the BdP, the Ministry of Economy, and other stakeholders, continue their efforts to promote more efficient financing allocation to the productive segments of the economy through the review and rationalization of existing government-sponsored measures, along EU state aid rules, as well as the promotion of alternative private funding options for SMEs. Specifically,

- *Review of Government-Guaranteed Credit Lines*. We will continue to strive to improve the performance of existing government-guaranteed credit lines, in line with international best practice. We have recently conducted an external audit of the National Guarantee System (NGS), which has helped identify preliminary policy recommendations aiming at making these schemes more efficient and minimizing risks for the state, by further enhancing pricing mechanisms and investment selection processes as well as the NGS risk management capabilities and governance structure. We will prepare by mid-June a detailed implementation plan of the key report recommendations, including a timetable of all the needed execution steps. Moreover, to support viable firms in financial difficulties, we will explore specific modalities for the provision of guaranteed credit conditional on the successful completion of a corporate restructuring process, with an initial proposal expected by early September. To support these efforts, we are establishing a new quarterly monitoring framework including key balance sheet indicators of the firms benefiting from government-guaranteed credit lines, with a first report to be prepared by end-June.

- *Development of SMEs Commercial Paper*. We are exploring possible changes to the regulatory and taxation environment to facilitate the expansion of the commercial paper market among a wider investor base, with a view to promote alternative funding options for SMEs. Detailed proposals by relevant entities have been requested by the government last April and are expected to be received by end-May. A first draft of the necessary amendments of the rules governing the commercial paper market will be prepared by end-June and will be subject to a review of any potential tax implications.

New initiatives to facilitate credit to firms by the Ministry of Finance, Ministry of Economy, and other relevant entities will be primarily focused on streamlining and improving the efficiency of existing schemes, without creating additional burden or posing risks to public finance. In this context, the government is conducting a stock-taking exercise aiming at streamlining and centralizing the management of EU structural funds.

23. **Central Credit Registry.** Efforts to promote information sharing, especially for SMEs, are ongoing. The BdP is further enhancing the data coverage and detail of the Central Credit Registry (CCR), namely to include additional financial products and to add supplementary classifications to the loans already reported to the CCR. Furthermore, BdP intends to implement the possibility of access by the financial institutions to historical information on their potential new clients, subject to the authorization of the Portuguese Data Protection Authority (CNPD). In parallel, the BdP is assessing available options for reducing information asymmetry for smaller companies, taking also into consideration other available data sources, such as the Central Balance Sheet Database (CBSD). The above mentioned enhancements, as well as a first progress report on the two last referred issues, are expected to be completed by end-October 2013.

24. **Private Sector Debt Restructuring**. We are stepping up our efforts to monitor closely the situation in the area of corporate and household insolvency. We will prepare quarterly reports on the application of the new corporate restructuring tools, including viability indicators for the companies going through these processes by end-June 2013. On household debt restructuring, we will continue to assess the effectiveness of the new regimes. We will conduct a survey of all insolvency stakeholders to inquire about the appropriateness of the existing debt restructuring tools and possible gaps or bottlenecks by end-July 2013.

25. **Bank Supervision.** Banks are making progress implementing recommendations with regard to their stress testing methodologies and impairment projections, issued as part of the original Special On-site Inspections Program. The BdP will launch a thematic review of banks' operational capacity in the area of loan restructuring and asset recovery to be completed by end-October 2013, with the aim to ensure that the banking system can effectively support the balance sheet adjustment of the private sector, by timely engaging troubled debtors before their financial viability is in jeopardy.

26. **Bank Recapitalization and Resolution Frameworks.** We have submitted to Parliament amendments to the law governing banks' access to public capital, allowing the state—under strict circumstances—to exercise control over recapitalized institutions and to perform mandatory recapitalizations. We are reviewing the recovery plans of the largest banks, and expect to receive recovery plans from all the other banks by end-November 2013. Institutions for which resolution plans are mandatory are expected to submit the data required in the supervisory notice of

December 2012 by end-July 2013. We remain committed to swiftly transpose the new EU Directive on bank recovery and resolution once it has been adopted.

27. **BPN SPVs.** We are implementing the strategy for managing the distressed assets from Banco Português de Negócios (BPN). The competitive bidding process to select a third party that will manage the credits currently held by Parvalorem, a state-owned Special Purpose Vehicle (SPV), has been launched in January and is on track to be completed by mid-2013. We will also ensure timely disposal of the subsidiaries and the assets in the other two state-owned SPVs. CGD's state guaranteed claim will be gradually settled in cash, according to the schedule agreed with the EC, ECB, and IMF staff. Any net recoveries realized on the assets will also be applied towards the settlement of CGD's claim.

Boosting Employment, Competitiveness, and Growth

28. **Labor Market Institutions.** Significant steps have been taken over the past year to make the labor market more dynamic and efficient—including the adoption of a revised labor code, the reform of unemployment benefits and a reform of the wage-setting mechanism. A new reform of severance pay is currently under consideration by Parliament. This reform will reduce severance payments to 12 days per year of service for all new permanent labor contracts. For existing permanent contracts and all fixed-term contracts, severance payments will be reduced to 18 days per year of service for the first three years of the contract, and to 12 days per year of service for subsequent years. The cap of 12 months of pay will remain in place for all contracts, and acquired rights will be protected. The relevant law will become effective on October 1, 2013 (*structural benchmark*).

29. **Ports.** To help reduce costs for exporters, we have reduced fees on port use (*TUP-Carga*) by 20 percent to date. The landmark revision of the Ports Work Law became effective in February 2013. It is aimed at lowering wage costs and making the use of labor more flexible. We are now seeking effective transmission of lower labor costs to end-users of port services. In particular, we will engage with concessionaires with a view to modifying existing concession contracts so as to foster price reductions. We will also revise incentives for port operators by adopting a new performance-based model for future concessions and encourage entry of new operators. A review of the overall savings generated and these reforms will be conducted by December 2013.

30. **Energy.** We continue our efforts to reduce excessive policy-induced rents and improve the sustainability of the national electricity system. With overall cost reduction targets broadly within reach, shortfalls are emerging with respect to a specific measure. This, as well as downward pressures on demand for electricity, is likely to lead to upward revisions to tariff debt projections. In light of this, the government will update its projections of the medium-term tariff debt path and identify policy options—including additional cost reduction measures—to achieve the initial objective of eliminating the tariff debt by 2020. These revised projections and potential corrective measures will be prepared by mid-June (*structural benchmark*) and discussed at the time of the 8th review.

31. **Services.** Reforms in the services sector aim at eliminating entry barriers and increase competition. Significant progress has already been made in amending sector specific legislations to align them with the Services Directive. We expect adoption of the remaining necessary amendments (including for construction, universities and higher education courses) by Parliament by end-June 2013. A new legal framework aimed at improving the functioning of the regulated professions (such as accountants, lawyers, notaries) for which regulation involves a professional body was recently published. The professional bodies' statutes are being amended accordingly for approval by Parliament, including by eliminating unjustified restrictions to activity and further improving the conditions for mobility of professionals in line with EU Directives in the area of free movement of professionals.

32. **Licensing and Administrative Burden.** Progress is being made on initiatives to tackle excessive licensing procedures, regulations and other administrative burdens—which are impeding the establishment, operation, and expansion of firms. We are carrying out an inventory of the costs of regulations in the economy, starting with the most burdensome. On the basis of this analysis, to be presented by end-June 2013, the government will devise a roadmap for a regulatory simplification. We will step up the efforts to make operational the Point of Single Contact, an e-government portal which allows administrative procedures to be done online. Progress is being made toward implementing the New Late Payments Directive, which will help promote liquidity conditions for businesses.

33. **Regulation**. We have approved ahead of schedule a framework law for the functioning of regulators that draws on the findings and recommendations of the recently completed expert report, benchmarking the responsibilities, resources, and independence of the main sectoral regulators against best international practices. The law : (i) establishes a regulatory environment that protects the public interest and promotes market efficiency, (ii) guarantees the independence and financial, administrative and management autonomy of the National Regulatory Authorities in the exercise of their responsibilities, including the necessary conditions to guarantee adequate human and financial resources being able to attract and retain sufficiently qualified staff, and (iii) strengthens the role of the Competition Authority in enforcing competition rules. The framework law has been submitted to Parliament. The corresponding amendments to the bylaws of the National Regulatory Authorities will be approved by the Government in the three month following publication of the framework law. Once the NRA framework law and follow-up bylaws and internal regulations are in place, the regulators will continue to pursue adoption best international regulatory practices, including by organizing international peer review exercises.

34. **Judicial**. We continue pushing ahead with targeted measures to reduce the backlogged enforcement cases. Despite the challenges in addressing the backlog court cases, an additional 52,000 enforcement cases have been cleared, bringing down the total number by about 165,000 enforcement cases since November 2011. The inter-agency task forces have set quarterly targets for reviewing enforcement cases to be closed. We have further advanced the reforms to improve the efficiency of the judicial system. We have started preliminary steps to implement the comprehensive judicial roadmap to reduce the number of courts and streamline the court structure and the new

Code of Civil Procedure to speed up the judicial process. We will submit to Parliament by end-June 2013 an important draft bill to strengthen the authority and financing structure of the oversight body for enforcement agents and insolvency administrators (CACAJ) as well as recruitment which aims to meet market demands. The government will approve by end-June 2013 a fee structure that incentivizes speedy enforcement.

Table 1. Portugal: Quantitiative Performance Criteria

(In billions of euros, unless otherwise specified)

	Dec-12		Mar-13		Jun-13	Sep-13	Dec-13
	Program	Actual	Program	Actual			2/
1. Floor on the consolidated General Government cash balance (cumulative)	-9.0	-8.3	-1.9	-1.4	-6.0	-7.3	-8.9
2. Ceiling on accumulation of domestic arrears by the General Government (continuous indicative target) 1/	0	Met	0	Not met	0	0	0
3. Ceiling on the overall stock of General Government debt	180.0	177.2	182.2	178.5	187.3	188.9	187.4
4. Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by the general government (continuous performance criterion)	0	0	0	0	0	0	0

1/ Domestic arrears for the purpose of the program declined by close to €0.7 billion between end-September and end-December 2012, but increased in February 2013. Overall, domestic arrears declined by €1 billion between September 2012 and February 2013.
2/ Indicative target.

Table 2. Portugal: Structural Conditionality: Seventh Review Under the EFF

	Measure	Timing	Status
Prior Actions			
1	Adopt by the Council of Ministers and publish the medium-term fiscal framework that includes fully-specified measures to meet the 2014 deficit target (LOI ¶4 and MEFP ¶7).		Met
2	Submit to Parliament the supplementary budget that includes measures needed to meet the 2013 fiscal objective (MEFP ¶6).		Met
Structural Benchmarks			
A. Fiscal policy			
1	Submit to Parliament a new draft public administration labor law that will aim at aligning current public employment regime to the private sector rules, including for working hours and holiday time, and termination of tenure (MEFP ¶8).	July 15, 2013	
2	Submit to Parliament a draft law on the redesigned mobility pool (MEFP ¶8).	End-June 2013	
3	Submit to Parliament a legislative proposal that increases the statutory retirement age to 66 years (MEFP ¶8).	July 15, 2013	
4	Submit to Parliament a legislative proposal that aligns the rules and benefits of the public sector pension fund, CGA, to the general pension regime (MEFP ¶8).	July 15, 2013	
A. Strengthen financial stability			
5	Submit to Parliament amendments to the law governing banks' access to public capital (LOI ¶2).	End-January, 2013	Met
B. Enhance competitiveness and address bottlenecks to growth			
6	Enact the severance pay reform that reduces severance payments to 12 days per year for all new permanent labor contracts (MEFP ¶28)	October 1, 2013	
7	Update projections of the medium-term energy tariff debt path and identify policy options to eliminate the tariff debt by 2020 (MEFP ¶30).	June 15, 2013	
C. Strengthen fiscal institutions and reduce fiscal risks			
8	Revise and submit to Parliament the draft regional and local public finance law (LOI ¶2 and MEFP ¶18).	End-Dec 2012	Met
9	Implement a full-fledged Large Taxpayer Office (LTO), to cover audit, taxpayer services, and legal functions concerning all large taxpayers, including the adoption of account managers (LOI ¶2 and MEFP ¶13).	End-Dec 2012	Met

Attachment II. Technical Memorandum of Understanding

June 12, 2013

1. This Technical Memorandum of Understanding (TMU) sets out the understandings regarding the definitions of the indicators subject to quantitative targets (performance criteria and indicative targets), specified in the tables annexed to the Memorandum of Economic and Financial Policies. It also describes the methods to be used in assessing the Program performance and the information requirements to ensure adequate monitoring of the targets. We will consult with the EC, the ECB, and the IMF before modifying measures contained in this letter or adopting new measures that would deviate from the goals of the Program, and provide the EC, the ECB, and the IMF with the necessary information for Program monitoring.

2. For Program purposes, all foreign currency-related assets, liabilities, and flows will be evaluated at "Program exchange rates" as defined below, with the exception of the items affecting government fiscal balances, which will be measured at spot exchange rate (i.e., the rate for immediate delivery) prevailing on the date of the transaction. The Program exchange rates are those that prevailed on May 5, 2011. In particular, the exchange rates for the purposes of the Program are set €1 = 1.483 U.S. dollar, €1 = 116.8390 Japanese yen, €1.09512 = 1 SDR.

3. For reporting purposes, the MoF and BdP will employ the reporting standards and templates considered to be appropriate given the transmission of data covered by this TMU, unless otherwise stated or agreed with the EC, the ECB and the IMF.

General Government

4. **Definition.** For the purposes of the Program, the General Government, as defined in the Budget Framework Law, Law No. 91/2001 of August 20, amended by Law 22/2011 of May 20, includes**:**

- 4.1. The Central Government. This includes:
  - 4.1.1. The entities covered under the State Budget, which covers the budgets of the Central Administration, including the agencies and services that are not administratively and financially autonomous, agencies and services that are administratively and financially autonomous (*Serviços e Fundos Autónomos* – SFA).

- 4.1.2. Other entities, including Incorporated State-owned enterprises (ISOE), or extra-budgetary funds (EBF) not part of the State Budget, but which are, under the European System of Accounts (ESA95) and ESA95 Manual on Government Deficit and Debt rules, classified by the National Statistical Institute (INE) as part of the Central Government.

- 4.2. Regional and Local Governments, that include:

  - 4.2.1. Regional Governments of Madeira and Azores and Local Governments (*Administrações Regionais and Locais*);

  - 4.2.2. Regional and local government-owned enterprises or companies, foundations, cooperatives and other agencies and institutions, which are, under the ESA95 and ESA95 Manual on Government Deficit and Debt rules, classified by the INE as Local Government.

- 4.3. Social Security Funds comprising all funds that are established in the general social security system.

- This definition of General Government also includes any new funds, or other special budgetary and extra budgetary programs or entities that may be created during the Program period to carry out operations of a fiscal nature and which are, under the ESA95 and ESA95 Manual on Government Deficit and Debt rules, classified by the INE in the correspondent subsector. The MoF will inform the EC, ECB, and IMF of the creation of any such new funds, programs, entities or operations at the time of its creation or statistical re-classification or, in the case of Regional and Local Governments, at the time the Government acknowledges its creation.

- The General Government, as measured for purposes of Program monitoring in 2013, shall not include entities nor operations (including pension funds) that are re-classified into the General Government during 2013, but shall include those reclassified in 2011-12.[1]

5. **Supporting Material**

- 5.1. Data on cash balances of the State Budget will be provided to the EC, the ECB and the IMF by the MoF within three weeks after the end of the month. Data will include detailed information on revenue and expenditure items, in line with monthly reports that are published by the MoF.

[1] An operation refers to part of a legal entity that is involved in the production or delivery of goods and services—including government services provided on a nonmarket basis. As such, it does not include transactions relating to the assets or liabilities of an entity. For example, should an entity handle a number of PPPs, reclassifying only one PPP would be considered as reclassifying an operation. In contrast, taking over part of an entity's debt by the government would not qualify for the exclusion. On this issue, see also paragraph 13.

- 5.2. Data on the cash balances of the other parts of General Government as defined in paragraph 4[2] will be provided to the EC, the ECB and the IMF by the MoF within seven weeks after the end of the month. Data will include detailed information on revenue and expenditure items. Data will also include detailed information on PPP-related revenues and expenditures for those PPP reclassified within the General Government sector according to ESA 95, and called guarantees.

- 5.3. Data on domestic and external debt redemptions (securities), new domestic and external debt issuance (securities), change in the domestic and foreign currency assets and liabilities of the Central Government at the BdP and other financial institutions will be provided to the EC, the ECB, and the IMF by the BdP within 40 days after the closing of each month.

- 5.4. BdP will provide to the EC, the ECB, and the IMF detailed monthly data on the financing of the General Government, as defined in ESA95, within seven weeks after the closing of each month.

- 5.5. Data on the revenues, operating expenses, capital expenditure, remuneration of personnel, EBITDA, and number of staff will be provided for state-owned enterprises (SOEs) on a quarterly basis, within 7 weeks after the end of each quarter. Aggregate data for the SOEs within the perimeter will be provided, with company-specific information for REFER, Estradas de Portugal, Metro de Lisboa, and Metro de Porto. Furthermore data for Comboios de Portugal and Parpública (outside the perimeter) will also be provided.

QUANTITATIVE PERFORMANCE CRITERIA, INDICATIVE CEILINGS, AND CONTINUOUS PERFORMANCE CRITERIA: DEFINITIONS AND REPORTING STANDARDS

A. Floor on the Consolidated General Government Cash Balance (Performance Criterion)

6. **Definition.** The consolidated General Government cash balance (CGGCB) is defined as the sum of the cash balances of the entities covered by the State Budget, the ISOE, the Regional and Local Governments, and the Social Security Funds, and other entities and EBFs, as defined in paragraph 4. Privatization receipts will be excluded from cash receipts. In 2012 and beyond, revenues from the reclassification of pension funds into the general government will not be accounted for as cash revenues for the purpose of the calculation of the consolidated general government cash balance. In 2012-13, the cash proceeds from the sale of the ANA airport concession will be accounted for as cash expenditure-reducing transactions. The net acquisition of financial assets for policy purposes, including loans and equity participation will be recorded as cash

[2] In 2011, data exclude regional and local government-owned enterprises or companies, foundations, cooperatives and other agencies and institutions, which are, under the ESA95 and ESA95 Manual on Government Deficit and Debt rules, classified by the INE as Local Government, i.e., entities referred in paragraph 4.2.2.

expenditures, except for transactions related to the banking sector support and restructuring strategy under the Program. Called guarantees (excluding those related to the banking sector support and restructuring strategy), where entities of the General Government make cash payments on behalf of entities that are not part of the General Government, will be recorded as cash expenditures.

- 6.1. **The Cash Balance of the State Budget.** The cash balance of the State Budget will be measured from above the line, based on budget revenues (recurrent revenue plus nonrecurrent revenue, including EU revenues, minus tax refunds) minus budget expenditures of the State Budget as published monthly on the official website of the DGO of the MoF, and in line with the corresponding line items established in the State Budget. Budget expenditures will exclude amortization payments but include salaries and other payments to staff and pensions; grants to Social Security Funds, medical care and social protection; operational and other expenditure, interest payments; cash payments for military equipment procurement; and EU expenses.

- 6.2. **The Cash Balance of the Regional and Local Governments, Social Security Funds, ISOE and Other Entities or EBFs.** The cash balance of each of these parts of the General Government will be measured from above the line, based on revenues minus expenditures as it will be provided by the DGO of the MoF in the monthly General Government budget execution report (see Para 5), and in line with the corresponding line items established in their respective budgets. All entities including ISOE that prepare accrual-based financial statements will submit monthly cash flow statement in accordance with form and content specified by the MoF. The reporting by Local Government will be phased as set out in paragraph 8 below.

- 6.3. **Adjustor.** The 2013 quarterly floors on the consolidated general government cash balance will be adjusted for the cumulative amount of arrears settled in the context of the arrears clearance strategy: (i) health sector arrears (up to €432 million), (ii) local government arrears settled through the €1 billion credit facility created in May 2012, and (iii) RAM government arrears subject to concluding the agreement with the central government (up to €1.1 billion).

Other Provisions

7. For the purpose of the program, the expenditure of the central government that is monitored excludes payments related to bank support, when carried out under the program's banking sector and restructuring strategy. However, any financial operation by central government to support banks, including the issuance of guarantees or provision of liquidity, will be immediately reported to the EC, ECB, and IMF.

8. Quarterly consolidated accounts for the General Government on a cash basis will be reported for internal, EC, ECB, and IMF monitoring 7 weeks after the reference period, starting with the first quarter of 2012. The reports will be published externally starting with December 2011 data.

SOEs will be consolidated with the general government accounts starting with the first quarter 2012. The larger municipalities (defined as those with a population of 100,000 voters or more) are required to provide monthly reports under current arrangements, and their cash balance will be included in the calculation of the monthly cash General Government balance. The cash balance of the smaller municipalities, i.e. those with a population of under 100,000 voters, will be excluded until any necessary legal changes requiring them to provide monthly reports have been put in place. In this transitory period, the MoF will provide a monthly estimate of the cash balance of these smaller municipalities excluded from the General Government reports to the EC, the ECB, and the IMF.

9. **Supporting Material**

9.1. Data on cash balances of the State Government, ISOEs, Regional and Local Government and Social Security Funds will be provided to the EC, the ECB and the IMF by the MoF within seven weeks after the end of each month. The information provided will include general government net acquisitions of financial assets for policy purposes, including loans and equity participations, as well as called guarantees where entities that are part of the General Government make cash payments on behalf of entities that are not part of the General Government.

9.2. The MoF will submit quarterly data on General Government accounts determined by the INE in accordance with ESA 95 rules, showing also the main items of the transition from cash balances to the General Government balances in national accounts. The reconciliation will be accompanied by necessary explanatory materials for any indication of potential deviation of the annual general government cash target from the annual general government accrual target determined in accordance with ESA 95 rules.

B. Non-Accumulation of New Domestic Arrears by the General Government (Continuous Indicative Target)

10. **Definitions.** Commitment, liabilities, payables/creditors, and arrears can arise in respect of all types of expenditure. These include employment costs, utilities, transfer payments, interest, goods and services and capital expenditure. Commitments are explicit or implicit agreements to make payment(s) to another party in exchange for that party supplying goods and services or fulfilling other conditions. Commitments can be for specific goods and services and arise when a formal action is taken by a government agency, e.g., issuance of a purchase order or signing a contract. Commitment can also be of a continuing nature that require a series of payments over an indeterminate period of time and may or may not involve a contract, e.g. salaries, utilities, and entitlement payments. Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources (usually cash) embodying economic benefits or service potential. In relation to commitment, the liability arises when a third party satisfies the terms of the contract or similar arrangement. Payables/creditors are a subset of liabilities. For the purposes of the program payables/creditors exclude provisions, accrued liabilities. Arrears are a subset of payables/creditors. For the purposes of the Program domestic arrears are defined as payables/creditors (including foreigner commercial creditors), that

have remained unpaid for 90 days or more beyond any specified due date (regardless of any contractual grace period). In case no due date is specified, arrears are defined as payables/creditors that have remained unpaid for 90 days or more after the date of the invoice or contract. Data on arrears will be provided within seven weeks after the end of each month. The continuous indicative target of non-accumulation of new domestic arrears requires that the total arrears at the end of any month are not greater than the corresponding total at the end of the previous month—based on the same perimeter with respect to the entities covered. This also includes arrears that are being accumulated by the SOEs not included in the General Government.

11. **Supporting Material.** The stock of arrears will be measured through a survey. Reports on the stock of arrears of the General Government are being published monthly. The MoF will provide consistent data on monthly expenditure arrears of the General Government, as defined above. Data will be provided within seven weeks after the end of each month and will include total arrears classified by the different constituent sectors of the General Government sub-sector as defined in paragraph 4, as well as the monthly amounts of arrears cleared under the arrears clearance strategy (see paragraph 6.3).

12. **Adjustor.** In 2013, the monthly change in the stock of arrears will be adjusted for any stock adjustment related to the arrears clearance strategy as per paragraph 6.3. This will allow monitoring the underlying flow of new arrears.

C. Ceiling on the Overall Stock of General Government Debt (Performance Criterion)

13. **Definition.** The overall stock of General Government debt will refer to the definition established by Council Regulation (EC) No 479/2009 of 25 May 2009 on the application of the Protocol on the Excessive Deficit Procedure annexed to the Treaty establishing the European Community. For the purposes of the Program, the stock of General Government debt will exclude: (i) debt contracted for bank restructuring, when carried out under the Program's banking sector support and restructuring strategy; (ii) IGCP deposits; and (iii) (from end-September 2011) the *'prepaid margin'* on all EFSF loans.

14. **Adjusters.** For 2013, the ceiling of the overall stock of General Government debt will be adjusted upward (downward) by the amount of any upward (downward) revision to the stock at end-December 2012 general government debt of EUR 204.5 billion. From 2014 onwards, the ceiling of the overall stock of General Government debt will be adjusted upward (downward) by the amount of any upward (downward) reclassification of entities or operations that affects the stock at end-December of the previous year.

15. **Supporting Material.** Quarterly data on the total stock of General Government debt as defined in paragraph 12 will be provided to the EC, ECB, and IMF by the BdP no later than 90 days after the end of each quarter, as reported to the ECB and the Eurostat. Monthly estimates will be provided to the EC, ECB and IMF by BdP no later than seven weeks after the end of each month.

D. Non-Accumulation of New External Debt Payments Arrears by the General Government (Continuous Performance Criterion)

16. **Definition.** For the purposes of the Program, the definition of debt is the same as in paragraph 12. An external debt payment arrear will be defined as a payment on debt to nonresidents, contracted or guaranteed by the general government, which has not been made within seven days after falling due (taking into account any applicable contractual grace period). The performance criterion will apply on a continuous basis throughout the Program period.

17. **Supporting Material.** Any external debt payment arrears of the General Government will be immediately reported by the MoF.

E. Bank Solvency Support Facility

18. The dedicated Bank Solvency Support Facility (BSSF) account will be maintained at the Bank of Portugal. As per previous review, resources for the BSSF will be agreed at each review and deposited in the dedicated account.

F. Overall Monitoring and Reporting Requirements

19. Performance under the Program will be monitored from data supplied to the EC, the ECB, and the IMF by the MoF and BdP. The authorities will transmit to the EC, ECB, and IMF any data revisions in a timely manner.

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

Press Release No.13/209
FOR IMMEDIATE RELEASE
June 12, 2013

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Seventh Review Under an EFF Arrangement with Portugal, Approves €657.47 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the seventh review of Portugal's performance under an economic program supported by a 3-year, SDR 23.742 billion (about €27.19 billion) Extended Fund Facility (EFF) arrangement. The completion of the review enables the immediate disbursement of an amount equivalent to SDR 574 million (about €657.47 million), bringing total disbursements under the EFF arrangement to SDR 19.700 billion (about €22.56 billion).

The Executive Board also approved the authorities' request for modification of the end-June 2013 performance criteria.

The EFF arrangement, which was approved on May 20, 2011 (see Press Release No. 11/190) is part of a cooperative package of financing with the European Union amounting to €78 billion over three years. It entails exceptional access to IMF resources, amounting to 2,306 percent of Portugal's IMF quota.

After the Executive Board discussion, Ms. Nemat Shafik, Deputy Managing Director and Acting Chair, said:

"Considerable progress has already been made on fiscal and external adjustment and the structural reform agenda, despite strong headwinds. Market conditions have improved significantly and Portugal has been able to return to capital markets at long maturities. Nonetheless, given the still sizable risks to the outlook, the authorities need to sustain the reform effort to improve competitiveness, boost long-term growth, and further advance fiscal consolidation.

"The fiscal targets have been recalibrated to preserve the right balance between consolidation and support for economic growth and employment. However, scope for deviating further from the revised deficit path is limited in view of the elevated medium-term financing needs and debt ratios. Early implementation of the measures identified in the public expenditure review and continued strong implementation of the fiscal structural reform agenda remain imperative to bring public finances back to a sustainable path. The planned corporate income tax reform can also help foster investment and competitiveness, while rebalancing the adjustment mix.

"The authorities have a strong track record in preserving financial stability. Progress has been made in strengthening banks' liquidity and capital buffers, despite a difficult operating environment. Channeling credit to viable firms to support employment and facilitate economic recovery remains an important goal. The Eurosystem has a pivotal role to play in containing credit segmentation and restoring monetary policy transmission.

"Further advances with the structural reform agenda are critical to address remaining nominal rigidities in the economy and boost competitiveness and growth. These include further actions to remove bottlenecks to growth, reduce production costs, and minimize rents in network industries.

"In addition to strong program implementation, Portugal's success continues to depend on external support and effective crisis management policies at the euro area level. The envisaged lengthening of the maturities of the EFSF and EFSM loans to support the authorities' market re-access strategy is a welcome development in this regard."

Statement by Andrea Montanino, Executive Director for Portugal and José Cardoso, Advisor to Executive Director
June 12, 2013

1 - Overview and Fiscal Policy

We welcome the IMF staff report on the seventh review and, in particular, the recognition of the progress made under the adjustment program.

The strong implementation of the program has resulted in a progressive correction of the macroeconomic imbalances in the Portuguese economy. Fiscal consolidation has continued, as indicated by the improvement of the primary structural balance, from -6% of GDP in 2010 to a surplus of 0.2% in 2012. In addition, the current and capital account balance turned positive in 2012, which constitutes a major correction relative to the deficit of 9% of GDP in 2010. As a result, the Portuguese economy turned from a net borrowing position to a net lender, thus creating conditions to reduce the accumulated external debt. In terms of financial developments, the deleveraging process has continued and financial stability has been preserved.

At this stage of the program, conditions have become more challenging, in particular due to the weakening of external demand, the rising level of unemployment and the demanding task of implementing the deep reforms in the functioning of the State implied by, but not limited to, the Public Expenditure Review (PER). Priority should be given to restart growth and create employment, and achieve a broad political and social consensus on the program going forward.

Fiscal consolidation is going to proceed as indicated in the medium-term budgetary strategy document published at the end of April. During the seventh review, the authorities agreed with the mission to revise the fiscal deficit targets upwards to 5.5% in 2013 (from 4.5%), 4.0% in 2014 (from 2.5%) and 2.5% in 2015 (from 2.0%). This revision was based on the notion that the fiscal adjustment should be achieved in structural terms and, as shown in the IMF report, the new targets deliver the appropriate fiscal correction over the medium-term.

The focus on structural balance is important to take into account the social and economic costs of the adjustment. In practice, however, it is challenging to achieve the appropriate pace of consolidation. Indeed, the implementation of excessive austerity measures can generate negative confidence effects that could result in detrimental macroeconomic implications, thus creating risks to the fiscal adjustment. It is precisely to avoid these risks that the nominal targets of the program have been changed twice (the first time during the fifth review). It should be noted that such changes took into account the debt levels and the financing conditions of the sovereign. It is the authorities' view that the improvement in financing conditions that the Treasury has enjoyed in recent periods, as illustrated by the 10-year bond issuance in May 2013, has created the necessary room for the adjustment of the fiscal targets without adversely affecting market access. On the contrary, there is clear evidence that the recent adjustments in the deficit targets have been well received by market participants, thus reinforcing the idea that, within certain limits, having a smother but more credible fiscal adjustment path could even be conducive to an improvement in financing conditions for the sovereign even if the debt level is somewhat higher.

Going forward, it is the authorities' view that further room for allowing automatic stabilizers to work should be considered in case economic activity disappoints, taking into account the financing conditions of the sovereign.

As mentioned in the staff report, the Constitutional Court ruling of April 5 implied that the government had to identify new measures to make up for a fiscal gap in 2013 of about 0.8 percentage points of GDP in order to complete the review. This was done in the supplementary budget which was submitted to Parliament on May 31.

As regards the broad exercise of the PER, while some of the measures identified were already included in the 2013 budget, the bulk of the measures will be taken in 2014. The government has initiated contacts with the Social partners regarding the structural changes in the Public Administration. The legislative acts on the PER legislative measures are well on track to meet the structural benchmark deadlines in the MEFP. The provision that measures may be replaced by other measures of equivalent value and quality provides important flexibility not only to address eventual Constitutional risks of the measures but also to provide room for achieving political and social consensus.

2 - Economic Activity

According to the Portuguese national institute (INE) data for 2013Q1, the quarterly GDP rate of change was -0.4% (-4% y-o-y), indicating a slowdown of the recession compared with the last quarter of 2012 (-1.8% q-o-q). The GDP figures in 2013Q1 are close to the euro area average (-0.2% q-o-q) and the fall is milder than in other euro area countries. Figures for the second quarter generally suggest some improvement relative to the first quarter.

The IMF staff report states that while important progress has been achieved in implementing structural reforms in labor and product markets, progress on price-competitiveness has so far been modest. While the Portuguese authorities remain fully open to new proposal to tackle barriers to competitiveness, the evolution of the external adjustment process seems to contradict the assertion that lack of price competitiveness gains is a major obstacle to the external rebalancing of the Portuguese economy. In fact, markups in both tradable and non-tradable sectors have been declining, but a steeper decline has been experienced in the latter. In addition, unit labor costs have also been declining, thus resulting in competitiveness gains. To this end, the government believes that the labor reforms that have been put in place (and some still undergoing) have played an important role, by providing companies a broader set of tools to improve their competitiveness and to adjust to market cycles. We note furthermore, that the full effect of supply-side reforms is not immediate, as demonstrated by various past comparative analyses, also by the IMF.

It is difficult to assess whether the nominal adjustment that has been witnessed has occurred at the appropriate speed or if a faster adjustment would have been preferable. Nevertheless, it seems that, besides issues related to price competitiveness, the removal of past incentives for the maintenance of strong domestic demand, such as easy access to credit and expansionary fiscal policies, is a major force explaining the rebalancing. As the conditions that allowed the accumulation of imbalances before the sudden stop are unlikely to return soon, the external adjustment can be expected to proceed while prices and wages continue their gradual nominal adjustment. Thus, although part of the adjustment may be cyclical, a large part is likely to be structural and thus more sustainable.

3 - Initiatives to Promote Growth

Creating the conditions for a resumption of economic growth is a key concern of the government. In this regard, the government has recently taken several measures aiming at reducing financial constraints and providing incentives to promote investment. The government decided to provide a temporary and targeted investment tax credit in Corporate Income Tax (CIT), in order to boost investment. The benefit will amount to 20% of the investment made, with a limit of up to 70% of CIT collection. The eligible investments will have to take place between June 1 and December 31, 2013. Additionally, the government is proceeding with the objective of creating a financial development institution that will propose action plans for financing and industrial development, including corporate recapitalization plans and a wide range of financial instruments. It is expected to be fully operational in 2014. The government is reviewing the commercial paper legal framework to facilitate the expansion of the market. The aim is to diversify the current financing alternatives for firms, in particular for SMEs. Government guaranteed credit lines will be reviewed aiming at enhancing their effectiveness. Finally, the government approved a VAT Cash Accounting Scheme, to be operational in October, whereby businesses can now account for VAT on the basis of payments received and made (rather than tax invoices issued and received), thus helping reduce firms' liquidity needs.

The reduction of financial constraints in the Portuguese economy is linked to the access of the sovereign to the financial markets. In this regard, the process of returning to full market access by the sovereign should be seen as part of the strategy for growth. Conditions in the bond markets improved significantly, and therefore the Portuguese State was able to take another important step to regain full bond market access on May 7th, issuing a new 10-year bond line which follows a previous tapping of an existing bond maturing in 2017. The issuance was very successful, attracting strong demand from abroad and with a composition of investors more tilted to longer-term investors that can provide a more stable investor base.

Other initiatives are being studied. The Memorandum for "Growth, Employment and Industrial Development" specifies the intention of the government to put a strong emphasis in improving financial conditions for viable firms, namely those who have an orientation for the tradable sector.

4 - Financial Sector Policies

The Portuguese economy is going through a long and encompassing adjustment process. Unlike other countries severely hit by the global financial crisis, the Portuguese financial sector was not at the centre of the tensions, having remained broadly resilient throughout the global turmoil. Nevertheless, the Portuguese banking system is not insulated from the major adjustment process of the economy. During the last two years, the banking system underwent substantial changes, visible in a widespread strengthening of core solvency ratios, a significant improvement of the liquidity situation, a consistent reduction of leverage, improved transparency and a stronger regulatory framework. Profitability has been hurt by the deterioration of the economic situation, low money market rates and the need to deleverage. Restoring adequate bank profitability and improving the financial autonomy of the corporate sector are the major challenges going forward.

Core solvency ratios of Portuguese banks improved markedly during the last two years, thus improving the system's loss absorption capacity and reinforcing its financial strength. In December 2012, the average Core Tier 1 ratio of the Portuguese banking system stood at 11.5%, increasing 2.8 percentage points since December 2011. This significant increase reflected mainly the capitalization operations of the main banking groups during the first half of the year. More specifically, three of the main banking groups issued hybrid instruments eligible as Core Tier 1, subscribed by the State, amounting to nearly €5 billion. In the second half of the year, two banking groups increased their regulatory capital. At the end of 2012, seven of the eight largest Portuguese banking groups had a Core Tier 1 ratio above the 10% goal defined in the adjustment program. The remaining institution was recapitalized in January 2013, thus restoring required solvency levels.

The liquidity indicators of Portuguese banks have generally improved during the last year and the collateral buffers available for Eurosystem's financing operations were strengthened. The new platform for interbank unsecured lending developed by Banco de Portugal, which started operating in September 2012, is working smoothly, facilitating the redistribution of liquidity among domestic banks. Furthermore, amidst improved market sentiment, there was a gradual decrease of banks' risk premia, with some banks regaining access to senior medium term debt markets. Nevertheless, it is premature to consider that banks' access to wholesale debt markets is normalized, as the volumes issued are relatively small, while the spreads remain at historically high levels. This evolution has occurred in a context in which household deposits continue to display a significant resilience, observed since the onset of the financial crisis, even taking into account that recent developments in capital markets have been favorable to the investment of savings in alternative products. Reference should also be made to the very pronounced reduction in interest rates on new deposits, following the very high levels attained in the second half of 2011 which motivated prudential initiatives from Banco de Portugal, aimed at curbing aggressive practices susceptible of harming the whole system.

Bank profitability has been under significant pressure. Impairments have increased as a result of the ongoing recession. Net interest income is also under downward pressure as a result of several factors, namely the current low profitability of the residential mortgages portfolio, contracted in the past at fixed spreads; the persistence of high funding costs, namely in the deposit base and in hybrid instruments; and the low level of short term interest rates, which compresses the margin associated to sight deposits. Bank profitability is also affected by high operational costs in a context of lower demand for financial services over the medium term.

In a context of high risk perception by banks, the reduction in bank lending was consistent with the ongoing deleveraging of the resident non-financial private sector and the structural adjustment of banks' balance sheets to a more sustainable financing structure. Debt levels in the case of households have been on a declining path since 2009, while the indebtedness levels of non-financial corporations remain very high, both from a historical viewpoint and in comparison to other countries in the euro area. Against this background, it is critical to balance the need to deleverage in the financial and non-financial sectors with the need to ensure that the most productive and competitive sectors of the economy retain access to finance. While some firms are over-indebted and need to significantly strengthen their financial autonomy, others need access to funding to invest in productive and viable projects and, in many cases, to export. This difficult balance is being closely monitored by Banco de Portugal. In the context of a contraction of activity in 2013, credit risk will continue to materialize and banks will need to maintain a prudent policy to recognize the ensuing losses. To address this issue Banco de Portugal issued an Instruction aimed at identifying the level and dynamics of restructured loans in the banks' balance sheets. Going forward, the reduction of the level of risk perception by banks will be instrumental to revive lending flows to the private sector.

Banco de Portugal has implemented several measures over the last few years to strengthen the confidence in the Portuguese banking system and ensure that it continues to perform its vital intermediation function. Under the adjustment program, larger banks regularly submit funding and capital plans, which are thoroughly assessed, and quarterly stress-testing exercises have been implemented. The supervisory function of the Bank was enhanced in several dimensions, including a reinforcement of the resources involved in on and off-site supervision and the implementation of thorough asset quality review programs. The monitoring of developments of the delinquency in the loan portfolio is a particularly important concern at the current juncture. In this regard, it is worth emphasizing that, although credit in default and non-performing credit are climbing to successively higher levels, in particular in the case of loans to non-financial corporations and to households with purposes other than for the acquisition of housing, new episodes of default are stabilizing, when assessed in terms of flows. In 2012, Banco de Portugal implemented a thorough assessment of credit portfolios related to construction and commercial real estate exposures. In 2013, further inspections will be implemented, focusing on impairments recorded by the main banking groups and on credit risk management practices. Going forward, the use of macroprudential instruments will be particularly useful in mitigating the future build-up of risks and in enhancing the resilience of the economy to unforeseen shocks.

The regulatory framework of the financial system was also significantly improved in the recent past. New legislation was enacted on bank access to capitalization operations with recourse to public investment; preventive early intervention and resolution; deposit guarantee schemes; or prevention and management of non-compliance situations.

In the context of the banks' recapitalization process, the on-going negotiations with the European Commission (DG-Competition) must ensure that the banks' restructuring plans are implemented such that the viability of the individual institutions is not put at stake and that the overall process does not raise systemic effects jeopardizing financial stability and the regular financing of the economy.

Overall, the thorough asset quality reviews already undertaken, the strengthening of supervisory practices and the improvement of the regulatory framework have placed the Portuguese banking system on a favorable position to address the challenges posed by the creation of the Single Supervisory Mechanism.

5 - Structural Reforms

The government remains fully committed to its structural reform agenda, key in boosting the growth potential of the Portuguese economy. Proof is the regular introduction of new policy initiatives, such as a more ambitious agenda in the area of licensing and new programs of legislative simplification. The IMF report provides a description of the main measures being taken.

In what concerns the product market reforms, measures with a view to reduce costs in the use of ports were discussed. Namely the reduction of 20% of the port cargo tariff (TUP-Carga). The government is committed to this process of fostering export competitiveness through potential further reductions and by ensuring that the savings gained from the implementation of the new port labor law trickle down.

In the health sector, we continue monitoring all measures of cost control, rationalizing supply and implementing operational improvements. Following difficult negotiations with the pharmaceutical industry, we were also able to achieve the objective of limiting spending on drugs to 1.25% of GDP. The main objectives for the reorganization and rationalization of the hospital network were presented and the government remains committed to this endeavor, which will produce significant savings. Measures such as the compulsory e-prescription, changes in pharmacies' margins, in international reference price system and in pricing of generics, continue to yield results. The approval of the new list of countries of reference for pharmaceutical pricing is expected to yield circa 7% in savings.

We reaffirm our commitment to continue with the privatization program which we consider an important tool for opening up the Portuguese economy and attracting new investment that will increase Portugal's competitiveness in the medium-term. As such, the government is working to ensure that binding offers for companies such as CTT (postal company) and EGF (waste management) are received by the end of 2013 and the privatization of TAP (airline company) is launched during this year. Furthermore, the restructuring of Águas de Portugal is underway with a view to establishing a concession in 2014.

As stated in the report, reforms to improve the efficiency of the judicial system continue to progress well. In fact, the Code of Civil Procedure was already approved by the Parliament in

April 19, 2013 and subsequently submitted to the President of the Republic to be promulgated.

We are committed on implementing the initiatives to tackle excessive licensing procedures, regulations and other administrative burdens to remove the bottlenecks to growth and to cut companies operating costs.