INTERNATIONAL MONETARY FUND

IMF Country Report No. 16/300

PORTUGAL

September 2016

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR PORTUGAL

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2016 Article IV consultation with Portugal, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its September 19, 2016 consideration of the staff report that concluded the Article IV consultation with Portugal.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on September 19, 2016, following discussions that ended on June 30, 2016 with the officials of Portugal on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 5, 2016.
- An **Informational Annex** prepared by the IMF staff.

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

Selected Issues
Ex-Post Evaluation of Exceptional Access Under the 2011 Extended Arrangement

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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FOR IMMEDIATE RELEASE
September 22, 2016

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IMF Executive Board Concludes 2016 Article IV Consultation with Portugal

On September 16, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation[1] and Fourth Post-Program Monitoring[2] with Portugal.

The economic recovery in Portugal is losing momentum. The slowdown in economic activity that began in the second half of 2015 has persisted, despite still-favorable cyclical tailwinds and supportive macroeconomic policy settings. The fiscal loosening in place since last year and the ECB's appropriately supportive monetary policy stance have translated into robust consumption growth. However, overall GDP growth is being held back by weaker export growth and sluggish investment, with the latter being weighed down by uncertainty, high levels of corporate debt, and still-pronounced structural bottlenecks. Accordingly, output is expected to increase by only 1.0 percent in 2016.

Executive Board Assessment[3]

The Executive Directors welcomed that Portugal has achieved a major economic turnaround since the onset of the sovereign debt crisis, as market access has been restored, fiscal and current account balances have improved, and unemployment, though still high, has fallen substantially. Directors noted, however, that notwithstanding the progress, the recovery is moderating and risks are tilted to the downside. The slowdown in economic activity, together with banking sector vulnerabilities and high public debt, poses challenges. Directors welcomed the authorities' commitment to address these weaknesses and emphasized that a concerted policy effort, including decisive fiscal adjustment, improvement in banks' governance, and implementation of key structural reforms, will be critical to strengthening Portugal's macroeconomic position.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] The central objective of PPM is to provide for closer monitoring of the policies of members that have substantial Fund credit outstanding following the expiration of their arrangements. Under PPM, members undertake more frequent formal consultation with the Fund than is the case under surveillance, with a particular focus on macroeconomic and structural policies that have a bearing on external viability.

[3] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

While noting that sovereign financing conditions are subject to global developments, Directors welcomed the staff's assessment that risks to Portugal's capacity to repay the Fund remain manageable. In view of the authorities' intention to repay the Fund early, they underscored the importance of maintaining adequate cash buffers.

Directors considered the 2016 budget deficit target, 2.2 percent of GDP, to be appropriately ambitious, yet noted the difficulties in achieving this target given declining GDP growth and emerging expenditure pressures. They encouraged the authorities to pursue a well-specified adjustment path, focused largely on expenditure, that balances the need to put debt on a firmly downward trajectory while supporting growth. Directors called for a comprehensive spending review, aiming particularly at better means-testing of social benefits and controlling pensions and public sector wages. They also highlighted that tax policy should be more stable and predictable and designed to boost competitiveness and growth.

Directors emphasized that addressing banking sector vulnerabilities should be a top priority. They agreed that to return to profitability and successfully finance economic growth, banks should clean up their balance sheets, including through the tackling of nonperforming loans, supported by an increase in capital and provisions. Directors noted that banks should also reduce operating costs and improve their internal governance to let lending decisions be guided solely by commercial criteria. They also saw merit in finding national-level solutions to the challenges facing Portuguese banks, using the existing regulatory toolkit.

Directors emphasized that pushing ahead with structural reforms remains critical to enhancing competitiveness and promoting growth. They encouraged the authorities to fully implement the already-enacted reforms in labor and product markets, with a particular focus on streamlining the functioning of the public sector and limiting energy costs. To support implementation of these reforms, Directors encouraged the authorities to engage all stakeholders by means of an inclusive social dialogue.

Directors welcomed the ex post evaluation of exceptional access under the 2011–14 Extended Fund Facility. The program was a qualified success, given that it helped stabilize the Portuguese economy, but concerns about debt levels remain. Directors generally agreed that the pace of fiscal adjustment had been appropriate; that treating banks as going concerns had been justified in the absence of a banking crisis; and that sovereign debt restructuring had not been a realistic option during the program. Directors pointed to the need for realistic projections and targets, noting in this respect the limits to protecting growth in the face of necessary adjustment. Looking forward, Directors emphasized in particular: the need to develop program modalities and a toolkit for effective adjustment through internal devaluation; the importance of strong forward-looking banking supervision and a proactive approach to private sector deleveraging; the need to handle effectively legal constraints in program design; and the key role of country ownership in all branches of government to enable and sustain reforms.

Directors recognized the determinative role of EU support in Portugal's recovery and current stability. For the effective design of future Fund programs with members of currency unions, most Directors considered that high priority should be put on clarifying options for union-level conditionality, and for instruments to ensure that member countries' program goals can be met in the face of asymmetric shocks not easily resolved by union-wide monetary policy.

Portugal: Selected Economic Indicators

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

	2014	2015	Projections 2016	Projections 2017
Real GDP	0.9	1.5	1.0	1.1
Private consumption	2.2	2.6	2.2	1.4
Public consumption	-0.5	0.6	0.3	0.6
Gross fixed capital formation	2.8	4.1	-1.2	2.0
Exports	3.9	5.2	2.9	3.4
Imports	7.2	7.6	3.2	3.8
Contribution to growth (Percentage points)				
Total domestic demand	2.2	2.5	1.3	1.4
Foreign balance	-1.3	-1.1	-0.2	-0.3
Resource utilization				
Employment	1.6	1.1	0.8	0.5
Unemployment rate (Percent)	13.9	12.4	11.8	11.3
Prices				
GDP deflator	1.0	1.9	1.7	1.3
Consumer prices (Harmonized index)	-0.2	0.5	0.7	1.1
Money and credit (End of period, percent change)				
Private sector credit	-8.0	-4.1	-2.2	-0.5
Broad money	-0.9	4.1	2.3	2.0
Fiscal indicators (Percent of GDP)				
General government balance	-7.2	-4.4	-3.0	-3.0
Primary government balance	-2.3	0.2	1.6	1.5
Structural primary balance (Percent of potential GDP)	3.7	3.3	2.8	2.4
General government debt	130.2	129.0	128.5	128.2
Current account balance (Percent of GDP)	0.1	0.5	0.0	-0.6
Nominal GDP (Billions of euros)	173.4	179.4	184.4	188.9

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

INTERNATIONAL MONETARY FUND

PORTUGAL

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION AND FOURTH POST-PROGRAM MONITORING DISCUSSIONS

August 5, 2016

EXECUTIVE SUMMARY

Portugal has achieved a major economic turnaround since the onset of the sovereign debt crisis. Access to financing was restored following the large fiscal adjustment, the external current account position has moved from a large deficit into surpluses, while the unemployment rate—though still at high levels—declined sharply. The fiscal targets for 2016 and 2017 are appropriately ambitious, but achieving them will require tackling significant implementation challenges.

More recently, however, the economic recovery in Portugal has been losing momentum. The slowdown in economic activity that began in the second half of 2015 has persisted, despite still-favorable cyclical tailwinds and accommodative fiscal and monetary policies. The fiscal loosening in place since last year and the ECB's supportive monetary policy stance have translated into robust consumption growth. However, overall GDP growth is being held back by weaker export growth and sluggish investment, with the latter being weighed down by uncertainty, high levels of corporate debt, and persistent structural bottlenecks.

The weaker economic environment, high corporate debt, and the banking system's related challenges from high non-performing loans (NPLs) are mutually reinforcing. As banks continue to struggle with a large stock of NPLs, low profitability, and high operating costs, they are unable to reduce corporate indebtedness and provide adequate lending for investment. Weaker growth in turn, together with low interest rates and low inflation, makes it more difficult for banks to rein in their stock of NPLs and improve profitability.

A concerted policy effort is needed to address the interrelated weaknesses in the banking system, public sector finances, and the macroeconomic outlook. A credible and realistic fiscal adjustment path — going well beyond achieving a 3 percent headline deficit — is needed to ensure the medium-term sustainability of public finances. This would alleviate significant uncertainty about the direction and scope of future policies and support private sector investment plans. Structural reforms to promote growth and competitiveness, and efforts to improve banks' governance, would boost this positive dynamic. Lower uncertainty and improved growth prospects would in turn help support a strengthening of bank balance sheets, reduce potential fiscal costs of supporting banks, and facilitate the required fiscal consolidation.

Approved By
Mahmood Pradhan and Vikram Haksar

Discussions took place in Lisbon during June 15 – 29, 2016. The staff team comprised S. Lall (head), M. Gaertner, D. Gershenson, I. Yackovlev (all EUR); K. Wiseman (SPR); M. Queyranne (FAD); A. Bouveret (MCM); A. Adriano (COM); and H. Schoelermann (EUO). Mr. Thomsen participated in the concluding meetings with Minister of Finance Centeno and central bank Vice Governor Neves, and C. Cottarelli and I. Lopes (both OED) participated in key meetings. Y. Cai and V. Bezerra de Menezes (both EUR) provided assistance from headquarters.

CONTENTS

ANNEXES

ECONOMIC CONTEXT

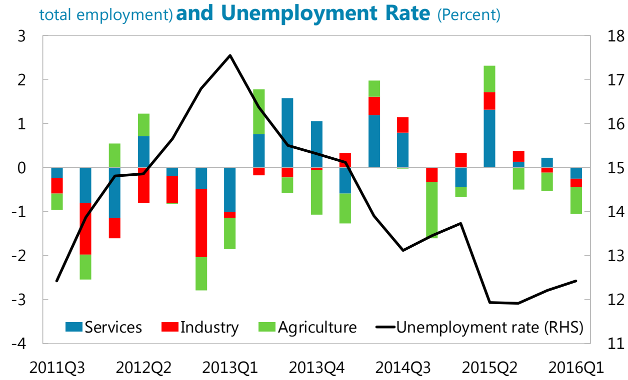
1. **Portugal's economic recovery began to lose steam in the middle of 2015 despite a generally supportive macroeconomic environment.** Historically low yields, notwithstanding occasional bouts of volatility, have afforded the public and household sectors relatively easy access to finance, and facilitated an expansionary fiscal stance since 2015[1]. Growth and employment have, however, underperformed, as robust private consumption has been offset by weakening investment and exports. By the first quarter of 2016, real GDP decelerated to 0.9 percent year-on-year (down from 1.7 percent in 2015Q1), and the unemployment rate inched upward to 12.4 percent.

Contributions to year-on-year growth
(percentage points, unless indicated otherwise)

	2015Q1	2016Q1
Total domestic demand	**1.8**	**1.9**
Final consumption expenditure	1.6	2.1
Public	-0.1	0.2
Private	1.7	1.9
Gross fixed capital formation	1.3	-0.3
Changes in inventories	-1.1	0.1
Foreign balance	**-0.2**	**-0.9**
Exports GS	2.8	1.0
Imports GS	-3.0	-1.9
Real GDP growth, percent	**1.7**	**0.9**

Source: Haver Analytics

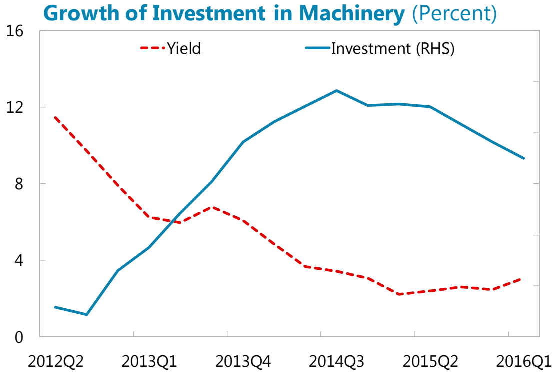
Portugal: Change in Employment (Percent of previous quarter's total employment) **and Unemployment Rate** (Percent)



Source: Haver Analytics.

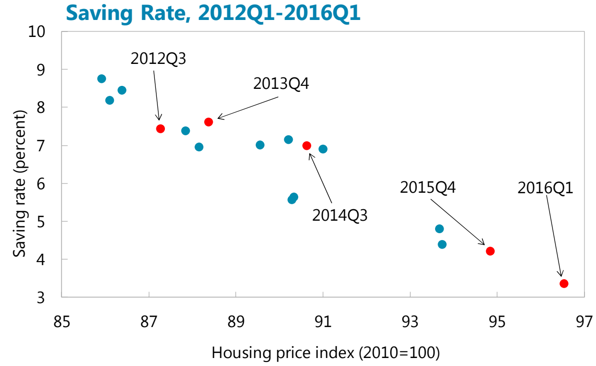
2. **The ongoing recovery has largely been consumption-driven.** Household consumption has grown by 10 percent between 2013Q1 and 2016Q1, even though disposable income has only increased by 4 percent over that period. This growth in consumption has been facilitated by an unprecedented decline in the savings rate, attributable to the post-crisis boost to confidence and

Portugal: Yield on 10-year Bonds and Average Growth of Investment in Machinery (Percent)



Source: Haver Analytics.

Portugal: Housing Price Index and Saving Rate, 2012Q1-2016Q1



Sources: Haver Analytics; and IMF staff calculations.

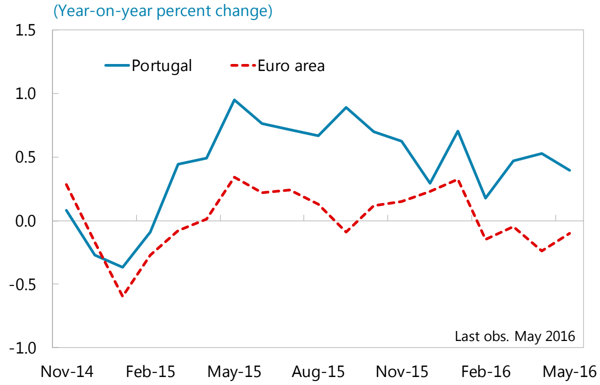
[1]For the summary of main recommendations of the 2015 Article IV consultation and authorities' response, see Annex I.

(continued)

the wealth effect from recovering house prices, in an environment of low interest rates. The ECB's Asset Purchase Program (APP),[2] together with the expanded refinancing operations, has helped improve access to financing for banks, but transmission to new corporate lending and investment has been constrained by the high level of NPLs and the need for corporate deleveraging (see SIP).[3]

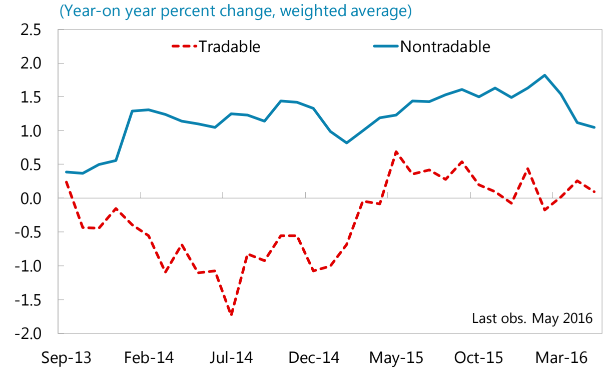
3. **Despite the lingering output gap, inflation in Portugal remains above the euro area average.** The continued price pressures from the nontradable sector, together with the fact that most of Portugal's trade is within the euro area, implied only a modest decline in Portugal's real exchange rate in 2015 notwithstanding the large nominal depreciation of the euro (Figure 5).

Harmonized Consumer Price Index
(Year-on-year percent change)



Source: Haver Analytics.

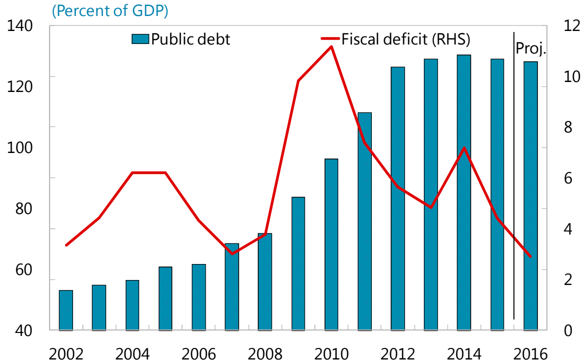
Portugal: Consumer Price Index
(Year-on year percent change, weighted average)



Sources: Haver Analytics; and IMF staff calculations.

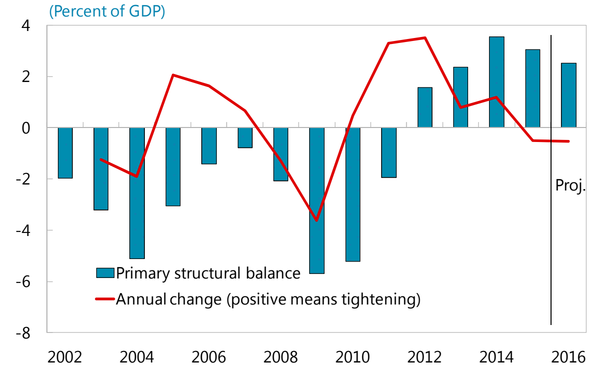
4. **The fiscal stance remains expansionary.** In 2015, the headline deficit of 4.4 percent of GDP—of which 1.4 percentage points was due to the resolution of Banif—was associated with a fiscal loosening of 0.5 percent.[4] The 2016 budget targets a fiscal deficit of 2.2 percent of GDP and an

Portugal: Fiscal Deficit and Public Debt
(Percent of GDP)



Source: Haver Analytics and IMF staff projections.

Portugal: Primary Structural Balance
(Percent of GDP)



Sources: Haver Analytics; and IMF staff calculations and projection.

[2] The APP was announced in September 2014 and launched in October 2014 in an effort to provide further monetary accommodation in the context of prolonged low inflation. This was initially limited to asset-backed securities and covered bonds, but was subsequently expanded to also include public sector securities under the PSPP, as well as corporate sector non-financial bonds under the CSPP.

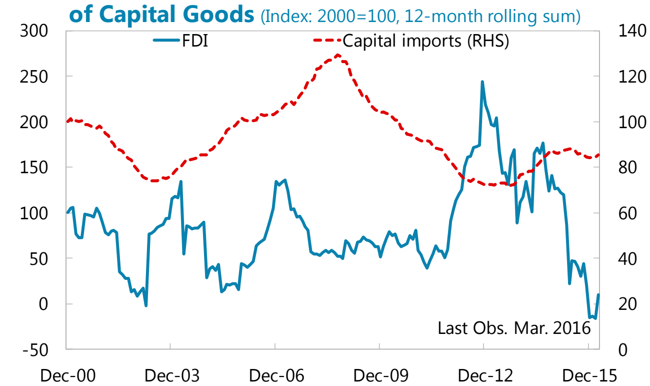
[3] The impact on bank lending appears to have been primarily on household credit, where NPLs are relatively modest, with corporate lending continuing to contract. On corporate deleveraging, see *IMF Country Report 15/126*.

[4] Details of the Banif recapitalization were outlined in *IMF Country Report 16/97*.

implied primary structural tightening of 0.1 percent. Staff projects a deficit of 3.0 percent, however, on the basis of more conservative macroeconomic and fiscal projections. This is consistent with a further 0.5 percent of GDP loosening in the fiscal stance.

5. The current account posted a surplus in 2015 for the third year in a row, but some weaknesses are emerging. Improving relative labor costs and likely some learning-by-doing for firms have fostered a robust expansion of exports as a share of total output. The tourism sector in particular continued its strong performance, with receipts reaching record levels in 2015, and with the trend continuing into early 2016. In early 2016, exports of goods have performed well in traditional EU destinations such as Spain and France, but have fallen markedly to Angola and, to a lesser extent, in the United States and China. At the same time, current account surpluses in 2014 and 2015 were to a large extent supported by favorable commodity prices. Foreign direct investment inflows turned negative for the first time in many years in 2015, as inward investment increasingly took the form of debt instruments (see Annex II for the External Stability Report).

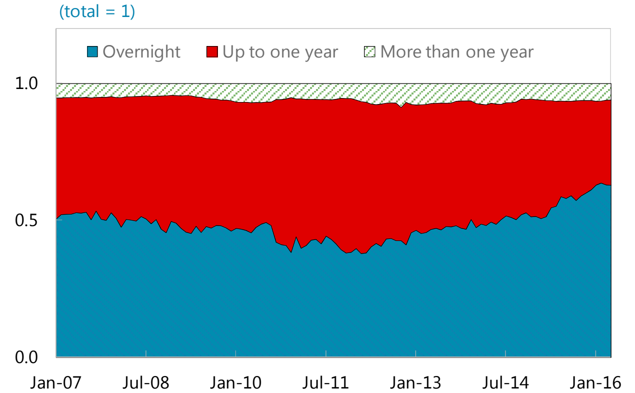
Portugal: Nominal FDI Inflows and Real Imports of Capital Goods (Index: 2000=100, 12-month rolling sum)



Source: Haver Analytics.

6. Against this economic backdrop, the banking system continues to suffer from weak profitability and rising NPLs (Figure 1). Prior to the crisis, banks had managed to remain profitable by intermediating large capital inflows—even with lower interest rate spreads and lower margins since the adoption of the euro—and by some efforts at reducing operating costs. The sovereign debt crisis and the ensuing recession have reduced net interest margins (NIMs) further and increased loan losses. At the same time, banks' efforts at reducing costs have not been very successful, holding back a return to robust profitability. More recently, the lower interest rate environment has also added to pressures on profitability, notwithstanding the notable shift from term to demand deposits by nonfinancial corporations. (see Table 5).

Non Financial Corporations: Deposits with Banks
(total = 1)

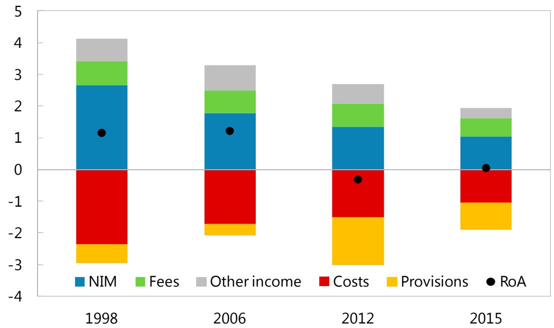


Sources: Banco de Portugal.
Last obs. Apr. 2016

Figure 1. Portugal: Banking System

Revenues declined….

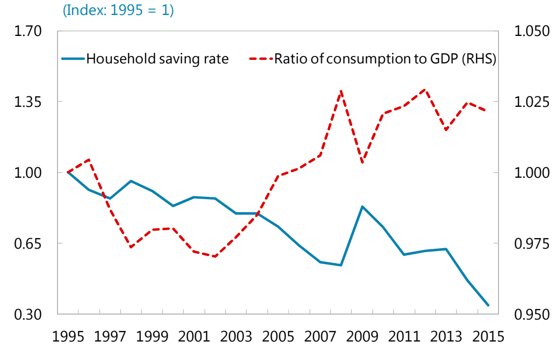
Portugal: Income Statement of the Banking System
(Percent of assets)



Sources: Bank of Portugal; and IMF staff calculations.

…while consumption had to be financed by inflows…

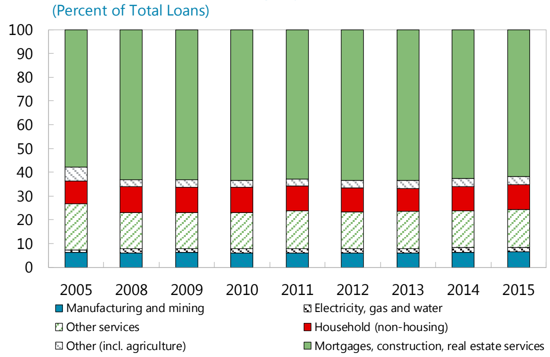
Portugal: Savings and Consumption
(Index: 1995 = 1)



Source: Haver Analytics.

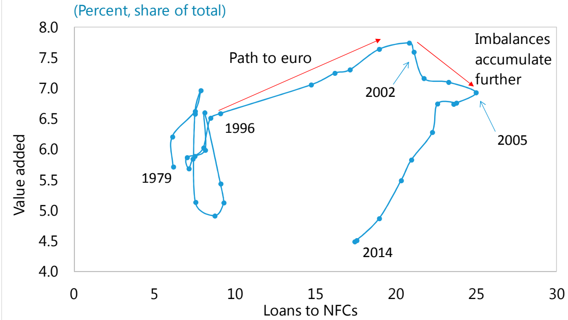
… and exposure to the nontradable sectors remained high

Portugal: Bank Lending by Sector
(Percent of Total Loans)



Sources: Bank of Portugal; and IMF staff estimates.

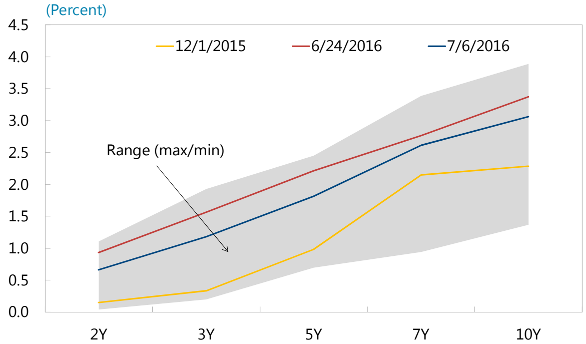
Portugal: Construction Sector
(Percent, share of total)



Source: Bank of Portugal; United Nations Statistics Division; and IMF staff calculations.

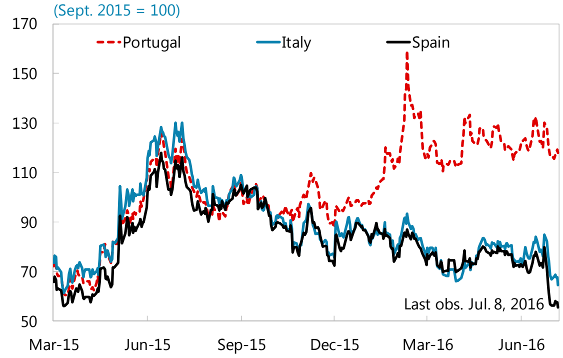
7. **Sovereign financing conditions remain linked to global developments but anchored by Portugal-specific considerations.** The sovereign has been successful in issuing long-term debt at relatively low yields, and Portugal is fully financed for the remainder of the year. The ECB's Public

Portugal: Yield Curve Since 1/1/2015
(Percent)



Source: DataStream.

10-year Sovereign Bond Yields
(Sept. 2015 = 100)



Source: Bloomberg.

Sector Purchase Program (PSPP) purchases have been equivalent to a large share of the government's gross financing needs and helped minimize volatility. Nevertheless, yields have diverged distinctly from those for Spain and Italy since last October and remain elevated, suggesting that markets are pricing in some Portugal-specific considerations.

Staff's views

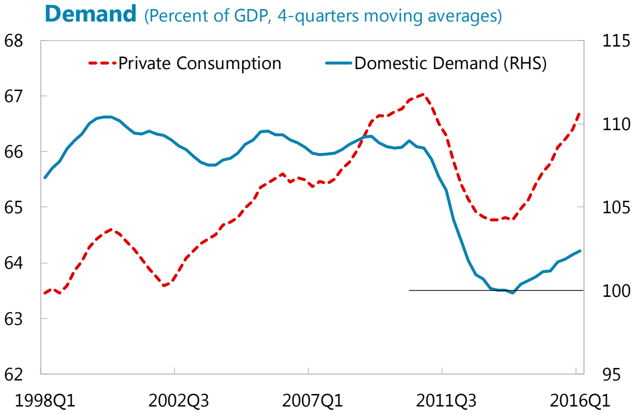
8. **The growth outlook has weakened.** As in the pre-crisis years, consumption is once again growing strongly, and the government is able to finance itself comfortably in bond markets. However, private and public debt levels are much higher than in 2011, and the prospects for further gains in competitiveness appear limited. As a result, the ongoing weakness in investment and the slowdown in export growth are likely to remain in place for some time. Accordingly, the 2016 growth forecast has been revised down, from 1.4 to 1.0 percent for this year. The impact of the U.K. referendum on Portugal's baseline growth outlook is expected to be marginal as of now, but has increased downside risks.[5]

Portugal: Contributions to Cumulative Growth, 2014-15
(Percentage points, unless indicated otherwise)

	Pre-QE projections 1/	Actual	Difference
Total domestic demand	0.5	4.6	4.1
Final consumption expenditure	-0.3	3.2	3.5
Gross capital formation	0.8	1.4	0.6
Foreign balance	1.7	-2.3	-4.0
Real GDP growth (percent)	2.3	2.4	0.1

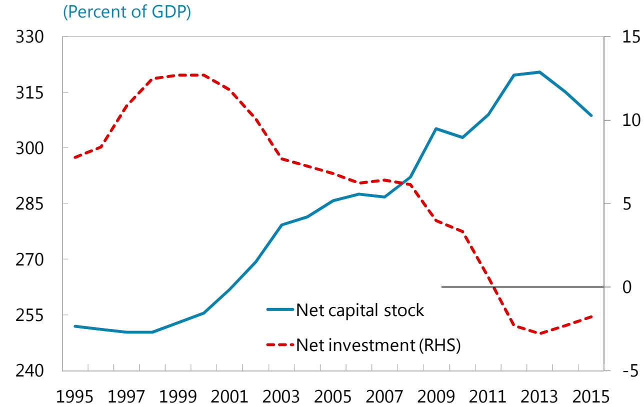
Sources: Haver Analytics; and IMF staff projections.
1/ Projections made at the time of the 8th-9th Review EFF, November 2013, *IMF Country Report 13/324*.

Portugal: Private Consumption and Domestic Demand (Percent of GDP, 4-quarters moving averages)



Source: Haver Analytics.

Portugal: Capital Stock and Investment
(Percent of GDP)



Sources: Haver Analytics.

9. **The banking system faces vulnerabilities from weak asset quality, thin capital buffers, and low profitability.** The banking system has required a series of taxpayer-financed interventions over the years, including most recently at the end of 2015 for Banif. Recapitalization needs of the largest bank Caixa Geral de Depósitos (CGD) and possible losses from the sale of Novo Banco may

[5] Based on the limited scenario presented in *IMF Country Report 16/169*. That scenario has been consistent with the post-referendum behavior of the financial markets.

(continued)

necessitate further injections of public money, consistent with the application of EU state aid rules and the Bank Recovery and Resolution Directive (BRRD).[6] In addition, financial markets' view of publicly traded banks has deteriorated, as reflected in rising CDS spreads. Furthermore, with a large fraction of banks' loan book tied up in financially weak and unproductive enterprises, banks are not in a position to spur economic growth by financing the investment needs of newly-created high-productivity firms.

10. Portugal's external position remains weaker than implied by medium-term fundamentals and desirable policy settings. The EBA estimates are mixed but have deteriorated since the last Article IV consultation. The real effective exchange rate measures indicate moderate to substantial overvaluation in 2015, even though the current-account measures suggest the external position is broadly in balance relative to medium-term fundamentals. Though somewhat lower than in 2014, the net international investment position remains highly elevated at around 106 percent of projected 2016 GDP. While the ES approach compares the current account balance with the balance required to stabilize external debt, a larger surplus is needed to put external liabilities on a path to more sustainable levels. Similarly, favorable oil price developments have masked the effect of rising consumption-based imports, which are projected to turn the current account into deficit over the forecast horizon.

Portugal: External Balance Assessment Results[1]

	Current account gap (Percent of GDP)		REER gap[2] (Percent)	
	2015[3]	2016	2015[3]	2016
Current account approach	1.9	0.0	-5	0
ES approach	1.2	0.5	-3	-1
Index REER approach	…	…	2.9	4.5
Level REER approach	…	…	8.5	8.5

Source: IMF staff projections.
[1]Estimates based on data available in January 2016.
[2]A positive REER gap indicates overvaluation.
[3]EBA estimates at the time of the 2015 Article IV Consultation.

11. Risks to the outlook are on the downside. The recent economic deceleration together with the all-time low savings rate suggest that the consumption-driven recovery may run out of steam in the near future. Additional recapitalization needs in the banking sector also cannot be ruled out. Moreover, the 2016 budgetary targets are unlikely to be achieved without additional measures. With an investment-grade rating—necessary for Portugal's participation in PSPP—provided by only one of the four rating agencies, the country is exposed to a low-probability but high-impact risk of a ratings downgrade. More broadly, Portugal remains dependent on external financing and exposed to financial turbulence arising from global risks including the aftermath of the U.K. referendum and lower-than-anticipated growth in Europe (see Annex III).

[6] On recent Banif and Novo Banco operations, see *IMF Country Report 16/97*. Any losses from the sale of Novo Banco will be recorded on the books of the Resolution Fund, an entity within the general government perimeter.

12. The currently comfortable access to market financing is being supported by the ECB's monetary policy stance. Sovereign yields have been contained due to market perceptions that the ECB's PSPP will be extended beyond the current end date. In view of this, the macroeconomic policy framework needs to be strengthened to ensure durable access to financing once the monetary policy stance normalizes, even if the latter is a sufficiently distant prospect.

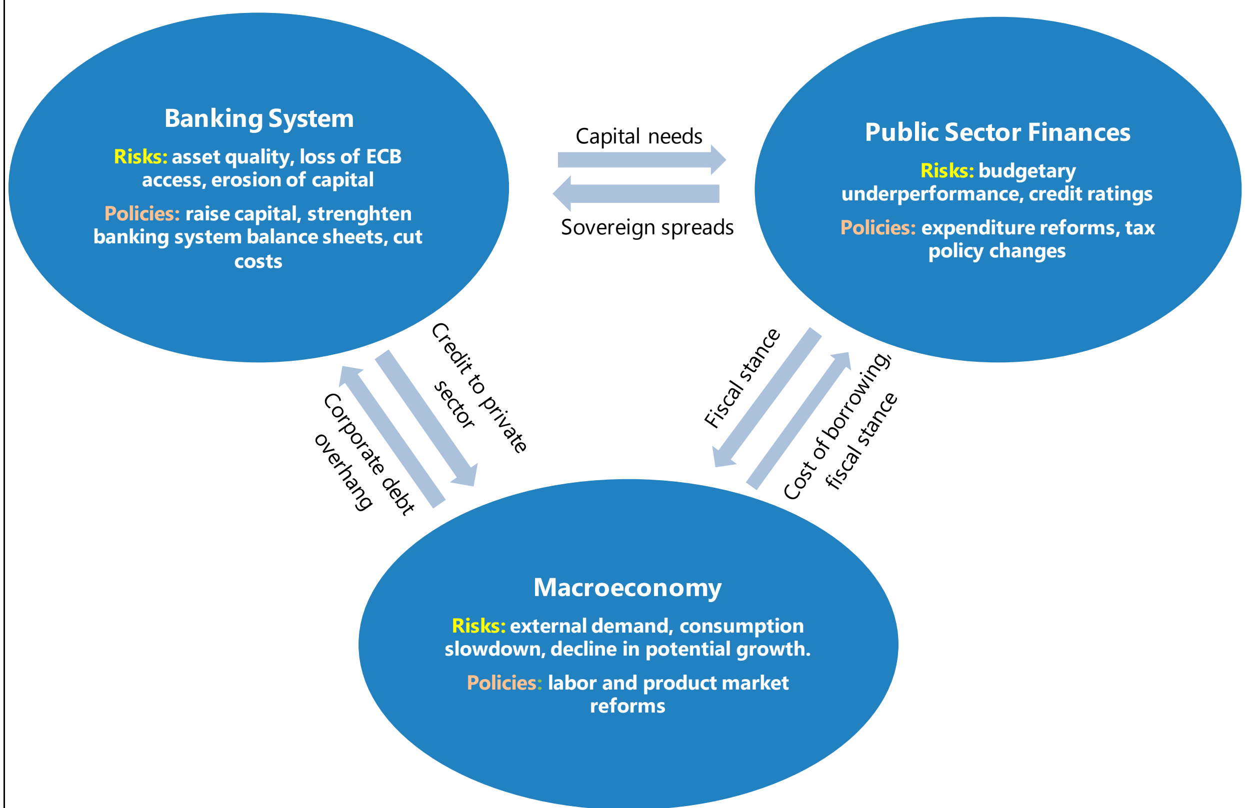
13. Even as QE provides a cushion, Portugal faces a multiplicity of self-reinforcing vulnerabilities. There are three major areas of weakness: the banking system (facing a high level of NPLs), public sector finances, and the macroeconomic outlook. Problems arising in any single area could impact all others, potentially leading to a spiraling effect (see Figure 2).

14. Any development that worsens the dynamics of public debt could trigger a sudden change in market sentiment. It could be fiscal slippages resulting from either policy reversals or a macro shock, or materialization of large contingent liabilities, including from the banking system. A sharp rise in borrowing costs would further worsen debt dynamics and could force a large fiscal adjustment, aggravating the impact on growth. In addition, an increase in yields would lower the value of banks' holdings of sovereign debt and weaken their capital position. Even if the fiscal consequences of higher yields were to materialize slowly due to the high average debt maturity, persistently high yields could dampen the general macroeconomic outlook and the prospects for the banking sector.

15. A negative reassessment of the country's macroeconomic prospects could similarly lead to a negative spiral. A poor macroeconomic outlook (due to, for instance, a global economic slowdown or an abrupt normalization of the domestic saving rate that is not offset by higher investment) would worsen the dynamics of public and private debt and negatively affect the fiscal outlook. Already-indebted corporations and households would struggle to pay their debts, further undermining banks' asset quality, while the government would find it difficult to access financing at favorable rates.

16. Even in the absence of an immediate challenge, failure to address the above-mentioned weaknesses could put Portugal on an unsustainable medium-term trajectory and leave it vulnerable to shocks. Without meaningful policy action, Portugal will be unable to adjust to the constraints of the monetary union or exploit the benefits of integration fully. Low growth, unreformed fiscal spending, and weak banks will preclude much-needed (and still possible) convergence and could lead to a loss of market access even under small shocks.

Figure 2. Risks and Policy Responses



Authorities' views

17. The authorities acknowledge the risks to the outlook emanating from the recent growth weakness. The authorities attribute some of that weakness to one-off factors—such as the economic contraction in Angola, work stoppages at the major oil refinery, and change in the output mix at a large automobile assembly plant—that will ease in the second half of the year. As a result, the Banco de Portugal has lowered its projection for growth to 1.3 percent in 2016, with a slight rebound to about 1.5 percent in the medium term. The Ministry of Finance maintains an unchanged baseline outlook—growth of 1.8 percent in 2016 and rising to about 2 percent in the medium term[7]—but acknowledged that the downside risks have become more pronounced.[8]

18. The authorities appreciate the challenges facing the country but remain confident that the policies in place are adequate to address them. The National Reform Program outlines an

[7] For additional discussion of the authorities' baseline outlook, see *IMF Country Report 16/97*.

[8] The Ministry of Finance's forecast implies a quarter-on-quarter growth of 0.8 percent for the remainder of 2016, a very high rate by historical standards. Staff projects the quarter-on-quarter growth of 0.3 percent on average, in line with the average quarter-on-quarter growth rate during this recovery (2013Q1 – 2016Q1) and still above the most recent average growth (0.2 percent during 2015Q3 – 2016Q1).

appropriate way forward on the structural front; the weaknesses in banks should be addressed at the European level; and the envisaged fiscal path strikes a right balance between the demands of fiscal sustainability and the need to support domestic consumption and investment.

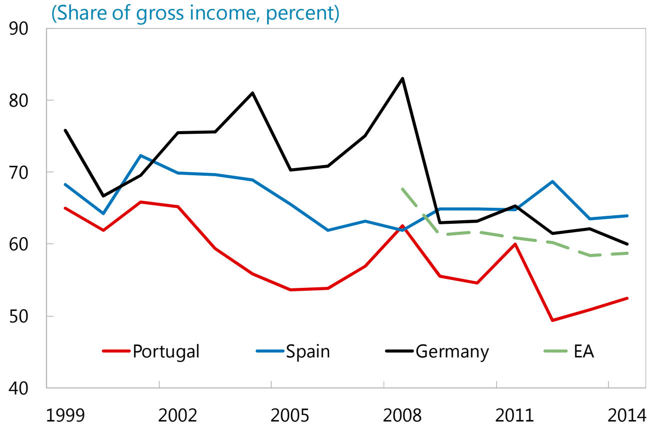
POLICY DISCUSSIONS

A. Financial Sector

19. Concerns over two large banks weigh on the outlook for the sector. Market participants are wary of the significant capital needs of the country's largest bank CGD (with publicly available estimates approaching 3 percent of GDP), taking them as possibly indicative of larger NPL problems in other banks as well. Another source of uncertainty is the size of losses other banks would sustain if the ongoing bidding for Novo Banco—which received a €3.9 billion injection of public money (2.2 percent of GDP) that will eventually need to be recouped from the banks—were to disappoint. Bank stocks have been under continuous downward pressure in recent months.

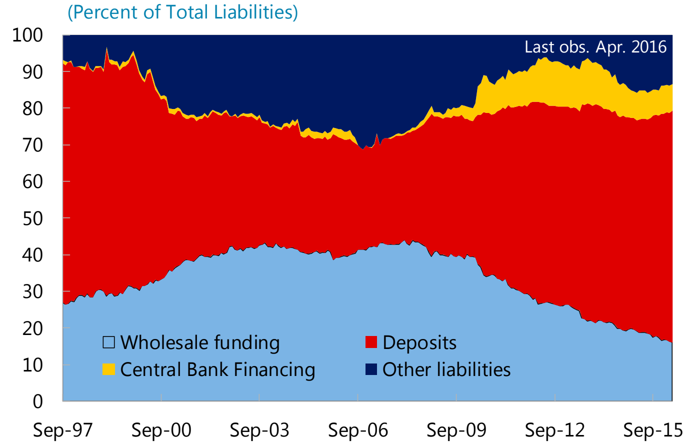
20. Looking ahead, banks are expected to be squeezed by both weak supply and demand for credit. On the supply side, the current balance sheet weaknesses and low expected profits (due to the projected low real growth, inflation, and interest rates), together with a low likelihood of large capital inflows will limit banks' ability to grant credit. On the demand side, overleveraged households and corporates are not in a position to accummulate more debt.

Net Interest Margin
(Share of gross income, percent)



Sources: European Central Bank; and OECD.

Portugal: Structure of Bank Liabilities
(Percent of Total Liabilities)

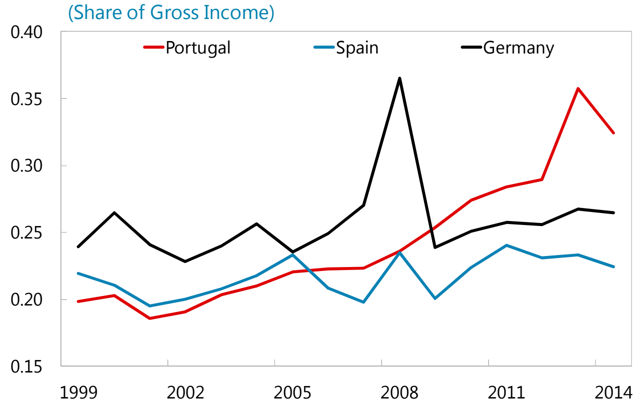


Sources: Haver Analytics; and IMF staff estimates.

Staff views

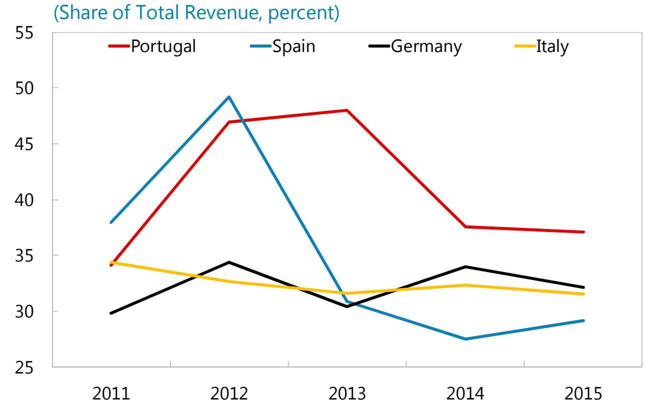
21. Addressing the challenges facing the banking system should be an urgent priority. A comprehensive approach is needed for banks need to clean up their balance sheets.[9] This should include restructuring problem loans supported by an increase in banks' capital buffers, provisions, and impairments.[10] This would also require appropriately pricing and selling poor quality legacy assets and raising capital, albeit under challenging circumstances. Moreover, a governance structure that more fully reflects the interests of the shareholders will make increasing profitability banks' primary objective (see SIP). Banks need to diversify exposures—in particular by shifting their attention from nontradable to tradable sectors—in order to better manage risks and to be well-positioned to finance new engines of growth. Since banks' interest income will be constrained by the projected low-interest environment,[11] and since banks already derive a relatively high proportion of their income from fees, cutting costs is necessary to achieve higher profitability. This would likely require further consolidation in the banking system, and cutting the extensive branch network and staffing costs. Focused bank supervision—already enhanced to pay more attention to capital weaknesses—will be an important driver of these policies.[12] The European framework provides flexibility to address specific issues currently under consideration (CGD and Novo Banco). Access to bank-level data would permit a more granular assessment of challenges facing the banking system than is currently feasible for staff. Broader issues facing the banking system are outlined in Box 1.

Bank Income from Fees and Commissions
(Share of Gross Income)



Sources: European Central Bank; and OECD.

Bank Compensation
(Share of Total Revenue, percent)



Sources: SNL Financial; and IMF staff estimates.

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[9] See *IMF Staff Discussion Note 15/19*. In Portugal, debt restructuring will unavoidably lead to the closure of many unproductive firms, but that would be an important step toward reallocating resources to more productive activities. According to firm-level data, Portugal's highly-indebted low-productivity firms account for 25 percent of employment and 20 percent of debt, but only for 5 percent of value added.

[10] There is evidence that higher capital ratios lead to lower bank funding costs and higher credit growth in the economy. See L. Gambacorta and H. S. Shin. 2016. "Why Bank Capital Matters for Monetary Policy." *BIS Working Paper 558*.

[11] See C. Borio, L. Gambacorta, and B. Hofmann. 2015. "The Influence of Monetary Policy on Bank Profitability." *BIS Working Paper 514*.

[12] For more on recent supervisory developments, see *IMF Country Report 15/21*.

(continued)

22. Dealing with corporate debt overhang is a matter of particular importance. Successful deleveraging would allow banks to reallocate resources away from less productive sectors of the economy and toward viable firms, which will in turn contribute to higher economic growth. To achieve this, a standardized bank-led, time-bound framework for restructuring—which would ideally entail an accelerated pace of SME restructuring and large-scale write-offs for the banks—is needed.[13]

Authorities' views

23. The authorities concurred that additional steps should be taken, both at national and European levels, to strengthen bank balance sheets and restore profitability to the banking sector. They underscored that high levels of non-performing loans are present in several euro area banking systems and therefore a systemic European solution for this issue—such as a pan-European asset management corporation—is required. The current low interest rate environment and the economic cycle are not favorable for Portuguese banks, despite the easing of financing conditions afforded by ECB's accommodative monetary policy. Banks also face additional hurdles in cleaning up their balance sheets because the current framework (BRRD) restricts the use of public money outside the resolution process, while allowing it only under exceptional circumstances during resolution.

B. Fiscal adjustment

24. The authorities' 2016 fiscal target appears at risk in the absence of additional measures to support spending restraint. The cash outturn for January-May shows a sizable under-execution of spending relative to the budget, reflecting significant efforts to contain discretionary expenditure. Revenue is expected to fall short of the full-year target as specified in the 2016 budget by 0.6 percent of GDP, however, with growth projected to decline well below the budget assumption of 1.8 percent, while maintaining expenditure restraint in the second half of the year is likely to be difficult. Spending pressures are likely to emerge from the move to the 35-hour work week for the majority of civil servants at the beginning of July, the continued rollback of public sector wage cuts and some catch-up in capital spending. The increase in arrears and non-financial debt during January-May, particularly from hospitals, already suggests that spending pressures may be building from the containment of intermediate consumption. In the absence of additional measures, staff projects a deficit of 3 percent of GDP, compared with the official target of 2.2 percent.

Staff views

25. Portugal remains uniquely vulnerable to shifts in market sentiment. The high stock of public debt, large refinancing needs, potential liabilities stemming from the financial sector, and low growth and inflation projected for the foreseeable future all point to the fact that fiscal policy should

[13] For more on corporate debt restructuring, see *IMF Country Report 15/126* and *IMF Country Report 16/97*.

be guided by debt sustainability considerations. At current levels, debt dynamics remain vulnerable to even relatively small shocks.

26. A credible fiscal adjustment is therefore needed to put public debt on a firmly downward trajectory and ensure the medium-term sustainability of public finances. Even though the objective of fiscal policy is often perceived as trying to meet a three-percent headline deficit target annually—viewed by many commentators as Portugal's European fiscal commitment—the public debate should internalize the need for realistic and appropriately paced fiscal consolidation. The authorities' Stability Program (SP) targets a 2.6-percent-of-GDP adjustment in the nominal fiscal deficit from 2016-2020, to be achieved through a decrease in the public sector wage bill, rationalization of intermediate consumption, reduction in fraudulent claims for social transfers, and interest savings from further prepayments to the Fund. The spending containment strategy in these areas is not supported by specific reforms, however, and relies heavily on assumed improvements in spending efficiency. In addition, the SP relies on optimistic growth and revenue assumptions to underpin the projected decline in expenditure-to-GDP and public debt ratios, with the latter falling to 110 percent of GDP by 2020.[14] For staff's debt sustainability assessment, see Annex IV.

Fiscal Projections, 2017
(Percent of GDP)

	Overall balance	Structural primary adjustment
Baseline	-3.0	-0.5
Staff recommendation	-2.0	0.5
Stability program[1]	-1.4	1.0

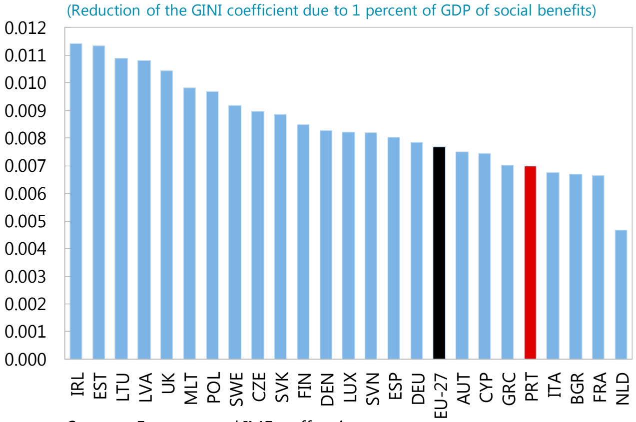
[1] Overall balance as given in the SP; implied adjustment calculated based on staff's macroeconomic scenario.

27. A structural primary adjustment of 0.5 percent of GDP in 2017 and 2018 would be an appropriate fiscal path, but that should be underpinned by credible measures. The focus of fiscal adjustment should be on spending reform, in particular in public wages and pensions, given Portugal's already-high tax burden. The authorities have recently launched a bottom-up exercise to identify scope for efficiency gains in the areas of health, education, public administration, and state-owned enterprises. Due to its non-systematic nature and lack of clear savings objective, however, such an exercise falls short of a comprehensive spending review needed to generate a lasting impact on the government's outlays. Going forward, the spending review should adopt a more top-down approach to fix the overall spending envelope of the general government, and take a medium-term perspective to achieve more ambitious savings, anchored on the SP's fiscal targets and locked in the annual budgets. Priority should be given to the most promising areas for generating savings, as follows:

[14] The projected decline in public debt also assumes substantial revenues from the sale of government-owned financial sector assets, which would be used to reduce new debt issuance.

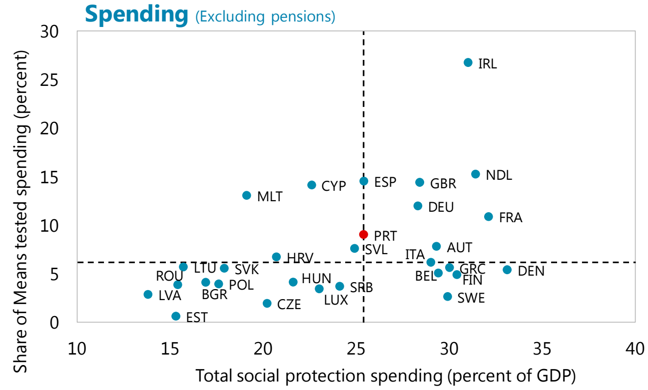
a. **There is a significant scope to improve the impact of public spending on poverty and inequality and to reduce growth of healthcare cost.** Stronger means-testing of social benefits would reduce fiscal costs, as Portugal has one of the highest shares of social benefits going to the high-income households. To partially offset the pressures from population aging, policies to reduce healthcare costs should be expanded and pursued forcefully (see Box 2 and SIP).

The Redistributive Power of Public Spending
(Reduction of the GINI coefficient due to 1 percent of GDP of social benefits)



Sources: Eurostat; and IMF staff estimates.

Social Protection Spending and Means-Tested Spending (Excluding pensions)



Source: Eurostat.
Note: Dashed lines represent medians.

b. **A clear strategy is needed to underpin the authorities' plan to reduce the public sector wage bill.** The targets presented in the SP rely heavily on natural attrition and could prove difficult to achieve given the full reversal of the program-era nominal wage cuts and the partial reinstatement of 35-hour work week in 2016. The authorities should adopt a well-specified strategy, including (i) exempting the health sector from the implementation of the 35-hour week, and pursuing school network consolidation given the declining school-age population; (ii) increasing the rate of natural attrition to gradually reduce public employment; (iii) reducing the wage premium relative to the private sector, by rationalizing allowances and supplements; and (iv) limiting the wage drift, by streamlining career path and maintaining the freeze in career progression beyond 2018.

c. **While recent pension reforms will generate large savings in the long term and should be preserved, more action is needed to reduce the high level of pension spending in the short term**. Reforms introduced to date will generate savings only over the long term due to extensive grandfathering rules that protect current retirees, while placing a substantial adjustment burden on future generations of retirees (see Box 2). Revisiting recent pension reforms should address inequities across generations and pension schemes including by accelerating the convergence between the public and private sector schemes and avoiding an increase in pensions' contribution that would finance higher benefits.

28. **The tax policy reforms outlined in the 2016 Stability Program have not been fully articulated, but appear to fall short of what is needed to boost competitiveness and growth.** Tax policy is primarily geared toward supporting household income to increase domestic

consumption through the complete elimination of the PIT surcharge by 2017, a reduction in the VAT rate for restaurants from July 2016, and a fiscally-neutral increase in income tax progressivity. More marginally, the government also intends to support corporate investment by expanding the targeted tax incentives for investment and SMEs. The government's other priorities include reducing compliance costs and the bias towards debt by corporates, which are in line with staff's earlier recommendations.[15] Overall, a more stable and predictable tax system is needed to stimulate corporate investment.

Authorities' views

29. The authorities were confident that their 2016 fiscal target as articulated in the budget (a 2.2-percent-of-GDP deficit) is within reach. They were encouraged by the January-May outturn, and optimistic that strong private consumption would help support revenue collection despite the slower headline growth. The authorities also noted that the frozen appropriation for purchases of goods and services has been increased in the 2016 budget, and believed that this should provide sufficient buffer to withstand any additional spending needs that might emerge in the second half of the year. They also cited scope for increased efficiency in the health sector that could help minimize any increase in overtime costs resulting from the shift to the 35-hour work week for some health professionals.

30. The authorities remain committed to the fiscal plans laid out in the SP, including a deficit target of 1.4 percent of GDP for 2017. They re-affirmed their commitment to the downsizing of the public sector through natural attrition, and hiring caps in line with replacement rules and were confident that the recently-launched spending review would effectively underpin the planned rationalization of intermediate consumption. In particular, they favored a deep bottom-up spending review in the areas they have identified for the ongoing exercise, with a subsequent broadening to other areas. The authorities also emphasized that any changes to the pension system would be mindful of both the long-term financial sustainability of the system and the existing rights of current beneficiaries.

C. Structural reforms

31. There has been little forward movement on structural reforms since the end of the adjustment program. Proposals to link future increases in minimum wages to productivity were set aside after the expiration of the program, and the minimum wage was raised in October 2014 by 4 percent. The minimum wage was raised once more in January 2016 by 5 percent, and accompanied by the reinstatement of four public holidays eliminated during the 2011-14 EFF, and a reopening of the TAP privatization and the public transport concessions, by renegotiating the former and suspending the Carris, STCP, and Metro de Lisboa subconcessions.[16] The structural

[15] See *IMF Country Report No. 15/127*.

[16] See *IMF Country Report 16/97*.

(continued)

reform agenda centers on developing human capital, reducing labor market segmentation[17], raising the minimum wage, and reforming state-owned enterprises[18] and public administration[19], although the details have yet to be specified fully.[20] Even though the interim objectives for eliminating the energy sector's tariff debt were met in 2015, the full tariff debt is now projected to be eliminated only in 2024 (four years after the target date under the program) to a large extent due to an increase in tariff subsidies.[21] Finally, the authorities announced a partial reversal of the 2014 judicial road map intended to consolidate locations and resources of court services to permit judicial specialization and enhance the efficiency of the courts.[22] In the absence of consolidated data, anecdotal evidence suggests that further efficiency gains are needed in the fiscal/administrative, and insolvency courts.

Staff views

32. Raising Portugal's growth potential is essential to accelerate income convergence and spur job creation. This takes on increased urgency in light of Portugal's demographic challenges, with an aging population and a declining labor force (Box 2). Raising Portugal's growth potential will require fully implementing the already-enacted reforms in labor and product markets to ensure that statutory changes are translated into tangible outcomes. Fresh labor market reforms are also needed, particularly with regard to re-integration of the longer-term unemployed and lower-skilled workers. There is little scope to reverse the policies that have made hiring and collective bargaining more flexible, since doing so could have adverse consequences for Portugal's growth outlook and prospects.

33. Uncertainty over the direction over structural reforms appears to be a significant factor in the slowdown in investment. While the authorities have not introduced any further

[17] In this area, the particular focus is on limiting temporary contracts, self-employment, and the scope for individual firms to deviate from sectoral collective bargaining agreements.

[18] The improvement in consolidated operational results of the state-owned enterprises has fallen short of government's targets. At end-September 2015, negative net income was about 6 times higher than projected, driven by the transport and health sectors, and the consolidated positive EBITDA is 44 percent lower than anticipated, mainly due to hospitals' underperformance.

[19] Efforts in this area are geared toward reducing red tape, simplifying the legal framework, and increasing decentralization.

[20] The National Reform Program (NRP) for 2016 puts forward initiatives to improve the skills of the labor force through reforms to the national education system, and additional funding for research in science and technology and IT training programs. In addition, the NRP seeks to foster innovation through investment in start-ups and SMEs. Financing for these various initiatives would primarily come from EU structural funds.

[21] Since 2006, the payments to electricity producers have been independent from demand, determined through contracts that hedged against oil price fluctuations, whereas end-user prices were set below cost. This resulted in multi-year tariff deficits, which generated a stock of tariff debt of €5 billion at end-2015.

[22] The implementation of a new judicial road map was intended to better align Portugal with European judiciary standards, and entailed closing 20 courts and converting 27 more to proximity sections. Prior to the implementation of the road map in 2014, Portugal had 3.18 courts and 19.2 judges per 100,000 inhabitants – significantly above the EU average of 2.37 courts per 100,000 inhabitants. The authorities have announced that all judicial units will be designated as courts and that five of the previous proximity sections will have permanent judges y.

changes in the labor market beyond the increase in the minimum wage, measures to protect sectoral collective bargaining—restraining the use of temporary contracts and limiting the flexibility for firm-level negotiations—remain under discussion. A change in the direction of reforms would add to the uncertainty already weighing on investment and diminish medium-term growth prospects. In particular, any unwinding of past policies that have succeeded in making hiring and collective bargaining more flexible would have adverse consequences for employment and the competitiveness of Portuguese firms (see Annex V).

34. An ambitious program of structural reforms is also needed to support the consolidation efforts, and promote growth and competitiveness. An efficient and effective public sector is essential for unlocking Portugal's growth potential through its positive effects on investor confidence, private employment and competitiveness. Priority should be given to streamlining the functioning of the public sector and limiting the energy costs. In particular:

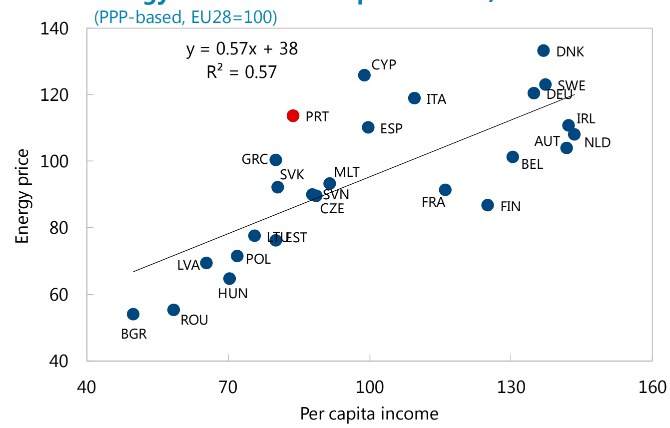
- Public administration reforms envisaged in the 2016 SP are limited and unlikely to generate savings. A more ambitious reform agenda is needed to reduce duplication in public service provision and improve efficiency at all levels of government. The authorities should also put more emphasis on the implementation of the new Budget Framework Law, which has suffered delays. Priority should be given to reinforcing the medium-term budget framework, reducing budget fragmentation, strengthening the financial management function in line ministries, and reinforcing transparency.

- In the judicial sector, the authorities should put on hold the reinstatement of courts and expansion of services pending a full consideration of a detailed cost-benefit analysis with the overall objective to bring the number of courts more closely in line with the European average. Efforts to improve the processing efficiency and reduce the disposition time in fiscal/administrative and insolvency courts should continue.

- The government should continue restructuring public enterprises forcefully and ensure that all SOEs are efficiently run to avoid incurring additional fiscal costs. In view of the authorities' argument that the subconcession process was suspended due to legal considerations, the process can now be restarted in line with appropriate legal requirements.

- In order to speedily eliminate the tariff debt, there should be no additional investment in energy infrastructure until the cost of previous investments has been fully recouped.

Energy Price and Per Capita Income, 2014
(PPP-based, EU28=100)



Source: Eurostat.

35. As outlined in earlier reports, an appropriately inclusive social dialogue is key to success of structural reforms. Engaging all stakeholders—including the unemployed, the broader labor force, and a wider cross-section of employers—in an open and transparent debate about the relative merits of reforms versus inaction will be crucial to creating and sustaining a pro-reform coalition in civil society.[23]

Authorities' views

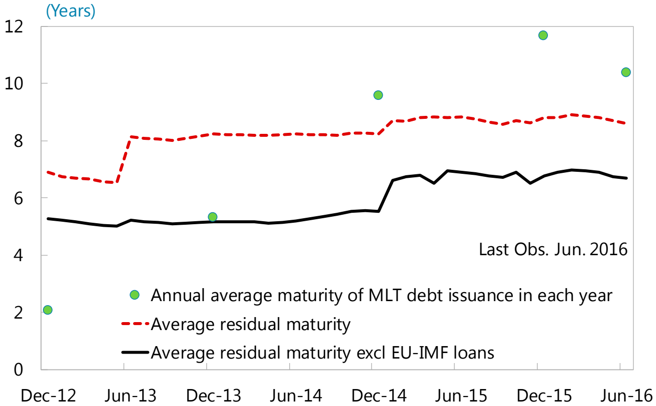
36. The authorities emphasized their commitment to carry forward the structural reforms implemented during the program. On the labor market, they noted that any changes would not constitute a change in the direction of reforms, but were intended to address social inequities that had emerged from growing labor market segmentation and the erosion of labor protection following the financial crisis.

POST-PROGRAM MONITORING

37. The risks to Portugal's capacity to repay are rising, but are expected to be manageable under the baseline. DBRS has maintained its investment-grade rating with a stable outlook, but most other outstanding risks—the sovereign's excessive reliance on external financing being principal among them—remain in place, and sovereign spreads and yields remain elevated.

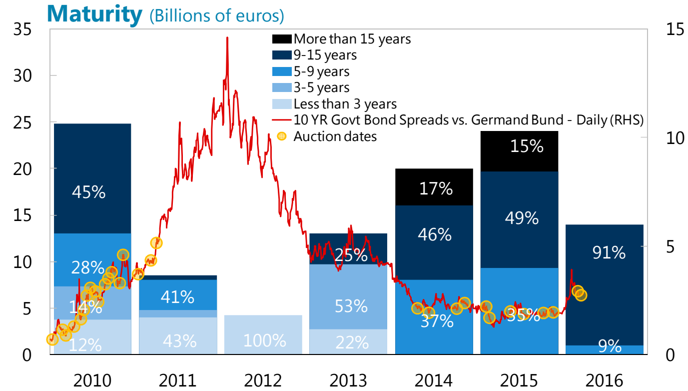
38. Portugal's debt management agency has been improving the profile of outstanding debt but has revised down its target cash balance for the end of the year. The average annual maturity of non-IMF/EU debt has risen from 5.1 years in 2013 to the current 6.7 years through a focus on long-term issuance and recent short-term debt buybacks. Debt risk metrics—such as gross financing needs and the debt-to-maturity ratio—are elevated, but remain inside the range of other high-yield and even some medium-yield European economies. Portugal has made €10.3 billion in advanced repurchases to the Fund in the PSPP era. Staff would welcome early payment

Portugal: Average Debt Maturity
(Years)



Source: IMF Vulnerability exercise database.

Portugal: Medium- and Long-Term Debt Issuance by Maturity (Billions of euros)



Sources: Portuguese Treasury and Debt Management Agency, Bloomberg, and IMF staff calculations.

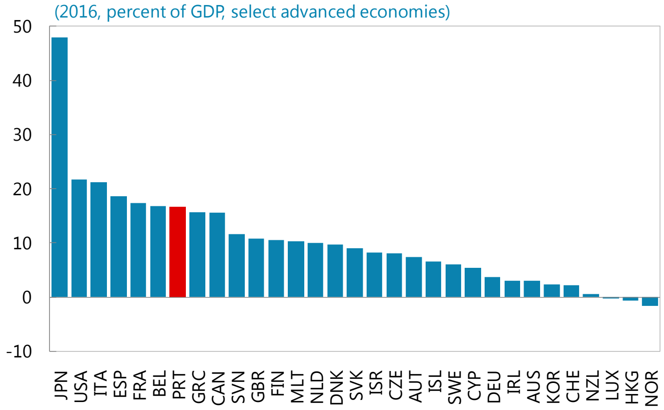
[23] For further discussion, see *IMF Country Report 15/126* and *IMF Country Report 16/97*.

commitments provided that adequate cash buffers can be maintained in the face of possibly volatile market conditions.

39. Market confidence remains essential. Spreads have been higher in 2016 than at any time since Portugal renewed the long-term debt auctions in April 2014. Further negative surprises in the financial sector, a renewed period of political instability arising from disagreements within the parties that support the Government in Parliament or with the EC, or external risks—such as fallout from the U.K. referendum, accelerated US monetary policy normalization, or a hard landing in China—could all push spreads even higher. PSPP purchases have been providing a guaranteed source of demand, but will likely hit the ECB's self-imposed limit of 33 percent of outstanding debt in early 2017, absent changes in the PSPP parameters.[24]

Gross Financing Needs

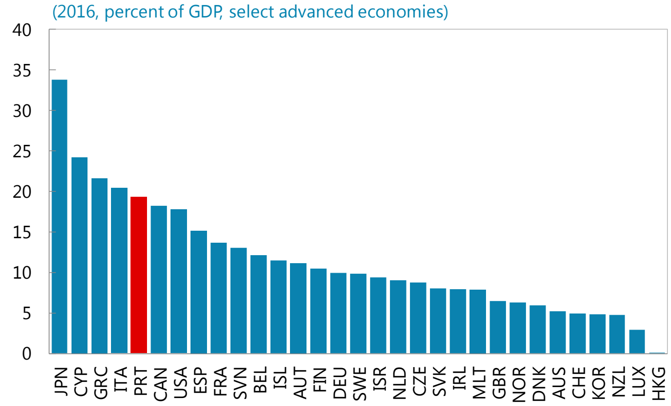
(2016, percent of GDP, select advanced economies)



Source: IMF Vulnerability exercise database, Summer 2016

Debt-to-Maturity Ratio

(2016, percent of GDP, select advanced economies)



Source: IMF Vulnerability exercise database, Summer 2016

STAFF APPRAISAL

40. Portugal has achieved a major economic turnaround since the onset of the sovereign debt crisis. Following the 2011-14 EFF, macroeconomic stability was regained and the economy began to recover from a deep recession. At the same time, comfortable market access was restored, current account deficits turned into surpluses and unemployment, though still high, has fallen from the peak of the crisis.

41. Notwithstanding these accomplishments, the economy is now at a challenging juncture. The consumption-based recovery of the past three years is running out of steam, the fiscal stance remains expansionary, the current account is weakening, and the banking system is plagued by low profitability and rising NPLs. Sovereign financing conditions are sensitive to global developments and are being supported to a large extent by ECB's PSPP, and the yields on

[24] Much of primary market demand is associated with the continued presence of the ECB as a secondary market buyer. The ECB is expected to purchase at least €6.6 billion in Portuguese bonds over the next 6 months against a planned issuance of €5.6 billion under the government's current fiscal projections.

Portuguese bonds, albeit low by historical standards, have diverged from those for Spain and Italy. The vulnerabilities in the banking system, public sector finances, and the macroeconomic outlook can potentially be self-reinforcing, with risks firmly on the downside.

42. A comprehensive approach is needed to address vulnerabilities in the banking system. To return to profitability and successfully finance economic growth, banks should clean up their balance sheets through a comprehensive approach to debt restructuring supported by an increase in capital, provisions, and impairments and by appropriately pricing and selling bad loans. In addition, banks should also reduce operating costs and improve their internal governance to let lending decisions be guided solely by commercial criteria. Solutions to the challenges facing Portuguese banks will ultimately need to be found at the national level, using the existing regulatory toolkit.

43. The 2016 budget target—a deficit of 2.2 percent of GDP—is appropriately ambitious but faces risks to execution. Even though the January-May outturn was broadly in line with the authorities' projections, declining GDP growth and emerging expenditure pressures—due to the move to the 35-hour work week for civil servants, the continued rollback of public sector wage cuts, and rising arrears—point to a deficit of close to 3 percent of GDP.

44. In view of vulnerabilities due to the high stock of public debt, the authorities need a credible fiscal strategy. With little room for corrective measures in 2016, policies need to look ahead. Well-specified measures, largely on the expenditure side and resulting in a structural primary adjustment of 0.5 percent of GDP in 2017 and 2018, would be an appropriate way forward. The authorities may wish to consider undertaking a top-down spending review, focusing in particular on better means-testing of social benefits, reducing healthcare costs, and controlling pensions and public sector wages. Tax policy should be more stable and predictable and aim at boosting competitiveness and growth rather than consumption.

45. The authorities should address uncertainty over the direction of structural reforms. Structural reforms are essential for raising Portugal's growth potential, but the recent reversals—among others, an increase in the minimum wage, reinstatement of public holidays, and revisiting of transport concessions—have generated uncertainty that appears to be a significant factor behind the slowdown in investment. Full implementation of the already-enacted reforms in labor and product markets must be complemented by additional steps to promote growth and competitiveness, with a particular focus on streamlining the functioning of the public sector and limiting the energy costs. Engaging all stakeholders by way of an appropriately inclusive social dialogue will be key to success of structural reforms.

46. Maintaining an adequate cash buffer becomes a priority. The authorities' commitment to repay Fund early is welcome, provided that adequate cash buffers can be maintained, in view of elevated spreads and pronounced risks.

47. Staff recommends the next Article IV consultation be held on the standard 12-month cycle.

Box 1. Banking System Challenges and Their Implications for Growth and Stability

The Portuguese banking system continues to suffer from high and rising non-performing loans. The majority of weak assets are loans to low-productivity firms in the nontradable sector. This legacy impedes the reallocation of credit to new higher-productivity sectors of the economy, while leaving the banking system vulnerable to negative shocks. A comprehensive solution to the banking system's challenges is therefore necessary to elevate Portugal's growth prospects and to safeguard financial stability.

Notwithstanding the macro-criticality of this issue, the prospects for progress are challenging: with inflation, growth, and interest rates all expected to remain low for long, Portuguese banks will not be able to generate sufficient profits in the foreseeable future to bolster capital cushions. With state ownership of CGD and Resolution Fund ownership of Novo Banco, two of the four major (and SSM-supervised) banks, and majority shareholders firmly in control of the other two, there is little impetus to aggressively cut costs and/or undertake measures that dilute ownership.

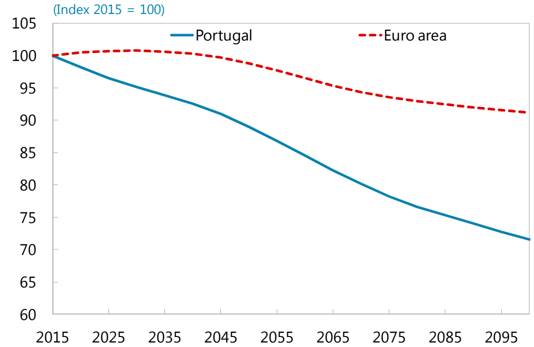
The true extent of a complete and decisive cleaning up bank NPLs is difficult to estimate. At the low end, the cost of raising the major banks' provisioning to 80 percent of recorded NPLs would entail around €3.5 billion (2 percent of GDP) in additional capital needs. This level of provisioning has been seen as the minimum needed by some of the healthier banks to dispose of NPLs without additional charges and can serve as a useful conservative benchmark. However, recent experience with Banif suggests that recorded NPLs may understate the true extent of the problem and overstate the residual value of assets. Applying more conservative assumptions would imply potentially larger system-wide costs of cleaning up legacy assets but would require access to detailed bank-level data to estimate with any degree of confidence.

Given the potential size of the problem and the incentives among banks in favor of the *status quo*, banks need to be more aggressive in addressing both legacy issues and improving their internal governance framework. While addressing legacy problems is an essential step to freeing up economic resources for new investment and job creation, there needs to be a fundamental change in the banking culture. In part, this means moving away from a bias towards lending to traditional corporates with whom banks have long-standing relationships. Moreover, banks' management should have the flexibility to restructure their operations and aggressively rein in costs, including through a reduction in branch network and staffing. Unless banks are focused on profitability and continuous reinforcement of capital buffers from their own resources, there is a high risk of onset of chronic banking system stress and calls for injection of public funds at repeated intervals. This would reinforce unhelpful bank-sovereign links and could lead to the build-up of problems in the future.

Box 2. The Demographic Challenge

Portugal is projected to face large adverse demographic developments. According to UN projections, Portugal's population has started to decline (by 2.2 percent between 2010 and 2015), and would further shrink by about 30 percent by 2100 in the baseline scenario, driven by continued migration outflows in the short term, and declining fertility rate in the medium and long terms.[1] As a consequence, the old age-dependency ratio would more than double in Portugal by 2050. These demographic developments would compare unfavorably with the Euro area average. And lower fertility or higher longevity scenarios point to an even larger impact on the ratio of old individuals to young, particularly in the long run.

Population Projections
(Index 2015 = 100)



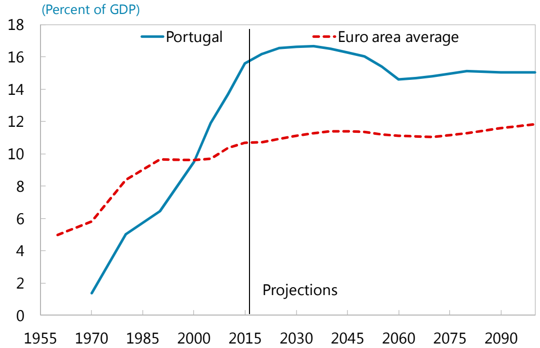
Source: United Nations.

These demographic developments would have a significant impact on economic growth. A reduction in the working-age population would negatively affect output, making it more difficult to reduce Portugal's high debt-to-GDP ratio over time. Labor market reforms could partially mitigate this trend by increasing labor force participation and reducing unemployment.

Shrinking population would place public finances under pressure, as age-related spending will significantly increase. With recent reforms limiting the fiscal impact of higher old-age dependency ratio, pension spending should remain roughly stable, albeit still significantly above Euro area average (by about 5 percentage points of GDP in 2050). However, total age-related spending would increase sharply under the baseline (about 6 percentage points of GDP in 2050), driven by health expenditure.[2]

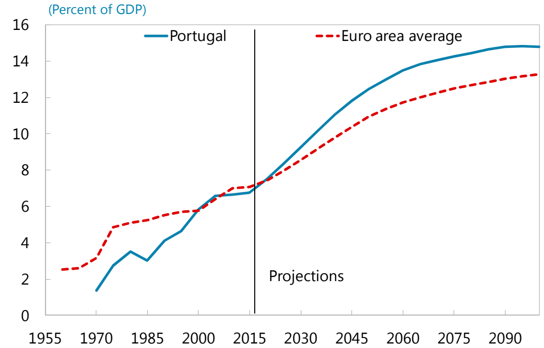
Therefore, a multi-pronged approach is needed to rein in age-related spending. Priority should be given to policies that affect demographics and labor markets in order to increase fertility rates, reverse migration outflows, and raise labor force participation of women and elderly. To rein in spending, the authorities should avoid policy-reversing pension reforms, while reducing grandfathering to generate savings in the short run. Improving efficiency of health spending would contain the growing costs of health care in the long run.

Pension Spending
(Percent of GDP)



Source: United Nations.

Health Spending
(Percent of GDP)



Source: United Nations.

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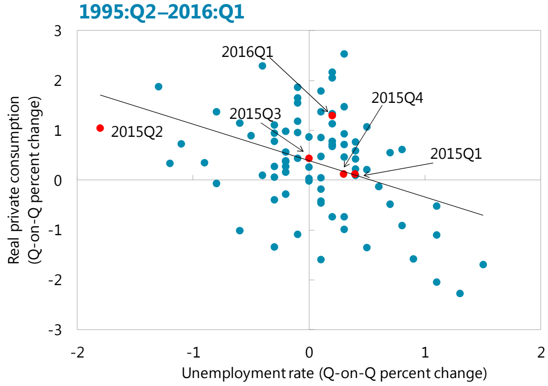
[1]All projections are based on Clements, B. *et. al.* (2015), "Fiscal Consequences of Shrinking Populations," *IMF Staff Discussion Note 15/21*.

[2] In addition, the EC projects an increase of long-term care spending of 0.5 percentage points of GDP by 2060.

Figure 3. Portugal: Selected Macroeconomic Developments

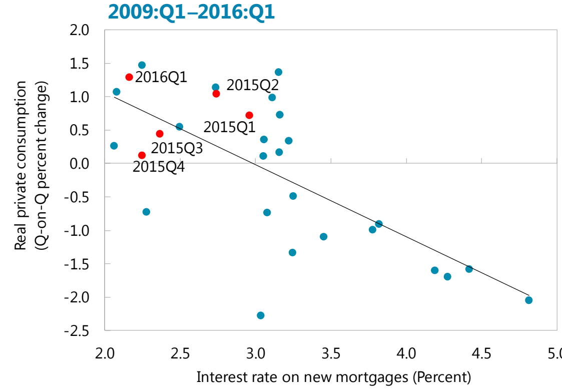
Falling unemployment is supporting consumption…

Consumption and Unemployment, 1995:Q2–2016:Q1



…as are low interest rates.

Consumption and Interest Rates, 2009:Q1–2016:Q1



Still-high debt constrains disposable income growth…

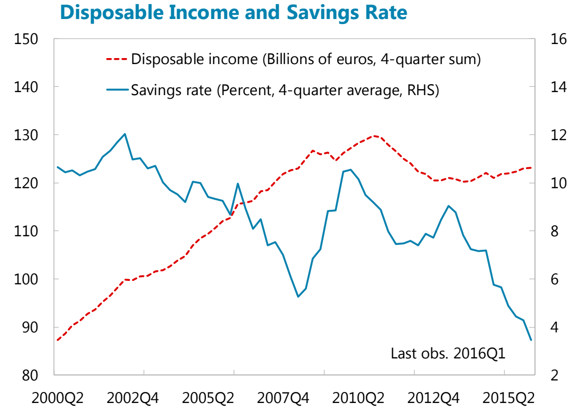
Composition of Non-Financial Sector Debt[1]

(Percent of GDP, unless otherwise indicated)

	end-2007	end-2015
Total non-financial sector debt	314.4	388.7
Public	85.9	163.8
General government (GG)	78.7	160.3
Of which: corporations inside GG	9.8	20.6
Corporations outside GG	7.2	3.5
Private	228.5	224.9
Corporations	138.1	144.8
Households and non-profit institutions serving households	90.4	80.1
Memorandum items:		
Consolidated GG debt	70.8	130.3
Public corporations inside and outside GG	17.0	24.1
Public and private corporations	155.1	168.9
Nominal GDP (Billions of euros)	*175.5*	*179.4*

…and the savings rate has fallen to a historically low level.

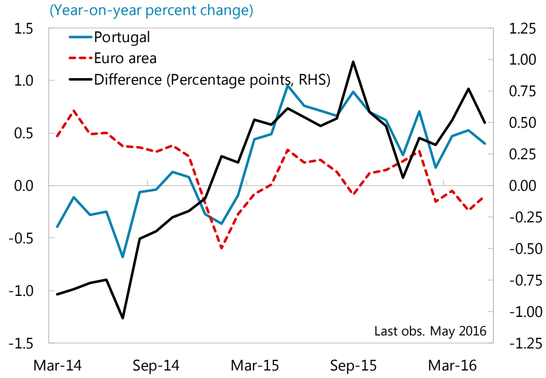
Disposable Income and Savings Rate



Inflation is back in positive territory…

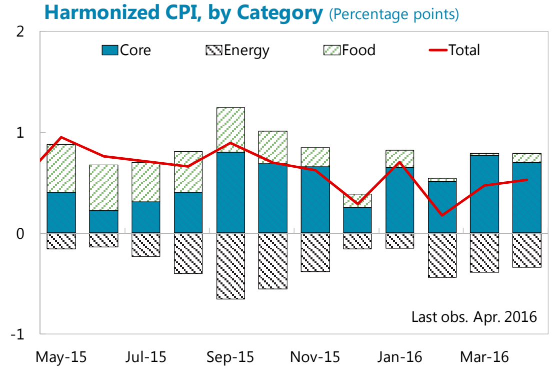
Harmonized Consumer Price Index

(Year-on-year percent change)



…driven by positive core inflation.

Contributions to Year-on-year Change in Harmonized CPI, by Category (Percentage points)



Sources: Haver Analytics; INE; and IMF staff calculations.

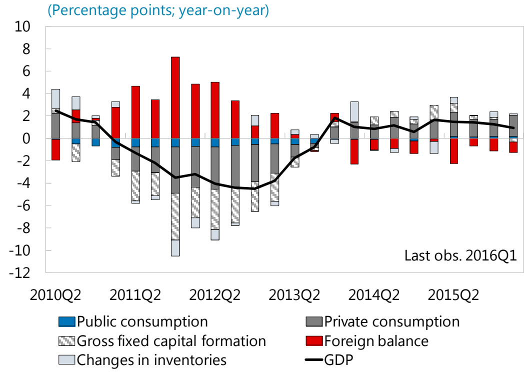
[1]Non-consolidated basis.

Figure 4. Portugal: Real Sector Indicators

Growth has eased to the 1.0-1.5 percent range.

Contributions to Real GDP Growth

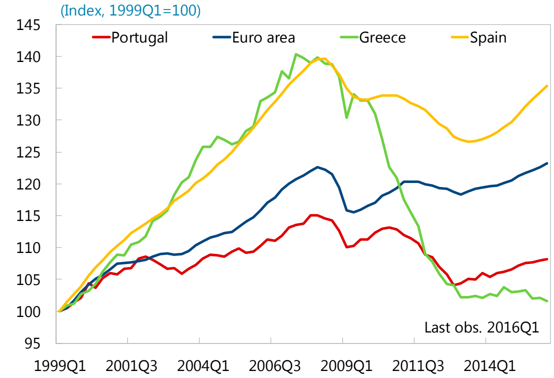
(Percentage points; year-on-year)



Portugal is not converging.

Real GDP

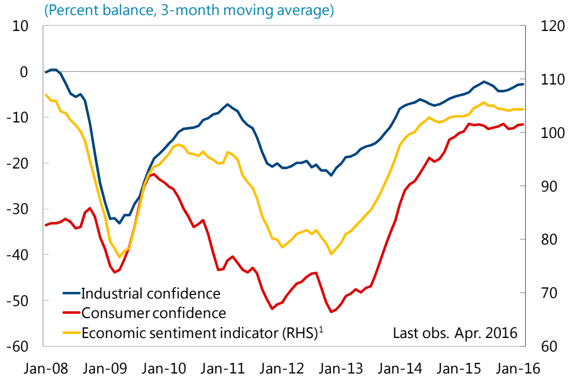
(Index, 1999Q1=100)



Confidence indicators remain strong.

Confidence Indicators

(Percent balance, 3-month moving average)



Minimum wages increased faster than average wages.

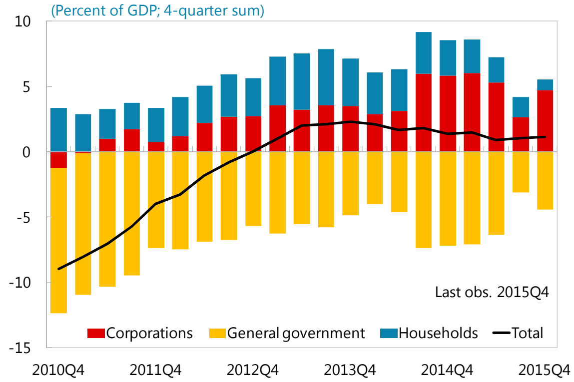
Ratio of Minimum Wage to Average Wage

(Full-time workers)

The country stopped borrowing...

Net Lending by Sector

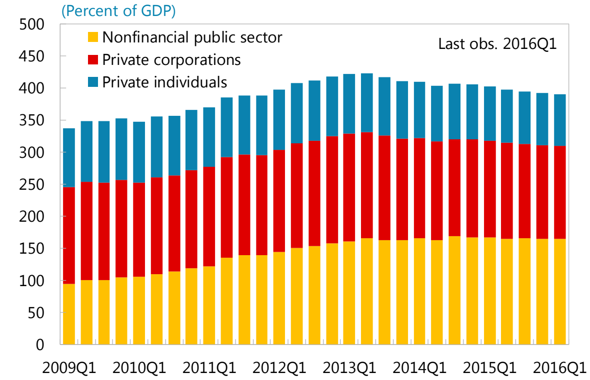
(Percent of GDP; 4-quarter sum)



...but debt is declining only gradually.

Non-Financial Sector Debt[2]

(Percent of GDP)



Sources: Bloomberg; Eurostat; Haver Analytics; INE; and IMF staff calculations.

[1]Long term average = 100.

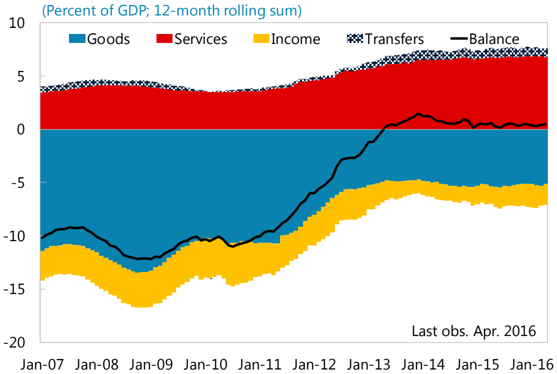
[2]Non-consolidated basis.

Figure 5. Portugal: Balance of Payments Developments

The current account has achieved a thin surplus …

Current Account

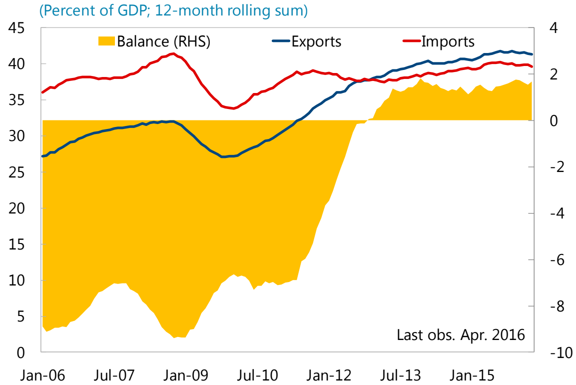
(Percent of GDP; 12-month rolling sum)



… driven by sustained performance in exports…

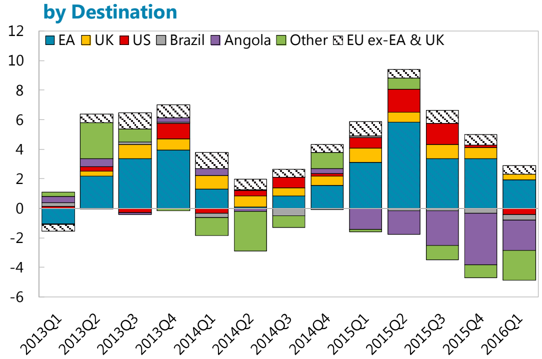
Trade in Goods and Services

(Percent of GDP; 12-month rolling sum)



… mostly to the euro area.

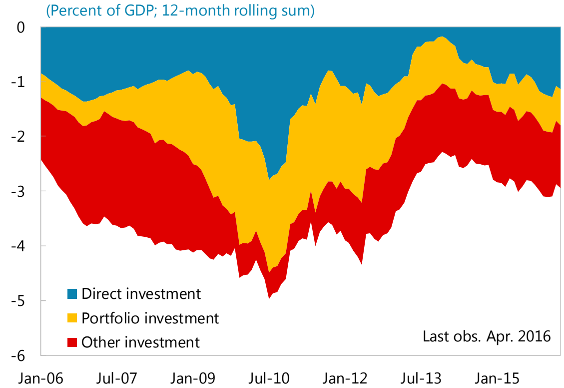
Contributions to Year-on-Year Export Growth by Destination



Income payments have declined with interest rates…

Income Account

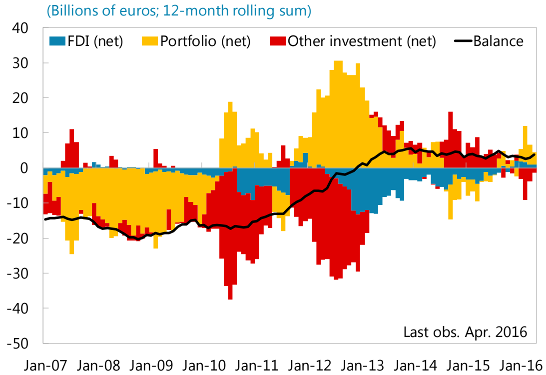
(Percent of GDP; 12-month rolling sum)



… with foreign investors investing in portfolio assets again.

Financial Account

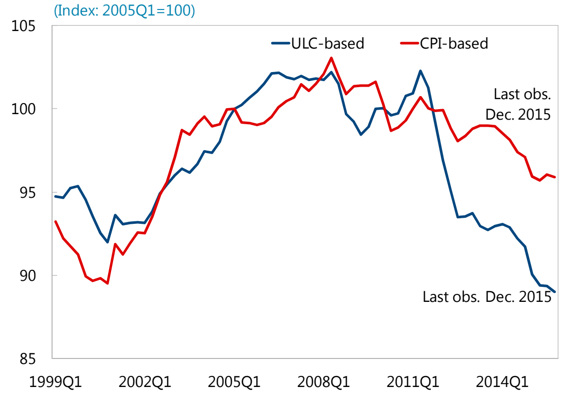
(Billions of euros; 12-month rolling sum)



Competitiveness indices have begun to improve, though sluggishly.

Real Effective Exchange Rate

(Index: 2005Q1=100)

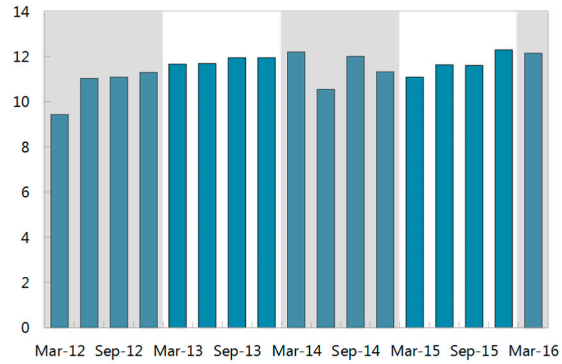


Sources: INE; Banco de Portugal; OECD; Eurostat; and IMF staff calculations.

Figure 6. Portugal: Financial Sector Developments

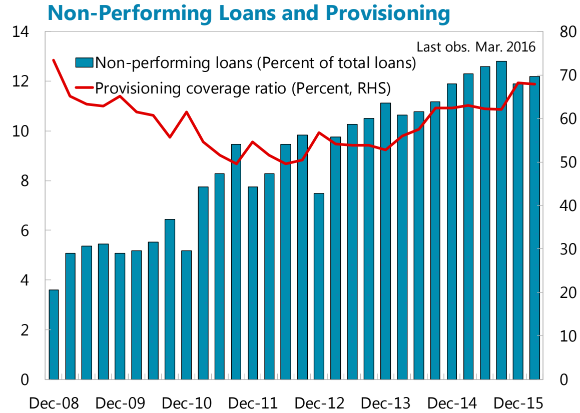
Capital is broadly stable…

Core Tier 1/Common Equity Tier 1 Capital Ratio
(Percent)



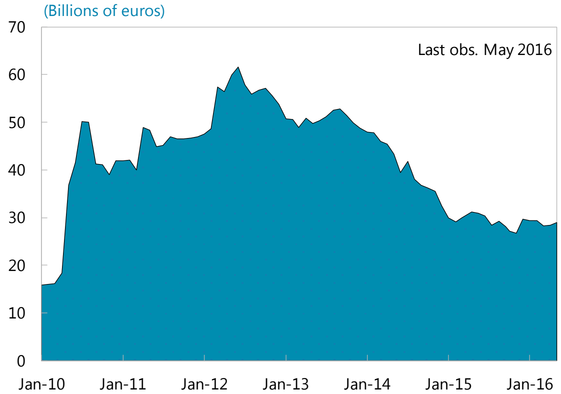
…but NPLs continue to rise as provisioning levels off.

Non-Performing Loans and Provisioning



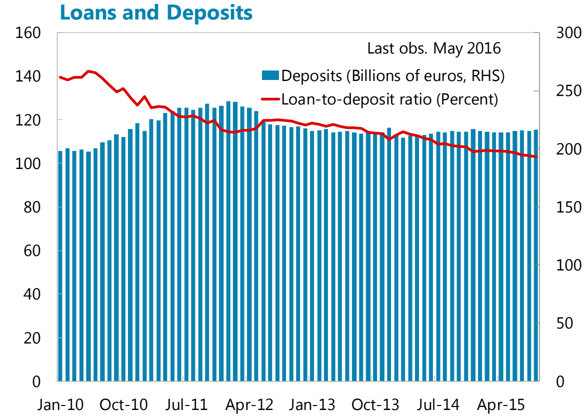
Reliance on Eurosystem financing has stabilized at a lower level…

Eurosystem Financing
(Billions of euros)



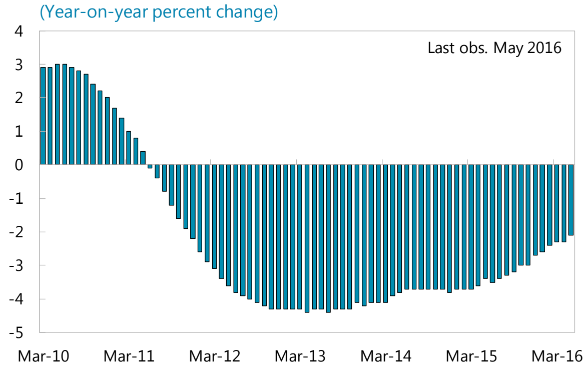
…and loan-to-deposit ratios are falling.

Loans and Deposits



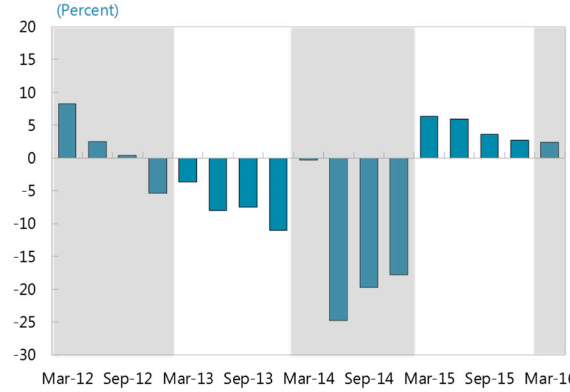
Lending continues to contract…

Private Sector Credit
(Year-on-year percent change)



…and profitability remains weak.

Return on Equity
(Percent)



Sources: Haver Analytics; Banco de Portugal; and IMF staff calculations.

Table 1. Portugal: Selected Economic Indicators, 2013–2021
(Year-on-year percent change, unless otherwise indicated)

	2013	2014	2015	2016 3rd PPM	2016 4th PPM	2017	2018	2019	2020	2021
				Projections						
Real GDP	-1.1	0.9	1.5	1.4	1.0	1.1	1.2	1.2	1.2	1.2
Total domestic demand	-2.0	2.2	2.5	1.4	1.2	1.3	1.3	1.3	1.3	1.3
Private consumption	-1.2	2.2	2.6	1.5	2.2	1.4	1.2	1.1	1.1	1.1
Public consumption	-2.0	-0.5	0.6	0.0	0.3	0.6	0.4	0.6	0.6	0.6
Gross fixed investment	-5.1	2.8	4.1	3.0	-1.2	2.0	2.4	2.4	2.4	2.4
Private	-3.3	3.0	3.2	3.3	-0.6	2.1	2.6	2.6	2.6	2.6
Government	-14.3	1.5	10.0	1.0	-4.4	1.1	1.1	1.2	1.2	1.2
Exports	7.0	3.9	5.2	4.2	2.9	3.4	4.2	4.0	4.1	4.2
Imports	4.7	7.2	7.6	4.0	3.2	3.8	4.3	4.1	4.2	4.2
Contribution to Growth										
Total domestic demand	-2.0	2.2	2.5	1.5	1.3	1.4	1.3	1.3	1.3	1.3
Private consumption	-0.8	1.5	1.7	1.0	1.4	0.9	0.8	0.8	0.8	0.8
Public consumption	-0.4	-0.1	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Gross fixed investment	-0.8	0.4	0.6	0.5	-0.2	0.3	0.4	0.4	0.4	0.4
Foreign balance	0.8	-1.3	-1.1	0.0	-0.2	-0.3	-0.2	-0.1	-0.2	-0.2
Savings-investment balance (Percent of GDP)										
Gross national savings	15.2	15.3	15.7	15.4	14.8	14.6	14.7	14.9	15.1	15.5
Private	18.1	20.4	17.9	16.4	15.7	15.6	15.6	15.8	16.1	16.5
Public	-2.8	-5.1	-2.2	-0.9	-1.0	-1.0	-0.9	-0.9	-0.9	-0.9
Gross domestic investment	14.6	15.1	15.2	14.5	14.7	15.1	15.4	15.8	16.3	16.9
Private	12.6	13.0	13.0	12.5	12.7	13.1	13.3	13.7	14.2	14.8
Public	2.1	2.1	2.2	2.0	2.0	2.0	2.0	2.1	2.1	2.1
Resource utilization										
Potential GDP	-0.3	-0.3	0.0	0.2	0.2	0.2	0.4	0.5	0.7	1.0
Output Gap (Percent of potential)	-6.2	-5.0	-3.7	-2.0	-2.9	-2.0	-1.2	-0.6	-0.2	0.0
Employment	-2.6	1.6	1.1	1.0	0.8	0.5	0.5	0.5	0.5	0.5
Unemployment rate (Percent)	16.2	13.9	12.4	11.6	11.8	11.3	10.9	10.4	10.0	9.5
Prices										
GDP deflator	2.3	1.0	1.9	1.5	1.7	1.3	1.4	1.5	1.7	1.7
Consumer prices (Harmonized index)	0.4	-0.2	0.5	0.7	0.7	1.1	1.4	1.5	1.6	1.8
Compensation per worker (Whole economy)	1.3	0.4	1.8	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Labor productivity	1.6	-1.5	0.4	0.4	0.2	0.6	0.7	0.7	0.6	0.6
Unit labor costs (Whole economy)	1.8	0.6	1.4	1.1	1.3	0.8	0.8	0.8	0.8	0.8
Money and credit (End of period, percent change)										
Private sector credit	-5.3	-8.0	-4.1	0.3	-2.2	-0.5	0.1	0.8	1.6	1.6
Broad money	0.2	-0.9	4.1	2.4	2.3	2.0	2.1	2.2	2.3	2.4
Interest rates (Percent)										
Short-term deposit rate	2.1	1.6	0.8	...	...	...	...	...	...	...
Government bond rate, 10-year	6.3	3.8	2.3	...	...	...	...	...	...	...
Fiscal indicators (Percent of GDP)										
General government balance	-4.8	-7.2	-4.4	-2.9	-3.0	-3.0	-2.9	-2.9	-2.9	-2.9
Revenues	45.1	44.5	43.9	43.6	43.7	43.5	43.4	43.2	43.1	42.9
Expenditures	49.9	51.7	48.3	46.5	46.6	46.4	46.2	46.1	46.0	45.8
Primary government balance	0.0	-2.3	0.2	1.7	1.6	1.5	1.5	1.5	1.4	1.4
General government debt	129.0	130.2	129.0	127.9	128.5	128.2	127.8	127.0	126.6	126.0
External sector (Percent of GDP)										
Trade balance (Goods)	-4.7	-5.5	-5.1	-4.5	-5.3	-6.0	-6.5	-6.9	-7.5	-7.9
Trade balance (Goods and Services)	1.8	1.1	1.7	2.7	1.8	1.1	0.8	0.6	0.2	-0.1
Current account balance	1.5	0.1	0.5	0.9	0.0	-0.6	-0.8	-1.0	-1.3	-1.6
Net international investment position	-116.5	-114.4	-109.4	-104.1	-105.2	-102.1	-99.1	-96.4	-94.0	-91.8
REER based on ULC (1999=100)	102.9	102.7	101.0	103.9	102.8	102.8	102.7	102.7	102.8	102.7
(Rate of growth)	1.7	-0.2	-1.7	2.7	1.8	0.0	-0.1	0.0	0.2	-0.1
REER based on CPI (1999=100)	107.4	106.9	106.4	108.9	107.1	107.2	107.4	107.5	107.6	107.8
(Rate of growth)	0.1	-0.5	-0.4	2.4	0.7	0.1	0.1	0.1	0.1	0.2
Nominal GDP (Billions of euros)	170.3	173.4	179.4	184.6	184.4	188.9	193.8	199.1	204.7	210.6

Sources: Banco de Portugal; Ministry of Finance; INE; Eurostat; and IMF staff projections.

Table 2a. Portugal: General Government Accounts, 2013–2021[1]
(Billions of euros)

	2013	2014	2015	Projections 2016	2017	2018	2019	2020	2021
Revenue	76.8	77.2	78.7	80.5	82.1	84.0	86.1	88.1	90.3
Taxes	42.7	43.6	45.5	46.8	48.1	49.4	50.7	52.1	53.5
Taxes on production and imports	23.3	24.6	26.1	27.5	28.3	29.1	29.8	30.6	31.4
Current taxes on income, wealth, etc. and capital taxes	19.4	19.0	19.5	19.3	19.8	20.3	20.8	21.4	22.0
Current taxes on income, wealth, etc.	19.4	19.0	19.5	19.3	19.8	20.3	20.8	21.4	22.0
Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	20.4	20.4	20.7	21.3	21.3	21.6	21.9	22.3	22.6
Grants and other revenue	13.6	13.3	12.4	12.4	12.7	13.1	13.4	13.8	14.2
Property income	2.1	1.7	1.4	1.4	1.4	1.5	1.5	1.5	1.6
Sales of goods and services	6.5	6.5	6.7	6.8	6.9	7.1	7.3	7.5	7.7
Other current revenue	3.1	3.6	3.0	2.8	2.9	3.0	3.1	3.2	3.2
Capital transfers and investment grants	1.9	1.4	1.3	1.4	1.5	1.5	1.5	1.6	1.6
Expenditure	85.0	89.7	86.6	86.0	87.7	89.6	91.9	94.1	96.5
Expense	86.3	91.2	88.0	87.9	89.6	91.6	93.9	96.2	98.6
Compensation of employees	21.3	20.5	20.3	20.8	21.2	21.7	22.3	22.8	23.3
Use of goods and services	9.6	10.1	10.6	11.5	11.8	12.1	12.5	12.8	13.2
Consumption of fixed capital	5.1	5.1	5.4	5.5	5.7	5.8	6.0	6.1	6.3
Interest	8.3	8.5	8.2	8.5	8.5	8.6	8.7	8.9	9.1
Subsidies	1.0	1.2	1.2	1.1	1.1	1.2	1.2	1.2	1.2
Social benefits	34.8	34.1	34.5	34.9	35.6	36.5	37.3	38.3	39.3
Grants and other expense	6.2	11.7	7.9	5.5	5.6	5.7	5.9	6.1	6.2
Other current expense	4.6	4.9	4.5	4.6	4.7	4.9	5.0	5.1	5.3
Capital transfers	1.5	6.8	3.4	0.8	0.9	0.9	0.9	0.9	1.0
Net acquisition of nonfinancial assets	-1.2	-1.5	-1.4	-1.9	-1.9	-2.0	-2.0	-2.1	-2.1
Gross fixed capital formation	3.8	3.6	4.0	3.7	3.8	3.8	4.0	4.1	4.2
(-) Consumption of fixed capital	-5.1	-5.1	-5.4	-5.5	-5.7	-5.8	-6.0	-6.1	-6.3
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
Gross Operating Balance	-4.4	-8.9	-3.9	-1.8	-1.8	-1.7	-1.8	-1.9	-2.0
Net lending (+)/borrowing (–)	-8.2	-12.4	-7.9	-5.5	-5.6	-5.6	-5.8	-6.0	-6.2
Net acquisition of financial assets	-2.0	-6.8	-4.4	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	1.2	0.0	-3.0	...	...	...	...	...	...
Debt securities	-0.3	-4.7	-1.0	...	...	...	...	...	...
Loans	0.0	-0.3	0.1	...	...	...	...	...	...
Equity and investment fund shares	-1.1	-2.1	-0.2	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.1	-0.3	...	...	...	...	...	...
Other accounts receivable	-1.8	0.2	-0.1	...	...	...	...	...	...
Net incurrence of liabilities	6.3	5.7	3.5	...	...	...	...	...	...
SDRs	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	1.2	4.9	4.0	...	...	...	...	...	...
Debt securities	-2.8	-1.8	11.2	...	...	...	...	...	...
Loans	9.0	3.6	-9.5	...	...	...	...	...	...
Equity and investment fund shares	-0.3	0.0	-0.2	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	0.0	...	...	...	...	...	...
Other accounts payable	-0.8	-1.0	-1.9	...	...	...	...	...	...
Memorandum items:									
Primary balance	0.0	-3.9	0.3	3.0	2.9	3.0	2.9	3.0	3.0
Debt at face value (EDP notification)	219.6	225.8	231.3	236.9	242.2	247.6	252.9	259.1	265.3
Nominal GDP	170.3	173.4	179.4	184.4	188.9	193.8	199.1	204.7	210.6

Sources: INE; and IMF staff projections.
[1]GFSM 2001 presentation.

Table 2b. Portugal: General Government Accounts, 2013–2021[1]
(Percent of GDP, unless otherwise indicated)

				Projections					
	2013	2014	2015	2016	2017	2018	2019	2020	2021
Revenue	45.1	44.5	43.9	43.7	43.5	43.4	43.2	43.1	42.9
Taxes	25.1	25.1	25.4	25.4	25.4	25.5	25.5	25.4	25.4
Taxes on production and imports	13.7	14.2	14.5	14.9	15.0	15.0	15.0	15.0	14.9
Current taxes on income, wealth, etc. and capital taxes	11.4	10.9	10.8	10.5	10.5	10.5	10.5	10.5	10.5
Social contributions	12.0	11.7	11.6	11.6	11.3	11.2	11.0	10.9	10.7
Grants and other revenue	8.0	7.7	6.9	6.7	6.7	6.7	6.7	6.7	6.7
Property income	1.3	1.0	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Sales of goods and services	3.8	3.8	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Other current revenue	1.8	2.1	1.7	1.5	1.5	1.5	1.5	1.5	1.5
Capital transfers and investment grants	1.1	0.8	0.7	0.8	0.8	0.8	0.8	0.8	0.8
Expenditure	49.9	51.7	48.3	46.6	46.4	46.2	46.1	46.0	45.8
Expense	50.7	52.6	49.1	47.7	47.4	47.3	47.2	47.0	46.8
Compensation of employees	12.5	11.8	11.3	11.3	11.2	11.2	11.2	11.1	11.0
Use of goods and services	5.6	5.8	5.9	6.3	6.3	6.3	6.3	6.3	6.3
Consumption of fixed capital	3.0	2.9	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Interest	4.9	4.9	4.6	4.6	4.5	4.4	4.4	4.4	4.3
Subsidies	0.6	0.7	0.7	0.6	0.6	0.6	0.6	0.6	0.6
Social benefits	20.4	19.7	19.2	18.9	18.9	18.8	18.8	18.7	18.6
Grants and other expense	3.6	6.7	4.4	3.0	3.0	3.0	3.0	3.0	3.0
Other current expense	2.7	2.8	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Capital transfers	0.9	3.9	1.9	0.5	0.5	0.5	0.5	0.5	0.5
Net acquisition of nonfinancial assets	-0.7	-0.9	-0.8	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Gross fixed capital formation	2.3	2.1	2.2	2.0	2.0	2.0	2.0	2.0	2.0
(-) Consumption of fixed capital	-3.0	-2.9	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0
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
Gross Operating Balance	-2.6	-5.1	-2.2	-1.0	-1.0	-0.9	-0.9	-0.9	-0.9
Net lending (+)/borrowing (–)	-4.8	-7.2	-4.4	-3.0	-3.0	-2.9	-2.9	-2.9	-2.9
Net acquisition of financial assets	-1.2	-3.9	-2.4	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	0.7	0.0	-1.7	...	...	...	...	...	...
Debt securities	-0.2	-2.7	-0.5	...	...	...	...	...	...
Loans	0.0	-0.2	0.1	...	...	...	...	...	...
Equity and investment fund shares	-0.6	-1.2	-0.1	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.1	-0.2	...	...	...	...	...	...
Other accounts receivable	-1.0	0.1	0.0	...	...	...	...	...	...
Net incurrence of liabilities	3.7	3.3	2.0	...	...	...	...	...	...
SDRs	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	0.7	2.8	2.2	...	...	...	...	...	...
Debt securities	-1.7	-1.0	6.3	...	...	...	...	...	...
Loans	5.3	2.1	-5.3	...	...	...	...	...	...
Equity and investment fund shares	-0.2	0.0	-0.1	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	0.0	...	...	...	...	...	...
Other accounts payable	-0.5	-0.6	-1.1	...	...	...	...	...	...
Memorandum items:									
Primary balance	0.0	-2.3	0.2	1.6	1.5	1.5	1.5	1.4	1.4
Structural balance (Percent of potential GDP)	-2.1	-1.0	-1.1	-1.6	-2.0	-2.3	-2.6	-2.8	-2.9
Structural primary balance (Percent of potential GDP)	2.5	3.7	3.3	2.8	2.4	2.1	1.7	1.5	1.4
Debt at face value (EDP notification)	129.0	130.2	129.0	128.5	128.2	127.8	127.0	126.6	126.0
Nominal GDP (Billions of euros)	170.3	173.4	179.4	184.4	188.9	193.8	199.1	204.7	210.6

Sources: INE; and IMF staff projections.
[1]GFSM 2001 presentation.

Table 3. Portugal: Monetary Survey, 2013–2021

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

	2013	2014	2015	2016	2017	2018	2019	2020	2021
				Projections					
Aggregated Balance Sheet of Monetary Financial Institutions (MFIs)[1]									
Assets	427,412	405,080	389,292	392,216	396,175	398,609	403,411	412,050	418,817
Claims on Bank of Portugal	9,841	5,093	9,353	8,096	7,853	7,617	7,389	7,167	6,952
Claims on non-residents	71,566	70,851	63,362	63,996	64,636	65,282	65,935	66,594	67,260
Claims on non-monetary resident sector	329,203	307,411	294,234	299,834	302,233	304,347	309,052	317,005	323,378
General government	38,691	41,503	39,945	47,630	52,069	54,184	56,756	61,605	64,568
Central government	32,935	34,990	33,634	41,259	45,689	47,739	50,312	54,918	57,851
Loans	1,725	3,092	2,547	5,311	7,966	9,453	13,808	17,493	20,792
Securities	31,210	30,072	29,087	21,748	22,483	28,991	29,450	28,665	28,051
General government, excluding central government	5,756	6,513	6,311	6,372	6,381	6,445	6,444	6,687	6,717
Private sector	241,767	222,379	213,194	208,504	207,461	207,669	209,330	212,679	216,082
Non-financial corporations	115,703	100,721	95,981	95,666	96,177	96,816	97,475	98,155	98,856
Private individuals[2]	126,064	121,658	117,213	112,838	111,285	110,853	111,855	114,524	117,226
Non-monetary financial institutions	46,693	43,327	41,081	43,700	42,703	42,495	42,966	42,721	42,727
Other assets	16,802	21,725	22,344	20,290	21,453	21,362	21,035	21,284	21,227
Liabilities	427,412	405,080	389,292	392,216	396,175	398,609	403,411	412,050	418,817
Liabilities to Bank of Portugal	48,810	32,503	29,616	28,728	27,866	27,030	26,219	25,432	24,669
Liabilities to non-residents	70,135	67,639	58,926	57,747	56,593	55,461	54,351	53,264	52,199
Liabilities to non-monetary resident sector	217,918	216,943	216,963	216,599	218,341	221,270	226,621	231,501	236,764
General government	10,530	10,550	8,474	11,700	9,700	8,000	7,929	7,858	7,754
Central government	9,222	9,120	6,667	9,205	7,631	6,294	6,238	6,182	6,100
General government, excluding central government	1,308	1,430	1,807	2,495	2,068	1,706	1,691	1,676	1,653
Private sector	155,144	156,344	160,673	165,159	169,809	174,627	179,620	184,794	190,155
Non-monetary financial institutions	43,761	41,062	37,358	39,740	38,833	38,644	39,072	38,850	38,855
Securities other than capital	37,858	28,670	24,404	25,136	25,890	26,667	27,467	28,291	29,140
Capital and reserves	52,691	59,325	59,383	64,006	67,485	68,181	68,752	73,561	76,045
Money and Credit									
Broad money (M3)	147,774	146,488	152,561	156,063	159,124	162,462	166,077	169,939	173,955
Intermediate money (M2)	143,949	143,762	149,632	153,067	156,069	159,342	162,888	166,676	170,615
Narrow money (M1)	50,475	54,989	66,401	67,925	69,258	70,710	72,284	73,964	75,713
Private sector credit	241,767	222,379	213,194	208,504	207,461	207,669	209,330	212,679	216,082
Public sector credit	38,691	41,503	39,945	47,630	52,069	54,184	56,756	61,605	64,568
(Percent of GDP)									
Broad money	86.8	84.5	85.1	84.6	84.2	83.8	83.4	83.0	82.6
Private sector credit	142.0	128.2	118.9	113.1	109.8	107.1	105.1	103.9	102.6
Public sector credit	22.7	23.9	22.3	25.8	27.6	28.0	28.5	30.1	30.7
(Percentage change)									
Broad money	0.2	-0.9	4.1	2.3	2.0	2.1	2.2	2.3	2.4
Private sector credit	-5.3	-8.0	-4.1	-2.2	-0.5	0.1	0.8	1.6	1.6
Public sector credit	-0.2	7.3	-3.8	19.2	9.3	4.1	4.7	8.5	4.8
Memorandum items:									
ECB access (Percent of assets)	11.4	8.0	7.6	7.3	7.0	6.8	6.5	6.2	5.9
Credit to deposits (Percent)	128.7	121.6	116.7	118.3	118.9	118.3	117.4	118.5	118.5
Loan to deposits (Percent)	111.0	105.4	100.6	99.9	99.8	99.3	99.6	100.6	101.2
Wholesale market funding (Percent of assets)[3]	21.4	19.6	16.6	17.0	17.3	17.8	18.1	18.2	18.5

Sources: Haver Analytics; Banco de Portugal; and IMF staff estimates.

[1]Excludes Banco de Portugal.

[2]Including emigrants.

[3]Includes foreign interbank borrowing and securities issued.

Table 4. Portugal: Balance of Payments, 2013–2021
(Billions of euros, unless otherwise indicated; end of period)

			Est.	Projections					
	2013	2014	2015	2016	2017	2018	2019	2020	2021
				(Billions of euros)					
Current account	2.5	0.2	0.8	0.0	-1.2	-1.6	-2.1	-2.7	-3.3
Balance of goods and services	3.1	2.0	3.1	3.3	2.0	1.6	1.1	0.5	-0.3
Trade balance	-8.1	-9.5	-9.2	-9.7	-11.4	-12.6	-13.8	-15.3	-16.7
Exports fob	46.5	47.2	49.0	47.9	51.2	54.0	56.6	59.3	62.4
Imports fob	54.5	56.7	58.2	57.6	62.6	66.6	70.4	74.6	79.1
Services, net	11.2	11.5	12.3	13.0	13.4	14.1	14.9	15.8	16.4
Exports	22.1	23.5	25.1	26.0	27.1	28.6	30.2	31.9	33.2
Imports	10.9	12.1	12.8	13.0	13.7	14.4	15.3	16.2	16.8
Of which:									
Tourism	6.1	7.1	7.8	8.1	8.4	8.9	9.4	9.9	10.3
Exports	9.2	10.4	11.4	11.8	12.3	12.9	13.7	14.5	15.1
Imports	3.1	3.3	3.6	3.7	3.9	4.1	4.3	4.6	4.8
Primary income, net	-2.2	-3.0	-3.8	-4.6	-4.5	-4.5	-4.5	-4.6	-4.5
Secondary income, net	1.5	1.3	1.6	1.3	1.3	1.3	1.3	1.4	1.5
Private remittances, net	3.1	3.0	3.2	3.0	3.0	3.1	3.1	3.2	3.3
Official transfers, net	-1.6	-1.7	-1.6	-1.7	-1.7	-1.7	-1.8	-1.8	-1.9
Capital account	2.8	2.6	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Financial account	17.2	8.4	3.3	2.3	1.1	0.7	0.2	-0.4	-1.0
Direct investment	-3.6	-2.6	1.9	2.0	2.0	2.0	2.1	2.1	2.2
Direct investment assets	5.1	7.2	0.7	0.7	0.8	0.8	0.8	0.8	0.9
Direct investment liabilities	8.7	9.8	-1.2	-1.2	-1.2	-1.2	-1.3	-1.3	-1.3
Portfolio investment, net	3.8	-1.3	-2.4	-2.4	-2.5	-2.6	-2.6	-2.7	-2.9
Financial derivatives	1.0	1.9	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Other investment, net	15.6	8.7	1.9	1.7	0.9	0.7	0.4	-0.2	-0.6
Reserve assets	0.4	1.7	1.5	0.7	0.4	0.2	0.1	0.0	0.0
Errors and omissions	0.3	0.4	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	11.7	5.2	...	...	...	...	...	...	...
European Union	8.2	3.5	...	...	...	...	...	...	...
IMF	3.4	1.8	...	...	...	...	...	...	...
Memorandum items:									
Net international investment position[1]	-198.3	-198.4	-196.2	-193.9	-192.8	-192.2	-192.0	-192.4	-193.4
Direct investment, net	-46.8	-47.9	-46.5	-44.6	-42.6	-40.6	-38.5	-36.4	-34.2
Portfolio investment, net	-18.4	-20.6	-23.4	-25.8	-28.3	-30.9	-33.5	-36.3	-39.1
Financial derivatives	-3.1	-1.8	0.1	0.4	0.7	1.0	1.3	1.6	1.9
Other investment, net	-142.7	-144.2	-144.2	-142.5	-141.5	-140.8	-140.5	-140.7	-141.3
Reserve assets	12.7	16.2	17.8	18.6	18.9	19.1	19.2	19.2	19.3
Nominal GDP	170.3	173.4	179.4	184.4	188.9	193.8	199.1	204.7	210.6
				(Percent of GDP)					
Current account	1.5	0.1	0.5	0.0	-0.6	-0.8	-1.0	-1.3	-1.6
Current account (Including capital transfers)	3.1	1.6	1.7	1.2	0.6	0.3	0.1	-0.2	-0.5
Of which: Balance of goods and services	1.8	1.1	1.7	1.8	1.1	0.8	0.6	0.2	-0.1
Net international investment position[1]	-116.5	-114.4	-109.4	-105.2	-102.1	-99.1	-96.4	-94.0	-91.8
Direct investment, net	-27.5	-27.6	-25.9	-24.2	-22.5	-20.9	-19.3	-17.8	-16.2
Portfolio investment, net	-10.8	-11.9	-13.0	-14.0	-15.0	-15.9	-16.8	-17.7	-18.6
Financial derivatives	-1.8	-1.0	0.1	0.2	0.4	0.5	0.7	0.8	0.9
Other investment, net	-83.8	-83.2	-80.4	-77.3	-74.9	-72.7	-70.5	-68.7	-67.1
Reserve assets	7.5	9.3	9.9	10.1	10.0	9.9	9.6	9.4	9.2

Sources: Banco de Portugal; and IMF staff estimates.
[1]End-of-period data.

Table 5. Portugal: Financial Soundness Indicators, 2012:Q1–2015:Q4[1]

(Percent)

	2012				2013				2014				2015			
	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.
Capital adequacy																
Regulatory capital to risk-weighted assets	10.7	12.3	12.3	12.6	13.0	13.1	13.4	13.3	12.3	12.0	13.0	12.3	12.0	12.5	12.6	13.3
Common Equity Tier 1 capital to risk-weighted assets									12.2	10.6	12.0	11.3	11.1	11.6	11.6	12.4
Regulatory tier 1 capital to risk-weighted assets	9.5	11.0	11.1	11.3	11.7	11.7	12.0	11.9	11.1	10.7	12.1	11.4	11.2	11.7	11.7	12.6
Capital to assets[2]	5.8	6.2	6.6	6.7	6.9	6.7	6.9	6.9	7.4	7.2	8.1	7.7	8.0	7.8	8.1	8.5
Asset composition and quality																
Non-performing loans to total gross loans[3]	8.0	9.2	9.8	9.8	10.4	10.6	11.2	10.6	10.8	11.2	12.0	12.0	12.3	12.6	12.8	11.9
Sectoral distribution of loans																
Residents	83.2	82.4	82.5	83.3	83.2	83.9	86.7	86.8	86.1	85.8	84.8	85.6	85.7	86.0	87.7	88.0
Nonresidents	16.8	17.6	17.5	16.7	16.8	16.1	13.3	13.2	13.9	14.2	15.2	14.4	14.3	14.0	12.3	12.0
Earnings and profitability																
Return on assets	0.5	0.1	0.0	-0.3	-0.3	-0.5	-0.5	-0.7	0.0	-1.8	-1.5	-1.3	0.5	0.5	0.3	0.2
Return on equity	8.2	2.5	0.3	-5.4	-3.7	-8.0	-7.5	-11.0	-0.4	-24.8	-19.8	-17.9	6.4	6.0	3.6	2.7
Interest margin to gross income	51.3	47.9	46.6	46.7	41.7	43.4	46.0	47.7	46.3	47.9	49.1	50.1	44.7	46.2	49.4	49.0
Noninterest expenses to gross income	58.2	55.0	57.0	59.6	66.2	66.6	68.5	70.4	59.5	66.9	67.0	67.4	53.3	55.0	59.6	59.3
Liquidity																
Liquid assets to total assets[4]	11.2	12.7	13.7	14.8	15.4	16.0	15.7	16.9	16.7	16.2	17.2	22.0	19.4	19.4	18.7	20.5
Liquid assets to short-term liabilities[4]	90.5	101.5	123.2	140.0	145.9	150.7	155.1	170.3	155.6	157.3	146.8	154.2	154.7	169.4	178.5	207.4
Loans to deposits[5]	136.9	136.3	133.3	127.9	124.0	122.6	120.7	116.9	117.2	113.9	111.9	107.2	106.9	106.0	104.6	102.6
Foreign-currency-denominated liabilities to total liabilities[6]	3.9	3.9	4.0	4.2	4.5	4.4	4.4	4.3	4.3	4.7	4.8	4.5	4.6	4.5	4.4	4.1

Source: Bank of Portugal.

[1]The banking system data present a break in time series in 2014Q3 due to the resolution measure applied to Banco Espírito Santo (BES). The break in time series stems, in particular, from the fact that the assets/liabilities not transferred to the balance sheet of Novo Banco (NB) are not considered in the aggregate of the banking system from August 2014 onwards. In the absence of accounting information for BES on a consolidated basis for the period from 30 June 2014 to the day of implementation of the resolution measure (closing balance sheet and statement of profit or loss), the reporting of BES on an individual basis, with reference to 31 July 2014, was considered when determining the aggregate results of the banking system for 2014Q3. However, the adjustments stemming from the resolution measure applied to BES were also not considered.

[2]On accounting basis; consolidated.

Source: Banco de Portugal.

[1]The banking system data present a break in time series in 2014:Q3 due to the resolution measure applied to Banco Espírito Santo (BES). The break in time series stems, in particular, from the fact that the assets/liabilities not transferred to the balance sheet of Novo Banco are not considered in the aggregate of the banking system from August 2014 onwards. In the absence of accounting information for BES on a consolidated basis for the period from June 30, 2014 to the day of implementation of the resolution measure (closing balance sheet and statement of profit or loss), the reporting of BES on an individual basis, with reference to July 31, 2014, was considered when determining the aggregate results of the banking system for 2014:Q3. However, the adjustments stemming from the resolution measure applied to BES were also not considered.

[2]On accounting basis; consolidated.

[3]New NPL ratio in line with international practices. On a consolidated basis.

[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.

Table 6. Portugal: External Debt Sustainability Framework, 2013–2021

(Percent of GDP, unless otherwise indicated)

			Est.	Projections						
	2013	2014	2015	2016	2017	2018	2019	2020	2021	Debt-stabilizing non-interest current account[6]
Baseline: External debt	227.1	235.6	223.0	216.3	211.2	208.2	205.0	201.3	198.1	-6.4
Change in external debt	-10.7	8.6	-12.6	-6.8	-5.1	-3.0	-3.2	-3.7	-3.1	
Identified external debt-creating flows (4+8+9)	-3.8	-4.4	-12.9	-6.9	-6.3	-6.1	-5.9	-5.5	-5.1	
Current account deficit, excluding interest payments	-7.3	-5.4	-5.5	-4.8	-3.6	-3.3	-2.8	-2.7	-2.0	
Deficit in balance of goods and services	-1.8	-1.1	-1.7	-1.8	-1.1	-0.8	-0.6	-0.2	0.1	
Exports	40.3	40.8	41.3	40.1	41.4	42.6	43.6	44.6	45.4	
Imports	38.4	39.7	39.6	38.3	40.3	41.8	43.0	44.3	45.5	
Net non-debt creating capital inflows (negative)	0.2	-0.1	-4.7	-4.6	-4.6	-4.6	-4.5	-4.5	-4.4	
Automatic debt dynamics[1]	3.3	1.2	-2.7	2.5	1.9	1.7	1.5	1.7	1.3	
Contribution from nominal interest rate	5.9	5.3	5.0	4.7	4.3	4.1	3.8	4.0	3.6	
Contribution from real GDP growth	2.7	-2.0	-3.3	-2.3	-2.4	-2.4	-2.4	-2.3	-2.3	
Contribution from price and exchange rate changes[2]	-5.3	-2.1	-4.5	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3)[3]	-6.9	12.9	0.3	0.1	1.2	3.2	2.6	1.8	2.0	
External debt-to-exports ratio (Percent)	563.7	577.7	540.1	539.7	509.8	488.6	470.5	451.5	436.2	
Gross external financing need (Billions of Euros)[4]	180.9	173.7	163.9	161.6	153.1	152.5	158.0	165.1	171.2	
Percent of GDP	106.2	100.2	91.4	87.6	81.0	78.7	79.4	80.6	81.3	
Scenario with key variables at their historical averages[5]				216.3	222.4	230.8	239.2	247.0	255.2	4.7
Key Macroeconomic Assumptions Underlying Baseline										
Real GDP growth (Percent)	-1.1	0.9	1.5	1.0	1.1	1.2	1.2	1.2	1.2	
GDP deflator in Euros (Percent)	2.3	1.0	1.9	1.7	1.3	1.4	1.5	1.7	1.7	
Nominal external interest rate (Percent)	2.5	2.4	2.2	2.2	2.0	2.0	1.9	2.0	1.8	
Growth of exports (Euros, percent)	6.5	3.2	4.7	-0.2	5.9	5.6	5.0	5.2	4.8	
Growth of imports (Euros, percent)	2.0	5.1	3.2	-0.5	8.0	6.3	5.7	6.0	5.7	
Current account balance, excluding interest payments	7.3	5.4	5.5	4.8	3.6	3.3	2.8	2.7	2.0	
Net non-debt creating capital inflows	-0.2	0.1	4.7	4.6	4.6	4.6	4.5	4.5	4.4	

Source: IMF staff calculations.

[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 7. Portugal: Indicators of Fund Credit, 2011–2021[1]

(Millions of euros, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Disbursements	13,050	8,219	3,406	1,786	...	...	...	...	...	...	...
(Percent of quota)	1,117	670	289	152	...	...	...	...	...	...	...
	(Projected debt service to the Fund, based on existing and prospective drawings)										
Total	178	460	621	822	9,211	5,083	2,512	421	2,508	5,012	4,247
Interest and charges	178	460	621	822	861	629	490	421	417	281	94
Repayments	0	0	0	0	8,350	4,454	2,022	0	2,092	4,731	4,153
Total debt service, in percent of											
Exports of goods and services	0.3	0.7	0.9	1.2	12.4	6.9	3.2	0.5	2.9	5.5	4.4
GDP	0.1	0.3	0.4	0.5	5.1	2.8	1.3	0.2	1.3	2.4	2.0
	(Projected level of credit outstanding based on existing and prospective drawings)										
Outstanding stock	13,494	21,583	23,998	27,105	20,845	15,974	13,922	13,899	11,765	7,020	2,866
Percent of quota[2]	1,117.1	1,787.1	2,076.2	2,228.0	1,589.1	621.5	542.7	542.7	460.9	275.3	112.4
Percent of GDP	7.7	12.8	14.1	15.6	11.6	8.7	7.4	7.2	5.9	3.4	1.4
Memorandum Items (Billions of euros)											
Exports of goods and services	62	64	69	71	74	74	78	83	87	91	96
GDP	176	168	170	173	179	184	189	194	199	205	211

Source: IMF staff estimates.

[1] Exchange rates reflect actual exchange rates where available, otherwise historical and projected WEO annual averages for flows and end-of-period values for stocks. Projections assume further advanced Fund repurchases in 2016–17, in line with the amount approved by Portugal's European partners. In the absence of additional advanced repurchases, Portugal's next repurchase is not due until September 2018.

[2] Quota increase in 2016.

Table 8. Portugal: General Government Financing Requirements and Sources, 2016–2021[1]

(Billions of euros)

	2016	2017	2018	2019	2020	2021
Gross borrowing need	38.1	29.2	26.8	33.3	35.3	42.3
Overall balance	5.5	5.6	5.6	5.8	6.0	6.2
Amortization	31.2	23.1	20.7	26.9	28.7	36.0
Medium- and long-term	16.2	10.5	10.2	14.3	13.4	21.3
Residents	4.1	3.1	4.4	7.3	5.6	11.4
Non-residents	12.2	7.4	5.8	7.0	7.8	9.8
Short-term[2]	10.5	10.5	10.5	10.5	10.5	10.5
Residents	6.8	6.7	6.7	6.7	6.7	6.7
Non-residents	3.7	3.8	3.8	3.8	3.8	3.8
EU and IMF[3]	4.5	2.0	0.0	2.1	4.8	4.2
Other (Net)[4]	1.4	0.6	0.5	0.6	0.7	0.2
Gross financing sources	38.1	29.2	26.8	33.3	35.3	42.3
Privatization receipts	0.0	0.0	0.0	0.0	0.0	0.0
Market access	36.9	28.5	26.1	32.3	35.1	42.3
Medium- and long-term	26.4	18.0	15.6	21.7	24.6	31.8
Residents	10.1	7.5	6.6	9.8	10.2	15.6
Non-residents	16.3	10.5	9.0	11.9	14.4	16.2
Short-term[2]	10.5	10.5	10.5	10.5	10.5	10.5
Residents	6.7	6.7	6.7	6.7	6.7	6.7
Non-residents	3.8	3.8	3.8	3.8	3.8	3.8
Use of deposits[5]	1.2	0.7	0.7	1.0	0.2	0.0
Net placement (Market access-amortization)	5.7	5.4	5.4	5.3	6.5	6.4
Residents	3.7	3.3	2.2	2.0	3.3	3.1
Medium- and long-term	3.8	3.3	2.2	2.0	3.3	3.1
Short-term (Net increase)	-0.1	0.0	0.0	0.0	0.0	0.0
Non-residents	1.9	2.1	3.2	3.3	3.1	3.2
Medium- and long-term	1.8	2.1	3.2	3.3	3.1	3.2
Short-term (Net increase)	0.1	0.0	0.0	0.0	0.0	0.0

Sources: Portuguese authorities; and IMF 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] For projection years, all treasury bill issuance is assumed to be short term (i.e. at maturities of 12 months or below).

[3] For EFSM loans, outstanding loans are assumed to be rolled over for an additional 7 years, as agreed with the EU. Projections assume further advanced Fund repurchases in 2016–17, in line with the amount approved by Portugal's European partners. In the absence of additional advanced repurchases, Portugal's next repurchase is not due until September 2018.

[4] 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.

[5] Changes in government deposits (including deposits in BSSF).

Table 9. Portugal: External Financing Requirements and Sources, 2016–2021

(Billions of euros, unless otherwise indicated)

	Projections					
	2016	2017	2018	2019	2020	2021
Gross financing requirements	161.6	153.1	152.5	158.0	165.1	171.2
Current account deficit	0.0	1.2	1.6	2.1	2.7	3.3
Medium- and long-term debt amortization	31.6	27.4	30.9	33.5	36.6	41.9
Public sector	12.2	7.4	5.8	7.0	7.8	9.8
Banks	14.1	15.6	19.7	19.9	20.2	20.5
Other private	5.3	4.4	5.4	6.5	8.7	11.6
Short-term debt amortization	125.5	122.5	120.0	120.4	121.0	121.8
Public sector	74.2	71.0	68.1	67.9	67.6	67.4
Central Bank	70.5	67.2	64.3	64.1	63.8	63.6
Of which: ECB access	28.8	25.5	22.6	22.4	22.2	22.0
General government and SOEs	3.7	3.8	3.8	3.8	3.8	3.8
Banks	35.1	36.9	38.7	40.7	42.7	44.8
Other private	16.3	14.6	13.2	11.8	10.7	9.6
EU and IMF[1]	4.5	2.0	0.0	2.1	4.8	4.2
Sources of financing	161.6	153.1	152.5	158.0	165.1	171.2
Capital account (Net)	2.3	2.3	2.3	2.3	2.3	2.3
Foreign direct investment (Net)	2.0	2.0	2.0	2.1	2.1	2.2
Inward	-1.2	-1.2	-1.2	-1.3	-1.3	-1.3
New borrowing and debt rollover	160.3	152.1	155.6	160.6	166.3	173.1
Medium and long-term borrowing	37.8	32.1	35.2	39.6	44.5	49.7
General government	16.3	10.5	9.0	11.9	14.4	16.2
Banks	15.2	16.8	20.7	21.1	21.3	22.0
Other private	6.4	4.8	5.4	6.5	8.7	11.6
Short-term borrowing	122.5	120.0	120.4	121.0	121.8	123.4
Public sector	71.0	68.1	67.9	67.6	67.4	67.2
Central bank	67.2	64.3	64.1	63.8	63.6	63.4
Of which: ECB access	25.5	22.6	22.4	22.2	22.0	21.7
General government	3.8	3.8	3.8	3.8	3.8	3.8
Banks	36.9	38.7	40.7	42.7	44.8	47.6
Other private	14.6	13.2	11.8	10.7	9.6	8.6
Other (Includes asset operations)	-2.9	-3.3	-7.3	-6.9	-5.6	-6.4
Of which: Net errors and omissions	0.0	0.0	0.0	0.0	0.0	0.0
Rollover rates						
General government	126.3	127.8	132.9	145.5	157.9	146.6
Private	103.2	102.8	102.2	102.6	102.6	103.8
Banks	105.8	105.8	105.2	105.3	105.1	106.5
Other private	97.4	94.6	92.9	93.5	94.5	95.5
Gross external debt	398.7	...	...	...	...	...
General government	164.7	...	...	...	...	...
Of which : short-term	6.1	...	...	...	...	...
Central Bank	80.1	...	...	...	...	...
Private	154.0	...	...	...	...	...
Banks	71.4	...	...	...	...	...
Of which : short-term	36.9	...	...	...	...	...
Non-financial corporates	82.6	...	...	...	...	...
Of which : short-term	14.6	...	...	...	...	...
(Percent of GDP)						
Gross external debt	216.3	...	...	...	...	...
General government	89.3	...	...	...	...	...
Central Bank	43.4	...	...	...	...	...
Banks	38.7	...	...	...	...	...
Non-financial corporations	44.8	...	...	...	...	...

Sources: Banco de Portugal; and IMF staff estimates.

[1] For EFSF loans, outstanding loans are assumed to be rolled over for an additional 7 years, as agreed with the EU. Projections assume further advanced Fund repurchases in 2016–17, in line with the amount approved by Portugal's European partners. In the absence of additional advanced repurchases, Portugal's next repurchase is not due until September 2018.

Annex I. Main Recommendations of the 2015 Article IV Consultation and Authorities' Response

Fund policy recommendations	**Policy actions**
1. Fiscal adjustment	
(a) Fiscal policy should be anchored around an annual structural primary adjustment of 0.5 percent of GDP.	The authorities' 2016 budget targets a primary structural adjustment of 0.2 percent of GDP, although there are significant risks to execution. The medium-term fiscal strategy targets an annual primary structural adjustment of 0.3 percent of GDP, although this depends in part on optimistic macroeconomic assumptions.
(a.1) Multi-year expenditure targets should be introduced to underpin a fiscal adjustment based on spending rationalization. (a.2) Specific policy measures to contain spending should be identified to enforce the expenditure targets, with a focus on public sector wages and pensions.	The 2016 budget frontloaded the unwinding of public sector wage cuts, to be offset by hikes in a range of indirect taxes. The authorities' medium-term fiscal strategy envisages a fiscal adjustment based on expenditure savings from a reduction of the public sector wage bill and rationalization of intermediate consumption, but contains little specificity on the required reforms. There are no immediate plans for introduction of multi-year expenditure ceilings.
(a.3) Priority should be given to the finalization and adoption of a new Budget Framework Law to improve budget preparation and execution.	The Budget Framework Law was approved in July 2015, but implementation has moved slowly.
2. Corporate deleveraging	
(b) Eliminating the corporate debt overhang is essential for Portugal's recovery .	Corporate deleveraging has moved slowly and high corporate indebtedness continues to constrain the pace of recovery. The large share of banks' assets tied up in unviable enterprises limits their space for new lending, while overleveraged households and corporates are not in a position to accumulate more debt.
(b.1) Banks should raise more capital and accelerate the pace of write-offs.	Banks have struggled to raise capital, reflecting weak profitability and concerns about asset quality. This in turn has limited their scope to deal more aggressively with NPLs and accelerate write-offs.
(b.2) The authorities should advance corporate governance reform to encourage firms to increase equity and reduce the tax debt bias.	The authorities' National Reform Program aims to increase investment in start-ups and SMEs by accessing EU structural funds.

3. **Structural reforms to restore competitiveness and growth**	
(c) Increase the effectiveness of the public sector and judicial system, and improve the payment discipline of public sector entities.	In 2016, the authorities announced a partial reversal of the 2014 judicial road map intended to consolidate locations and resources of court services to permit judicial specialization and enhance the efficiency of the courts. There have also signs of slippage on payment discipline, with a rise in public arrears in the first half of the year.
(d) Assess implementation gaps in measures to reduce the cost of energy, use of transport infrastructure and professional services. Provide greater resources and political support for the competition authority.	The interim objectives for eliminating the energy sector's tariff debt were met in 2015, but the full tariff debt is now projected to be eliminated only in 2024 (four years after the target date under the program), primarily due to an increase in tariff subsidies. There has been little movement in other areas.
(e) Invest in vocational training and programs to improve managerial skills. Develop a more inclusive unemployment support system and avoid premature increases in the minimum wage.	The National Reform Program aims to improve the skills of the labor force through reforms to the national education system, and additional funding for research in science and technology and IT training programs. The minimum wage was raised by 5 percent in January 2016, and accompanied by the reinstatement of four public holidays eliminated during the 2011-14 EFF. There have been no other changes on the labor market to date, but with discussions on possible measures to protect sectoral collective bargaining, restrain the use of temporary contracts and limit the flexibility for firm-level negotiations.

Annex II. External Stability Report

		Overall Assessment
Foreign asset and liability position and trajectory	**Background**. The negative net international investment position (NIIP) declined from its peak in 2012 of 117 percent of GDP to 109 percent of GDP at the end of 2015. This improvement has been driven by the dramatic reversal of the current account balance through the crisis, offset especially by improving external debt valuations. Gross external debt remains high at 222 percent of GDP. Both are expected to continue to decline but at a decelerating rate as the current account moves to deficit. **Assessment**. The large negative NIIP comes with external vulnerabilities, including from valuation changes and the large gross financing needs from external debt. Recent debt management efforts to reduce sovereign external risk, including by smoothing the profile for redemptions and lengthening the average maturity of the portfolio to 6.7 years have mitigated this risk somewhat. Nevertheless, Portugal remains exposed to a loss in confidence by external investors.	**Overall Assessment**: *The external position in Portugal in 2015 was weaker than that consistent with medium-term fundamentals and desirable policy settings. In 2016 the CA is projected to deteriorate somewhat with rising import demand, normalizing oil prices, and domestic price pressures.* In particular, despite the strong improvement in the current account since the crisis, reaching a more sustainable NIIP position would require a weaker effective exchange rate. **Potential policy responses**: Diminished reform momentum in 2015 gave way to partial reversals in 2016 which have moderated the outlook for sustained productivity improvements. A renewed effort to work out longstanding NPLs, accelerate judicial procedures, reduce electricity costs and improve transport links would help drive productivity improvements. Fresh labor market reforms to better integrate the low-skilled and long-term unemployed while maintaining past reforms to collective bargaining would help improve competitiveness on the cost side. Renewed fiscal consolidation, in concert with the ECB's current accommodative monetary policy would help reduce net interest payments and facilitate external deleveraging.
Current account	**Background**. The Portuguese current account achieved a surplus in 2013 after an extended period of deficits in the range of 10 percent of GDP, led by a meaningful expansion of exports as a percentage of GDP and a demand-driven contraction in imports. Since its peak surplus of 1.5 percent of GDP in 2013 the current account has drifted downward, in spite of significantly lower oil prices and a depreciated euro. It is expected to return to deficit due to consumption in 2017. **Assessment**. EBA model-based estimates suggest an elimination of the current account gap, representing a 2 percent decline since the 2014 assessment. Nevertheless, staff assesses the current account surplus to be insufficient in view of the large NIIP deficit which needs to be put on a sustained downward trajectory. Relative to a current account surplus which would achieve a meaningful medium-term reduction in the NIIP, staff assesses a current account short fall of between 2 and 4 percent of GDP, consistent with EBA results on the REER. By contrast the current baseline is for a current account turning to deficit in the next 2 years.	
Real exchange rate	**Background**. In 2015 the CPI-based real effective exchange rate (REER) declined by more than 5 percent from its pre-crisis peak while the unit labor cost-based REER fell by more than 10 percent, though labor costs in non-tradable sectors played an outsized role in this change. While the euro has remained depressed in the aftermath of Brexit, Portugal is experiencing higher inflation than other euro area countries while the increase in the minimum wage and acceleration in public wage increases will likely put further pressure on competitiveness. **Assessment**. The EBA's *index* and *level* REER regression models indicate an overvaluation of 5 and 9 percent respectively for 2015. These metrics are in line with staff's views about the competitiveness challenges in Portugal and the need to put the NIIP deficit on a decisive downward trajectory, and staff's estimate of a current account shortfall of between 2 and 4 percent.	
Capital and financial accounts: flows and policy measures	**Background**. Financing conditions have eased dramatically since the resumption of sovereign market access in 2014, but sovereign spreads to bunds demonstrate rising investor concern but are contained by ECB purchases under PSPP. Wholesale funding of banks has continued to decline sharply. External financing in general appears to be turning increasingly away from equity towards debt-based instruments. **Assessment**. A current account surplus and ECB policy actions have helped support external financing rollover needs for the immediate future. Further policy action will be needed over the medium term to maintain investor confidence and rule out negative equilibria.	
FX intervention and reserves level	**Background**. The euro has the status of a global reserve currency. **Assessment**. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.	

Annex III. Risk Assessment Matrix[1]

Source of Risks	Relative Likelihood	Impact	Policy response
Loss of investor confidence due to reform reversals or other negative surprises potentially including difficulties in the banking sector or loss of sole investment-grade rating: • Increase in sovereign bonds yields and reduction in foreign direct investment.	High	**High** Significant funding distress higher public and private borrowing costs.	**To minimize exposure:** Strengthen policy buffers and avoid backtracking on reforms. **If risk materializes:** Take steps to restore market access at favorable terms and ensure banks' access to liquidity is maintained. Take fiscal measures to ensure fiscal targets are being met.
Tighter or more volatile global financial conditions: • **Sharp rise in risk premia with flight to safety:** Investors withdraw from specific risk asset classes as they reassess underlying economic and financial risks in large economies, or respond to unanticipated Fed tightening, and increases in U.S. term premia, with poor market liquidity amplifying volatility. Safe haven currencies—especially the US dollar—surge creates balance sheet strains for FX debtors.	Medium	**High** Given its high corporate and private debt levels, Portugal would be highly susceptible to financial contagion. The result would be a heightened financial stress in the Portuguese banking system, as balance sheet fragilities in both banking and corporate sectors are still significant.	**To minimize exposure:** Shore up liquidity and capital buffers; encourage private savings, and shrink private sector balance sheets. **If risk materializes:** ECB policy actions to ensure market liquidity, encourage lending to productive investment opportunities, and ensure orderly monetary transmission mechanisms, including expansion of asset purchase programs.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short term" and "medium term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Source of Risks	Relative Likelihood	Impact	Policy response
Economic fallout from political fragmentation: • **Protracted uncertainty associated with negotiating post-Brexit arrangements** could weigh on confidence and investment more than expected—most prominently in the UK and the rest of Europe with possible knock-on effects elsewhere. Increased barriers could also dampen the longer-run economic performance of affected countries more than expected.	**Medium**	**Medium** Portugal exports 3 percent of its GDP to the UK, the fourth most among Portuguese export destinations but below average across EA economies. Market reaction to the referendum result was meaningful but within recent swings.	**If risk materializes:** UK and EA institutions should work collaboratively towards a smooth and predictable transition. ECB policy actions rein in financial volatility risk. Renewed structural reform effort to expand exports to other markets.
Weaker-than-expected global growth: • **Structurally weak growth in key advanced and emerging economies:** Weak demand, low productivity growth, and persistently low inflation from a failure to fully address crisis legacies and undertake structural reforms, leading to lower medium-term path of potential growth (the Euro area, Japan, and the United States) and exacerbating legacy financial imbalances especially among banks (the Euro area) (high likelihood). Tighter financial conditions and insufficient reforms undermine medium-term growth in emerging markets (medium likelihood).	**High (US, euro area, and Japan)** **Medium (Emerging Markets)**	**High** Low growth would imperil debt dynamics in all sectors, with the euro area accounting for 60 percent of total exports putting the current account balance and IIP at risk.	**To minimize exposure:** Step up structural reforms to improve competitiveness and reduce debt overhang. **If risk materializes:** Accelerate and deepen domestic structural reforms.

Source of Risks	Relative Likelihood	Impact	Policy response
Persistently lower energy prices, triggered by supply factors reversing more gradually than expected.	High	Medium A low fuel import bill is potentially offset by greater difficulties in Angola, a key economic and financial partner.	**To minimize exposure:** Step up efforts to clean up corporate balance sheets, including the reduction of exposures to Angola. **If risk materializes:** Shore up the banks using the existing toolkit, while ensuring public debt dynamics are not compromised. Renewed structural reform effort to expand exports to other markets.
Financial distress in one or more banks, requiring intervention.	Medium	High Loss of confidence in the banking system, resulting in potentially high fiscal costs.	**To minimize exposure:** Proactive bank supervision to ensure balance sheet clean-up, a build-up of capital buffers in banks and of fiscal buffers. Strengthen oversight of banks' risk management practices. **If risk materializes:** Shore up the banks using the existing toolkit, while ensuring public debt dynamics are not compromised.

Annex IV. Public Debt Sustainability Analysis (DSA)

Staff's analysis, applying the Public DSA framework for Market-Access Countries, suggests that Portugal's gross debt trajectory is subject to significant risks, in the context of a sizable debt burden and gross financing needs. Debt dynamics remain highly vulnerable to adverse yet plausible macro-fiscal and contingent liabilities shocks, including the possible need for further fiscal support for the financial sector. The risk of a contingent liabilities shock materializing remains elevated, in light of financial sector vulnerabilities. Staff's baseline projections reflect the authorities' current fiscal policies; additional fiscal consolidation remains critical to anchor debt safely on a downward-sloping path, boosting policy credibility and strengthening the country's resilience to reversals in market sentiment.

I. Baseline Scenario

1. There was a modest decline in public debt in 2015 despite large fiscal costs related to financial sector operations. Public debt fell from 130.2 to 129.0 percent of GDP at end-2015, primarily reflecting a large drawdown of deposits, as the authorities used large cash reserves to help finance early Fund repurchases. Portugal's debt net of central government deposits rose further to 121.6 percent of GDP from 120 percent of GDP at end–2014. A modest decline in public debt is projected to continue through 2021 as the headline fiscal deficit stabilizes just below 3 percent of GDP, but public debt would still remain elevated at 126.0 percent of GDP in 2021. The further drawdown of cash deposits from 2016–21 is projected to be modest, reflecting the authorities' intention to maintain cover for 6 months' refinancing needs. Potential proceeds from the sale of financial sector assets (including Novo Banco) have not been included in the baseline, reflecting considerable uncertainty over prospects for the sale of these assets.

II. Risk Assessment

2. Portugal's sizable debt burden and gross financing needs continue to pose significant risks to debt sustainability and leave debt dynamics very sensitive to macro shocks. As shown in Figure 1, Portugal's debt ratio already exceeds the debt burden benchmark for advanced economies of 85 percent of GDP under the baseline scenario. While the authorities have made progress over the past year in borrowing at longer maturities in order to smooth the repayment profile of public debt, Portugal's public financing needs also exceed the relevant benchmark of 20 percent of GDP during the projection period. However, the debt profile is subject to medium to low risks in terms of market perception, projected change in short-term debt, and the share of public debt held by nonresident.[1] Moreover, in the case of Portugal, since bank vulnerabilities are below the relevant thresholds identified by the MAC DSA template, the standardized contingent liabilities shock does not apply. Nevertheless, this is replaced by a customized shock given the risks posed by the materialization of contingent liabilities from SOEs and PPPs (please refer to the stress test customized scenario).

III. Realism of Baseline Assumptions and Alternative Scenarios

3. Realizing the potential growth rate assumed in the current projection has important implications for the debt adjustment path. Portugal's growth forecast track record shows a relatively large median error compared with other countries with Fund-supported programs, especially during the pre-crisis period (Figure 2). The achievement of a growth rate of 1.2 percent over the medium term, as per staff's updated projection, is consistent with moderate growth convergence. If growth were to turn out lower than currently projected—for instance as a result of reversal of structural reforms—the rate of debt decline would significantly slow down, as also shown in Figures 4 and 5. Similarly, risks from a protracted period of negative inflation in Portugal could further impede the repair of already-weak private and public balance sheets, as highlighted by the customized deflation scenario in Figure 5.

4. Given Portugal's sizable debt burden and financing needs, the primary balance is expected to exceed its debt-stabilizing threshold over the projection period. Under staff's baseline scenario,[2] the fiscal primary balance is expected to stabilize at around 1.5 percent of GDP over the medium term. Nevertheless, Portugal's debt profile remains highly vulnerable to a primary balance shock (Figures 4 and 5), as also highlighted by the asymmetric fan chart analysis in Figure 1, which shows the risks to the debt outlook if only negative shocks to the primary balance were to materialize. The authorities' medium-term fiscal strategy under the Stability Program for 2016–20 envisages a reduction in public debt to 110.3 percent of GDP by 2020. However, this projection is based on a very ambitious timetable for fiscal adjustment and incorporates optimistic assumptions on both receipts from the sale of financial sector assets and medium-term growth. The Stability Program assumes annual real GDP growth of 2.0 percent in 2017–20, as opposed to staff's baseline projection of average annual growth of 1.2 percent over the same period.

[1] The total (public and private) external financing requirements exceed significantly the relevant benchmark under the baseline. However, in the case of Portugal, the figure includes, among others, non-residents bank deposits, accounting for about 45 percent of GDP.

[2] In line with the WEO guidelines, medium-term assumptions that are not backed up by well-defined fiscal measures are not incorporated by the team under the baseline scenario.

IV. Stress Test

5. The baseline remains highly sensitive to macro-fiscal and contingent liabilities shocks (Figure 5):

- Under a *growth shock* that lowers output by nearly 4.5 percentage points in 2016–17 (and in turn inflation by a cumulative 1 percentage point), debt would peak at about 139 percent of GDP in 2018, 11 percentage points higher than under the 2016 baseline. However, debt dynamics would be severely compromised under a *deflation scenario* where a sharper growth shock (that lowers output by 5½ percentage points in 2016–17) is associated with deflationary pressures (with inflation lower by cumulative 4 percentage points), in the context of a widening output gap and high unemployment. Under this scenario, debt would rise to 148 percent of GDP by 2018 and remain close to this level over the medium-term.

- A sustained interest rate shock of 200 basis points throughout the projection period is not expected to 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 about 3 points higher compared with the baseline.

- Further materialization of contingent liabilities would also have implications for Portugal's debt dynamics. While the recent debt management operation for SOEs has significantly addressed fiscal risks from the transport and infrastructure sectors, staff's assessment suggests that, under a severe scenario, further contingent liabilities could potentially materialize of about 10 percent of GDP, due to financial sector risks, SOEs, PPPs, and State guarantees.[3] A contingent liabilities shock of this magnitude would push the 2017 debt ratio to 138 percent of GDP.

- A severe combined shock that incorporates the macro-fiscal and contingent liabilities adverse scenarios mentioned above would significantly affect the country's debt dynamics, with debt rising to 147 percent of GDP in 2018 and then remaining at this level over the medium term.

6. The authorities took note of the risks highlighted by staff, but also stressed the divergence of their medium-term outlook from staff's baseline scenario. The authorities were optimistic that reforms in recent years have laid the foundation for stronger export-oriented growth,

[3] Staff's assumptions for the adverse contingent liabilities scenario include (i) the hypothetical cost of further financial sector operations; (ii) staff's estimate of potential contingent liabilities from PPPs based on financial rebalancing requests by concessionaires; (iii) the hypothetical settlement of the outstanding stock of arrears; (iv) staff's estimate of potential contingent liabilities from other non-bank debt directly guaranteed by the State and/or classified outside the general government perimeter.

which would underpin a larger improvement in medium-term debt dynamics than projected by staff. In addition, they remained confident that the 2016 fiscal deficit target will be achieved, resulting in a larger reduction of the debt-to-GDP ratio by the end of the year, and putting debt dynamics on a trajectory to improve at a faster pace than envisaged under staff's baseline scenario. Over the medium-term, the authorities reiterated their commitment to medium-term fiscal consolidation as outlined in their 2016 Stability Program. In the near-term, they were optimistic that Portugal's record of fiscal adjustment and reform implementation under the adjustment program had strengthened their credibility with investors, and would enable them to avoid any prolonged deterioration in market access.

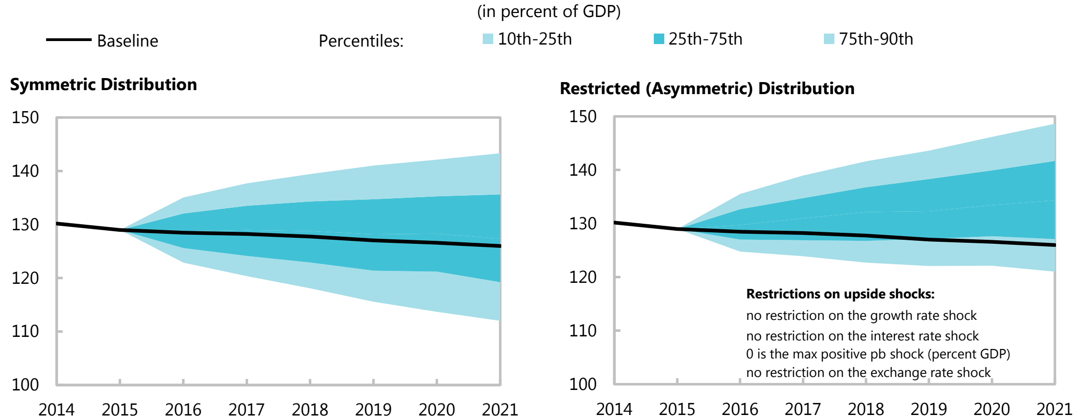
Portugal: Public DSA Risk Assessment, 2014–2021

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

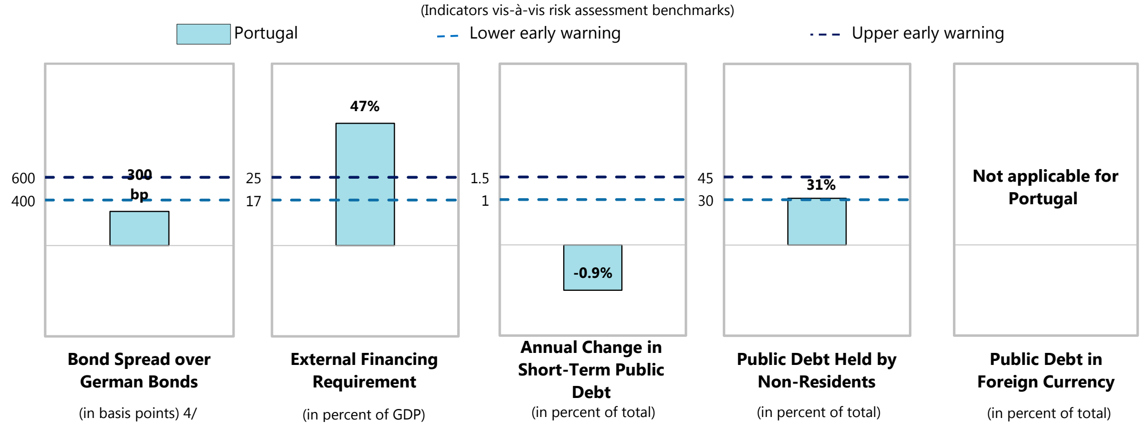
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)



Source: IMF staff estimates.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant. In the case of Portugal, the benchmark is already exceeded under the baseline (implying that any specific shock, regardless of its size, is reported as red). Moreover, the standardized contingent liabilities shock of the MAC DSA template (based on bank vulnerabilities and below the relevant threshold for Portugal) is replaced by a customized shock based on contingent liabilities risks from SOEs and PPPs.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

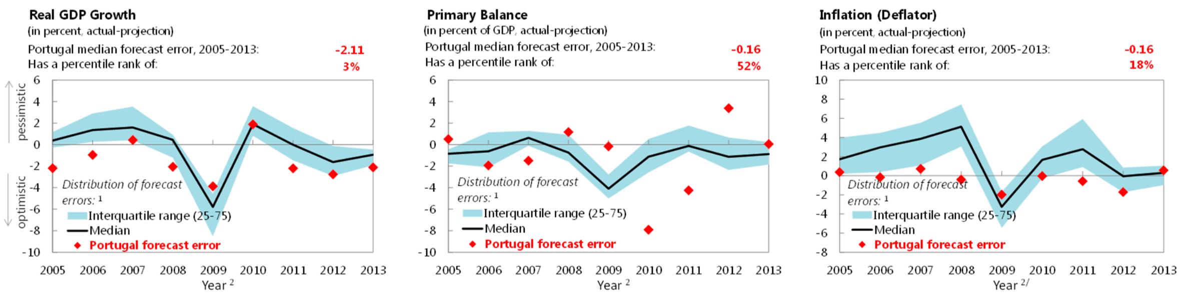
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents. In the case of Portugal, the external financing requirements figure includes bank deposits by non-residents (accounting for about 45 percent of GDP).

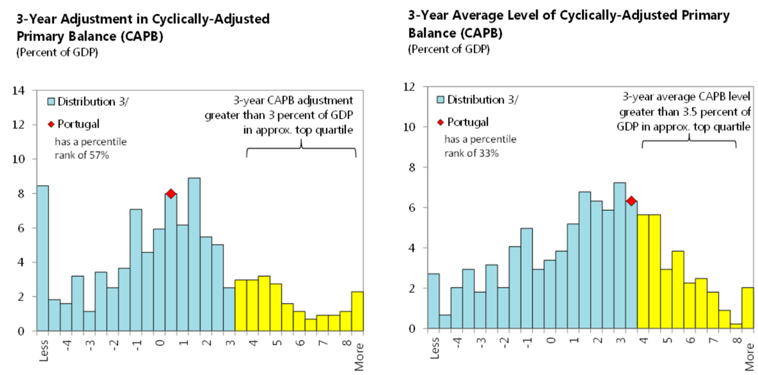
4/ An average over the last 3 months, 13-Apr-16 through 12-Jul-16.

Portugal: Public DSA - Realism of Baseline Assumptions

Forecast Track Record, versus program countries



Assessing the Realism of Projected Fiscal Adjustment



Source: IMF staff estimates.

[1]Plotted distribution includes program countries; percentile rank refers to all countries.

[2]Projections made in the spring WEO vintage of the preceding year.

[3]Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. percent of sample on vertical axis.

Portugal: Public Sector Debt Sustainability Analysis (DSA)
Baseline Scenario, 2005–2021
(Percent of GDP, unless otherwise indicated)

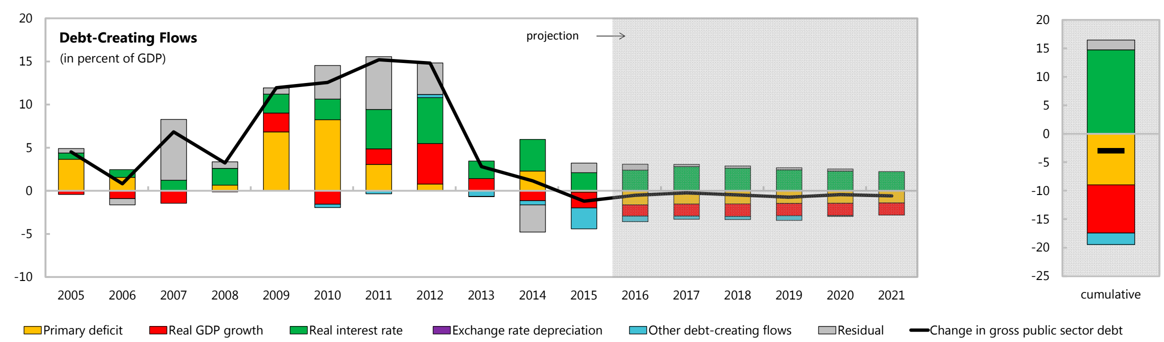
Debt, Economic and Market Indicators [1]

	Actual		Prel.	Projections					
	2005-2013 [2]	2014	2015	2016	2017	2018	2019	2020	2021
Nominal gross public debt	89.9	130.2	129.0	128.5	128.2	127.8	127.0	126.6	126.0
Public gross financing needs	...	30.9	22.5	20.0	15.2	13.6	16.5	17.0	20.1
Real GDP growth (in percent)	-0.3	0.9	1.5	1.0	1.1	1.2	1.2	1.2	1.2
Inflation (GDP deflator, in percent)	1.6	1.0	1.9	1.7	1.3	1.4	1.5	1.7	1.7
Nominal GDP growth (in percent)	1.3	1.9	3.4	2.8	2.5	2.6	2.7	2.8	2.9
Effective interest rate (in percent) [4]	4.4	3.9	3.6	3.7	3.6	3.5	3.5	3.5	3.5

As of July 12, 2016		
Sovereign Spreads		
Spread (bp) 3/		324
CDS (bp)		312
Ratings	Foreign	Local
Moody's	Ba1	Ba1
S&Ps	BB	BB
Fitch	BB+	BB+

Contribution to Changes in Public Debt

	Actual		Prel.	Projections							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	8.1	1.2	-1.2	-0.5	-0.2	-0.5	-0.7	-0.4	-0.6	-3.0	
Identified debt-creating flows	5.6	4.3	-2.3	-1.2	-0.5	-0.7	-1.0	-0.7	-0.6	-4.7	
Primary deficit	2.8	2.3	-0.2	-1.6	-1.5	-1.5	-1.5	-1.4	-1.4	-9.0	0.8
Primary (noninterest) revenue and grants	41.8	44.5	43.9	43.7	43.5	43.4	43.2	43.1	42.9	259.6	
Primary (noninterest) expenditure	44.5	46.8	43.7	42.1	41.9	41.8	41.8	41.6	41.5	250.6	
Automatic debt dynamics [5]	3.0	2.5	0.3	1.1	1.4	1.2	1.0	0.9	0.8	6.3	
Interest rate/growth differential [6]	3.0	2.5	0.3	1.1	1.4	1.2	1.0	0.9	0.8	6.3	
Of which: real interest rate	2.4	3.7	2.1	2.4	2.8	2.6	2.4	2.3	2.2	14.8	
Of which: real GDP growth	0.6	-1.1	-1.8	-1.3	-1.4	-1.4	-1.4	-1.4	-1.4	-8.4	
Exchange rate depreciation [7]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.1	-0.5	-2.4	-0.7	-0.4	-0.4	-0.5	-0.1	0.0	-2.0	
Privatization Revenue (negative)	-0.3	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Increase in deposits and other (- means drawn down of deposits)	0.2	-0.3	-2.4	-0.7	-0.4	-0.4	-0.5	-0.1	0.0	-2.0	
Residual, including asset changes [8]	2.4	-3.2	1.1	0.7	0.3	0.3	0.3	0.2	0.0	1.7	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Bond Spread over German Bonds.

4/ Defined as interest payments divided by debt stock at the end of previous year.

5/ 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).

6/ The real interest rate contribution is derived from the denominator in footnote 4 as r - π (1+g) and the real growth contribution as -g.

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

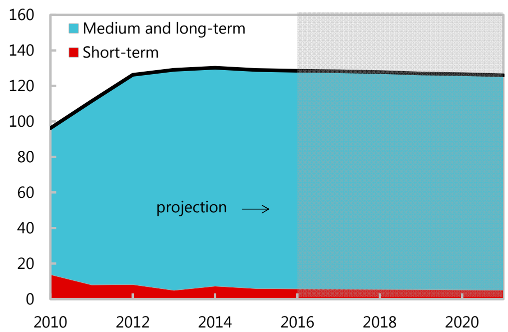
8/ For projections, this line includes exchange rate changes during the projection period.

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.

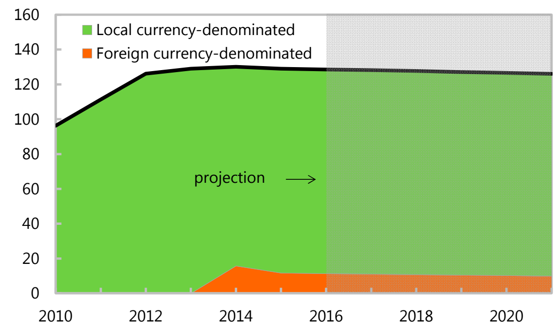
Portugal: Public DSA - Composition of Public Debt and Alternative Scenarios, 2010–2021

Composition of Public Debt

By Maturity
(in percent of GDP)



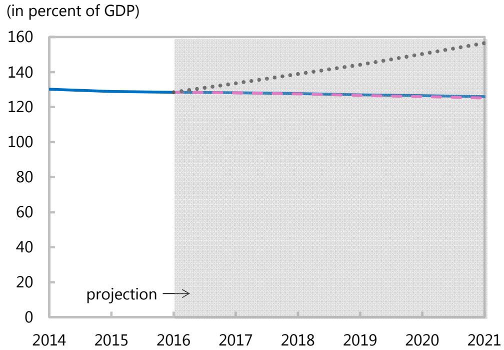
By Currency
(in percent of GDP)



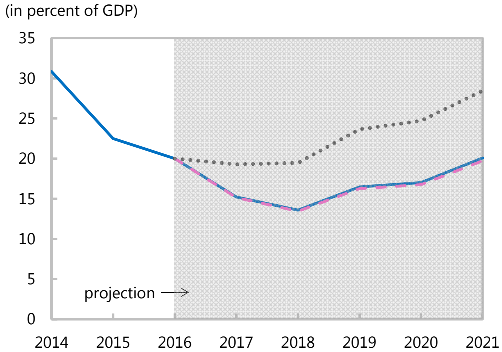
Alternative Scenarios

Baseline   Historical, 2004-2013   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

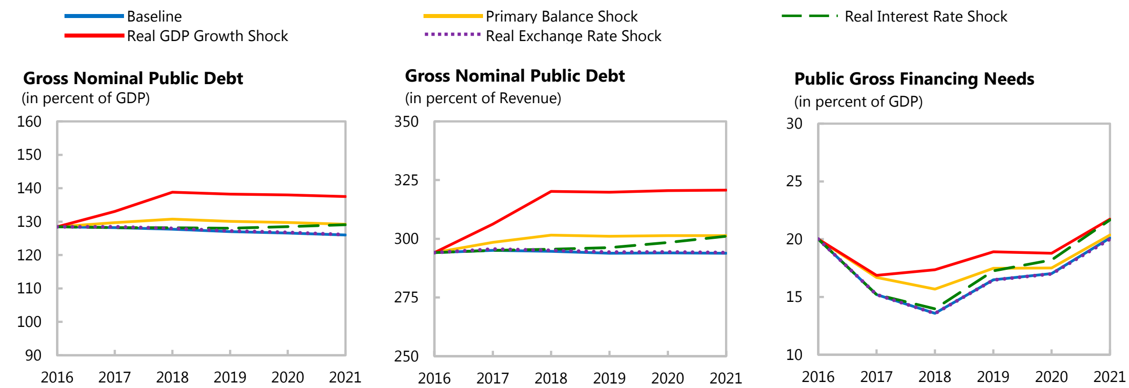
Baseline Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	1.0	1.1	1.2	1.2	1.2	1.2
Inflation	1.7	1.3	1.4	1.5	1.7	1.7
Primary Balance	1.6	1.5	1.5	1.5	1.4	1.4
Effective interest rate	3.7	3.6	3.5	3.5	3.5	3.5
Constant Primary Balance Scenario						
Real GDP growth	1.0	1.1	1.2	1.2	1.2	1.2
Inflation	1.7	1.3	1.4	1.5	1.7	1.7
Primary Balance	1.6	1.6	1.6	1.6	1.6	1.6
Effective interest rate	3.7	3.6	3.5	3.5	3.5	3.5

Historical Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	1.0	-0.1	-0.1	-0.1	-0.1	-0.1
Inflation	1.7	1.4	1.4	1.4	1.4	1.4
Primary Balance	1.6	-2.3	-2.3	-2.3	-2.3	-2.3
Effective interest rate	3.7	3.6	3.6	3.7	3.8	3.9

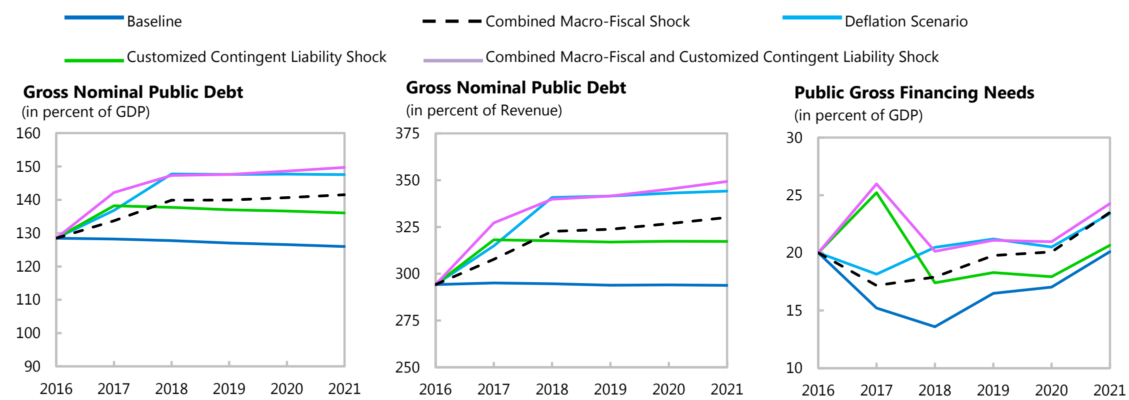
Source: IMF staff estimates.

Figure 5. Portugal: Public DSA - Stress Tests, 2016–21

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

	2016	2017	2018	2019	2020	2021
Primary Balance Shock						
Real GDP growth	1.0	1.1	1.2	1.2	1.2	1.2
Inflation	1.7	1.3	1.4	1.5	1.7	1.7
Primary balance	1.6	0.1	0.1	1.5	1.4	1.4
Effective interest rate	3.7	3.6	3.6	3.6	3.6	3.5
Real Interest Rate Shock						
Real GDP growth	1.0	1.1	1.2	1.2	1.2	1.2
Inflation	1.7	1.3	1.4	1.5	1.7	1.7
Primary balance	1.6	1.5	1.5	1.5	1.4	1.4
Effective interest rate	3.7	3.6	3.9	4.0	4.2	4.5
Combined Shock						
Real GDP growth	1.0	-1.1	-1.1	1.2	1.2	1.2
Inflation	1.7	0.8	0.9	1.5	1.7	1.7
Primary balance	1.6	0.1	-0.9	1.5	1.4	1.4
Effective interest rate	3.7	3.6	3.9	4.0	4.3	4.5
Customized Contingent Liability Shock						
Real GDP growth	1.0	1.1	1.2	1.2	1.2	1.2
Inflation	1.7	1.3	1.4	1.5	1.7	1.7
Primary balance	1.6	-8.5	1.5	1.5	1.4	1.4
Effective interest rate	3.7	3.6	3.4	3.5	3.5	3.5

	2016	2017	2018	2019	2020	2021
Real GDP Growth Shock						
Real GDP growth	1.0	-1.1	-1.1	1.2	1.2	1.2
Inflation	1.7	0.8	0.9	1.5	1.7	1.7
Primary balance	1.6	0.4	-0.9	1.5	1.4	1.4
Effective interest rate	3.7	3.6	3.6	3.6	3.6	3.5
Real Exchange Rate Shock						
Real GDP growth	1.0	1.1	1.2	1.2	1.2	1.2
Inflation	1.7	1.4	1.4	1.5	1.7	1.7
Primary balance	1.6	1.5	1.5	1.5	1.4	1.4
Effective interest rate	3.7	3.6	3.5	3.5	3.5	3.5
Deflation Scenario						
Real GDP growth	1.0	-1.7	-1.6	1.2	1.2	1.2
Inflation	1.7	-0.8	-0.7	1.5	1.7	1.7
Primary balance	1.6	-0.6	-2.8	1.5	1.4	1.4
Effective interest rate	3.7	3.6	3.6	3.9	3.8	3.7
Combined Macro-Fiscal and Customized Contingent Liability Shock						
Real GDP growth	1.0	-1.1	-1.1	1.2	1.2	1.2
Inflation	1.7	0.8	0.9	1.5	1.7	1.7
Primary balance	1.6	-8.8	0.6	1.5	1.4	1.4
Effective interest rate	3.7	3.6	3.9	4.1	4.4	4.6

Source: IMF staff estimates.

Annex V. No Extension Without Representation? New Evidence on the Role of Extending Collective Bargaining Agreements in Portugal[1]

In Portugal, administrative extensions of collective agreements had a negative impact on employment growth in 2010-2011. Moreover, these effects tend to be concentrated among those firms that are not directly involved in the bargaining process. The lack of representativeness of employer associations is a potentially important factor behind the adverse effect of extensions. Another is the role of retro-activity (backdating) in combination with the administrative time lags in processing extensions.

In many countries, including Portugal, collective bargaining coverage is supported by administrative extensions that widen the reach of collective agreements beyond their signatory parties to all firms and workers in the same sector. Because of their potential role in reinforcing downward wage rigidity and exacerbating the negative impact of recessions on employment, extensions have become the focus of an increasingly intense policy debate in recent years. A new study[2] of collective bargaining in Portugal provides the following insights into this subject:

First, extensions tended to reduce employment growth and, therefore, were likely to have amplified the unemployment response to the sovereign debt crisis. The effect was large, with employment growth at the firms that were subject to the subsequently-extended agreements lower by about 5 percentage points compared with that at the firms that were subject to the agreements that were not extended (Figure 1).

Second, the adverse impact of extensions on employment growth tends to be concentrated among the firms that are not affiliated with an employer association, i.e. those that are not directly involved in the bargaining process. The concentration of adverse employment effects among the non-affiliated firms suggests that extensions suit the interests of affiliated firms rather than those of non-affiliated firms. In other words, the lack of representativeness of employer associations is a potentially important factor behind the adverse effects of extensions.

Third, the degree of representativeness of employer associations does not appear to matter significantly for the impact of extensions on employment growth. This may reflect the difficulty of identifying the role of representativeness in a context when it is very low. Alternatively, it may reflect

[1] Prepared by Alexander Hijzen (OECD).

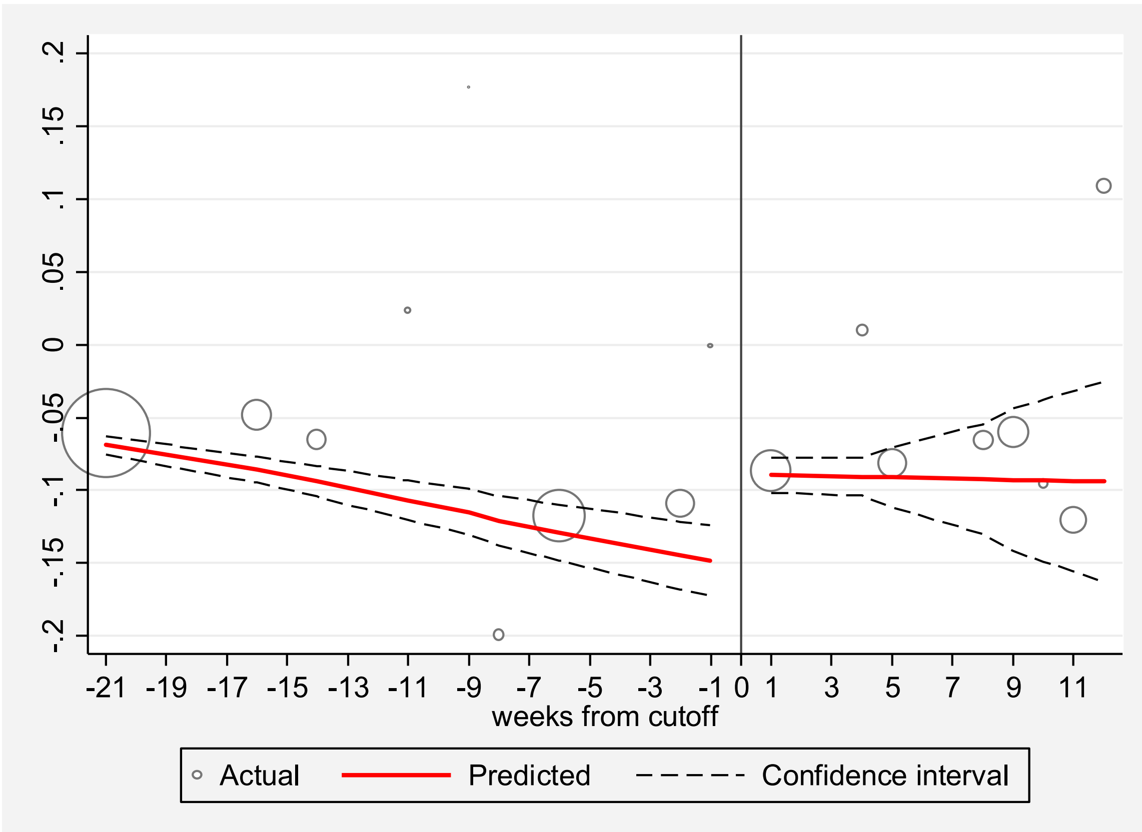
[2] Hijzen, A. and P. Martins (2016), "No Extension without Representation? Evidence from a Natural Experiment in Collective Bargaining", IMF Working Paper 16/143. This paper uses a regression discontinuity design that exploits the sharp and unanticipated decline in the extension probability for the collective agreements signed in the months just after March 1, 2011. That decline resulted from the immediate suspension of extensions by the government that took office several months later, on June 21, 2011, in combination with the time needed for processing the extension applications.

the possibility that representativeness criteria (such as those implemented in Portugal in 2012, based on affiliated firms representing at least 50 percent of the workforce of the sector) do not ensure that agreements are in the public interest. This suggests that representativeness criteria may need to be fine-tuned further or be complemented with a meaningful test of public interest. However, the introduction of the strict representativeness criteria in 2012 is likely to have had a major impact on wage adjustment and therefore employment by greatly reducing the number of extensions issued. Representativeness criteria also may help to promote employer organization, particularly if introduced gradually, and thereby contribute to the quality of industrial relations as well as the degree of trust between the social partners.

Fourth, the retro-activity in combination with the often substantial administrative time lags associated with extension decisions implied that non-affiliated firms had to back pay wage increases over the period from the time that the original agreement was signed until the time that a decision on its extension was made. This significantly increased the adverse impact of extensions on employment growth. This may suggest that the present results are to some extent specific to the weak economic conditions during the period of analysis. If there is no uncertainty about the extension of agreements and firms are not liquidity-constrained, then retro-activity should not be expected to slow down employment growth. It also suggests that the 2012 labor market reform may have helped to reduce the adverse effect of extensions by removing their retro-activity. Concerns that this undermines the spirit of sectoral bargaining and extensions can partly be addressed by shortening the administrative delay associated with issuing extensions.

To conclude, the positive effects of extensions in terms of higher wages for low-wage workers and greater wage compression should be weighed against their adverse effects on employment growth.

Figure 1. The Effects of Administrative Extensions on Employment Growth
Percent change in employment between 2010-2011 by collective agreement publication date (in weeks before or after March 1, 2011)



Collective agreements signed before March 1, 2011 (week 0) were extended while agreements signed after 1 March 2011 were not. Actual: average employment growth by publication date; the size of the circles is proportional to the level employment of the corresponding collective agreement(s). Predicted: estimated employment growth by publication date based on employment-weighted regression of employment growth on constant, treatment dummy and linear relative time effects. Confidence interval: 90-percent confidence interval based on robust standard errors clustered by collective agreement and signature date.

Source: Hijzen and Martins (2016)

INTERNATIONAL MONETARY FUND

PORTUGAL

August 5, 2016

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION AND FOURTH POST-PROGRAM MONITORING DISCUSSIONS—INFORMATIONAL ANNEX

Prepared By

European Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of June 30, 2016)

Membership Status: Joined: March 29, 1961; Article VIII

General Resources Account:	**SDR Million**	**Percent Quota**
Quota	2,060.10	100.00
Fund holdings of currency	16,374.42	794.84
Reserve position in Fund	465.49	22.60

SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	806.48	100.00
Holdings	535.51	66.40

Outstanding Purchase and Loans:	**SDR Million**	**Percent Quota**
Extended Arrangements	14,779.80	717.43

Financial Arrangements:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
EFF	May 20, 2011	June 30, 2014	23,742.00	22,942.00
Stand-By	Oct 07, 1983	Feb 28, 1985	445.00	259.30
Stand-By	Jun 05, 1978	Jun 04, 1979	57.35	0.00

Projected Payments to Fund[1:]
(SDR Million; based on existing use of resources and present holdings of SDRs)

			Forthcoming		
	2016[2]	**2017**	**2018**	**2019**	**2020**
Principal	0	0	1,461.39	3,823.67	3,823.67
Charges/Interest	242.74	482.64	481.64	381.16	226.24
Total	**242.74**	**482.64**	**1,943.02**	**4,204.82**	**4,049.90**

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.
[2] Does not include possible early repurchases.

Exchange Rate Arrangement:
Portugal's currency is the euro, which floats freely and independently against other currencies. Portugal has accepted the obligations of Article VIII, Section 2, 3, and 4, and maintains an exchange

system free of restrictions on payments and transfers for current international transactions, other than restrictions notified to the Fund under Decision No. 144 (52/51).

Article IV Consultations:
Portugal is on the standard 12-month consultation cycle. The previous consultation discussions took place during March 5-17, 2015, and the staff report (Country Report No. 15/126) was discussed on May 6, 2015. Article IV consultations with Portugal were a 24-month cycle during the Extended Arrangement from 2011-2014.

Post-Program Monitoring Discussions:
The Fourth Post-Program Monitoring Discussions were held in Lisbon during June 15-29, 2016, together with the Article IV consultation discussions. The Third Post-Program Monitoring Discussions took place during January 27-February 3, 2016, and the staff report (Country Report No. 16/97) was discussed on March 30, 2016.

Resident Representative:
The resident representative office in Portugal closed in September 2015.

STATISTICAL ISSUES

As of July 12, 2016

I. Assessment of Data Adequacy for Surveillance
General. Data provision to the Fund is adequate for surveillance purposes.
Real sector. Since 2000, and until August 2014, INE published a full set of national accounts based on the *ESA 1995* methodology, including quarterly GDP estimates. Since September 2014, all information regarding National Accounts follows the *ESA 2010*.
Fiscal sector. Data have undergone a number of revisions during the transition to the *ESA 2010*, sizably altering revenue and expenditure and hampering comparisons across years. From 2001 onward, budgets have been presented in a manner consistent with recent changes in national and fiscal accounting methodology. Quarterly general government statistics on an accrual basis are available as derived from the national accounts statistics.
Trade and balance of payments. Data are provided according to the IMF's sixth edition of the *Balance of Payments Manual*. The external trade data meet the timeliness standards. The portfolio investment collection system has a simplified threshold of €500 million, which is relatively high in comparison with many EU countries. The authorities estimate however, that only about 1.5 percent of transactions are not captured on a monthly basis by this threshold, and that this reporting simplification does not significantly hamper the quality of the monthly balance of payments. Moreover, they indicate that all transactions below this threshold are included in the first release of the annual balance of payments data, and the monthly numbers are revised accordingly. **Monetary sector.** Data on the central bank balance sheet and on the consolidated balance sheet of other monetary financial institutions are available from the Bank of Portugal's BPStat website.

II. Data Standards and Quality	
Portugal is subject to the statistical requirements and timeliness and reporting standards of Eurostat and the European Central Bank (ECB). Portugal subscribes to the Special Data Dissemination Standard Plus (SDDS+), and the relevant metadata have been posted on the Dissemination Standards Bulletin Board.	No data ROSC is available.

Portugal: Table of Common Indicators Required for Surveillance
(As of July 12, 2016)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	07/12/16	07/12/16	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	6/16	7/16	M	M	M
Reserve/Base Money	5/16	7/16	M	M	M
Broad Money	5/16	7/16	M	M	M
Central Bank Balance Sheet	6/16	7/16	M	M	M
Consolidated Balance Sheet of the Banking System	5/16	7/16	M	M	M
Interest Rates[2]	5/16	7/16	M	M	M
Consumer Price Index	6/16	7/16	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	3/16	6/16	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	3/16	6/16	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	3/16	6/16	M	M	M
External Current Account Balance	4/16	6/16	M	M	M
Exports and Imports of Goods and Services	4/16	6/16	M	M	M
GDP/GNP	2016:Q1	6/16	Q	Q	Q
Gross External Debt	2016:Q1	5/16	Q	Q	Q
International Investment Position	2016:Q1	5/16	Q	Q	Q

[1]Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I); and not available (NA).

Statement by Mr. Cottarelli, Executive Director for Portugal, and Ms. Lopes, Advisor to the Executive Director
September 16, 2016

I – Overview

We thank staff for the report on the Article IV consultation and the fourth Post-Program Monitoring (PPM) discussions. We also thank staff for the report on the Ex-Post Evaluation of Exceptional Access (EPE) under the 2011 Extended Arrangement. As the Portuguese authorities have had the opportunity to comprehensively express their views on the EPE separately, the current statement will focus on the Article IV and fourth PPM report.

The Portuguese Government takes note of the Staff Report on the fourth Post-Program Monitoring and Article IV Consultation and reiterates its commitment to economic and fiscal policies that promote competitiveness, economic growth and social cohesion, together with sound and sustainable public finances.

Several structural reforms, clearly outlined in the National Reform Program, are presently being implemented, thus strengthening the reform momentum. The assessment made by Fund staff does not fully recognize this progress, downplaying the present structural reform agenda.

Moreover, the Portuguese Government would like to highlight that, between the third PPM Mission (January 2016) and this fourth Mission, the State Budget, the Stability Program and the National Reform Program were all approved by Parliament, and subsequently welcomed by the European Commission. The report understates the value of political stability in a socio-political environment where a low Eurosceptic sentiment prevails.

The Portuguese economy is recovering from a weak second half of 2015. Recovery signs are still mild and should be supported by appropriate policies. Portuguese exports are gaining market share to the EU. Economic confidence indicators are rising. Recent data points to a more dynamic labor market. These encouraging developments also impact positively on budgetary outcomes. The Portuguese Government is aware of the existence of downside risks, such as possible external shocks coming, for example, from economic developments in emerging markets. Against this background, the Portuguese Government reiterates its commitment to a rigorous implementation of the 2016 State Budget as agreed in the National Assembly and with the European partners. Additionally, the Portuguese Government continues to be engaged in working constructively with international institutions.

II – Economic Activity

In 2015, economic activity in Portugal decelerated gradually, mostly due to a slowdown in investment and less favorable external demand from some of Portugal's main trading partners (mainly Angola). These factors spilled-over into the first half of 2016, although with different magnitudes. Additionally, export performance was hindered by the temporary closure of an oil refinery unit and the phasing-out of a major carmaker's old car model. The refinery is now fully operational and the production of a new car model will start in 2017.

Nonetheless, exports to EU markets – which represent over 70 percent of Portugal's sales – rose by 3.6 percent in June y-o-y and by 0.8 in July y-o-y. Importantly, labor market data offer some positive indicators on the outlook for the rest of the year. The unemployment rate stood at 10.8 percent in the second quarter of 2016 (11.9 percent in the same quarter of 2015), and the number of employees grew by 2.2 percent since the beginning of the year, according to Social Security contributions' data.

Private consumption grew at a rate close to the one envisaged in both the State Budget and the Stability Program. Moreover, the economic climate indicator started accelerating at the end of the first quarter, after a slowdown that started in the third quarter of 2015. Confidence indicators in services, retail and construction are on the rise. The balance of payments adjustment continues, with the trade balance surplus increasing by 242 million euro compared to the first six months of 2015.

The Stability Program and the National Reform Program, approved by the National Assembly and welcomed by the European Commission, laid down the Government's multiyear budgetary strategy as well as its reform agenda. Both are important to build confidence and stability, benefiting investment decisions. These developments clearly bode well for economic predictability and political stability, making staff's emphasis on instability uncalled for.

Additionally, the financial sector outlook has improved. Banif was resolved in December 2015 and CGD's recapitalization has been agreed with European institutions. Progress is also being made by other private financial institutions. The authorities are committed to preserve financial sector stability, which should also promote both an efficient transmission of monetary policy measures and the financing of productive activities.

Likewise, in 2015, the real effective exchange rate depreciated by 2.7 percent (-0.5 percent in 2014), which points to gains in price competitiveness. The persistent gains of market share and terms of trade point also towards an enhanced non-price competitiveness of Portuguese exports.

III – Fiscal Policy

The Portuguese Government reiterates its commitment to a rigorous implementation of the 2016 State Budget. Portugal will achieve a result compatible with European rules and, therefore, exit the Excessive Deficit Procedure this year.

Given a less favorable international financial environment, the 2016 State Budget introduced new expenditure cuts that are curbing expenditure commitments by 0.2 percent of GDP since March 31st.

In the first seven months of 2016, the general government budget deficit on a cash basis improved by 0.4 percentage point of annual GDP vis-à-vis the same period of 2015. Intermediate consumption is decreasing (-0.6 percent). The primary surplus stood at 316 million euro (901 million euro more than in 2015). This development is explained by a higher increase in revenue (2.8 percent) than in expenditure (1.3 percent):

- Net tax revenue increased by 1.9 percent. This performance is highly influenced by an increase of 549 million euro in tax refunds decided in 2015. In gross terms, tax revenue is increasing steadily, notably thanks to increases from taxes on oil and energy products (44.9 percent), tobacco taxes (41.6 percent), and taxes on vehicles (14.4 percent). CIT payments in July increased by 2.1 percent relatively to 2015.
- Social contributions rose by 4.3 percent, largely due to the 4.5 percent increase of Social Security contributions.

The Portuguese Government is committed to implement a spending review that goes beyond the one launched during the Adjustment Program, with the objective of producing long-term efficiency gains. The spending review is focused on the health and education sectors, major SOEs, public procurement and the management of state-owned real estate assets. In the following three years, the spending review will be expanded to other areas. The efficiency of revenue collection will also be addressed.

IV – Structural Reforms

The Portuguese Government remains committed to the full implementation of structural reforms, whose ambition, recognized by the European Commission, is reflected in the Portuguese National Reform Program. This program builds on reforms implemented in previous years and benefitted from their assessment by the European Commission, as presented in the recent Country Report. The National Reform Program is translated into concrete quantifiable measures and each of them has a chronogram of implementation. Some of the measures involve support from EU Structural Funds, the Junker Plan or the European Investment Bank.

Several structural reforms are currently being implemented. These are broadly framed in programs to foster the skills of the labor force, the recapitalization of firms and the modernization of Public Administration, making the latter closer to citizens and to business, thus reducing costs for both.

This translated into the launching of: *i) Programa Qualifica* to develop human capital, namely the qualification of the workforce through better formal education and lifelong learning, as well as improvements in managerial skills in internationalization; *ii) Programa Capitalizar* for firms, with more than 100 measures to change tax incentives for equity usage, simplification of procedures, corporate restructuring, leverage productive investment and improve the access to equity markets; *iii)* a revamped *Simplex +* to modernize Public Administration, containing a large number of changes that will significantly improve the business environment for firms, thereby facilitating productivity and competitiveness gains; *iv) Programa Capacitar*, aiming to improve applied R&D and innovation by strengthening the role of interface entities (*e.g*. technological centers) between universities, laboratories and companies, facilitating the diffusion of technology; *v) Startup Portugal*, the national strategy for entrepreneurship, aimed at facilitating the birth and development of new enterprises, as well as promoting international investment and a focus on international markets.

Concerning the energy sector, the new measures under consideration by the Government to further reduce the tariff debt should be noted.

Finally, in late 2015, the Portuguese Government established a dedicated unit to evaluate structural reforms. This effort has been acknowledged by the OECD.

V – Financial Sector Policies

The Portuguese banking system has gone through a significant adjustment process in recent years. However, at the end of the Adjustment Program several challenges remained. The sector still faces important challenges that need to be addressed in the near future, taking into account the European context. Currently, the most important challenges faced are the resolution of high levels of non-performing loans (NPLs) in banks' balance sheets and the compliance with stringent capital requirements in a context of weak growth and compressed profitability. The Portuguese authorities have been working to overcome the difficult environment, while safeguarding the taxpayer and a normal flow of credit to the economy.

The turnaround in the liquidity profile of Portuguese banks since 2010, with the very significant reduction in the loan to deposit ratio (from levels as high as 165 percent to just below 105 percent in late 2015), is one of the most prominent features of the adjustment of Portuguese banks. That trend continued during the first quarter of 2016, despite the concerns raised at the beginning of the year related to two resolution measures applied to Portuguese banks, which, however, did not have any impact on the retail deposit base of the banking system. That resilience reveals the confidence of the public in the system as a whole. The reliance on Eurosystem financing continued to decline in 2015, even though the ECB pursued and intensified its quantitative easing measures. Finally, capital ratios have also improved, when compared to 2014, mainly driven by the resolution measure applied to Banco Espírito Santo, in December 2015, and by the decrease in risk weighted assets. In the first quarter of 2016, the phase-in of CRDIV/CRR measures contributed to a slight reduction of the Core Tier 1 ratio when compared to end-2015 figures.

Despite the progress, adjustment efforts should continue, as the Portuguese banking system still faces significant challenges in several areas, most notably in reducing the high level of NPLs and in regaining sustained and sufficient levels of profitability. The current low economic growth (observed and projected), the very low nominal interest rates and low inflation do not provide a favorable background to address these challenges. In 2015, even though most banks returned to profits after several years of losses, the level of profits was still feeble, although, in part, as a result of non-recurring factors. In the first quarter of 2016, (annualized) profits remained at a level similar to 2015 and net interest income continued to recover, on account of lower deposit interest rates, while income from financial operations, by nature less recurring, declined. The restructuring efforts that led to the reduction in administrative costs in 2015 continued to yield lower operating costs in the first quarter of 2016. Despite that, further efforts are needed, as banks continue to adjust to the current macroeconomic scenario characterized by low levels of demand for financial services. Restructuring should involve further downsizing and reallocation of human resources.

As mentioned before, the high stock of legacy assets on banks' balance sheets, such as NPLs and real estate, persists as a major micro and macroprudential concern given the impact on banks' capital and, potentially, on their ability and willingness to finance the economy. The flow of NPLs has declined as a result not only of the timid cyclical upturn underway, but also of the improvements in credit risk management processes that Portuguese banks have put in place. Nevertheless, the NPL stock remains very high and the efforts to resolve this problem will continue. In particular, given the multipronged nature of the problem, with intertwined constraints at several levels, a holistic strategy, comprising measures on supervision, legal, judicial and fiscal levels, must be continued and, in some cases, reinforced. Additionally, as the high NPL stock is a problem common to various major banks in several European countries, and considering their potential underlying impact on financial stability, a European solution aimed at the removal of NPLs from banks' balance sheets should be pursued.

Deleveraging at the non-financial corporations' level continues, although at a slower pace. The path of credit growth is very heterogeneous across firms: credit to those economic activity sectors more affected by the macroeconomic adjustment and contraction in demand, such as the construction and real estate sectors, continued to decline, while credit to manufacturing and exporting companies is recovering. In addition, credit is being channeled to those companies that rank better in the credit quality spectrum, while there is evidence of a clear price discrimination according to the risk profile of the debtor. In the second quarter of

2016, the stock of credit to households for house purchase continued the declining path initiated in 2011, while credit for consumption has been accelerating and showing positive growth rates since the second half of 2015. The implementation of the above-mentioned *Programa Capitalizar* should also support companies' efforts to diversify their financing sources and, simultaneously, to strengthen their capitalization with the contribution of financial, fiscal and legal instruments.

The uncertainty underlying the global economic outlook, in conjunction with some geographic concentration of banks' activity, represents an additional risk for the banking sector. In particular, the direct and indirect exposures of Portuguese banks to emerging market economies (i.e. loans to corporations with significant commercial and investment relations with those economies), as Angola, are significant and may lead, in the current juncture, to additional losses for Portuguese banks.

Regarding *Caixa Geral de Depositos*, the state owned bank and the largest bank in Portugal, an agreement on its recapitalization was reached between the Government and the European institutions. The chosen approach is a market-based operation that allows for the bank to be adequately capitalized and able to fulfill its mission, while complying with EU rules.

To sum up, despite some positive signals observed more recently (in terms, for instance, of the banks' financing structure and of firms' deleveraging), the adjustment of the banking sector is still ongoing and some significant challenges persist, notably regarding their profitability and the high stock of NPLs.

VI – Conclusion

The Portuguese authorities are certain that their obligations towards the Fund will be timely met, as has been the case so far.

Economic growth, social cohesion, sound public finances and financial stability are the goals to be met, whilst the unintended effects of the adjustment process, *i.e.* rising inequality and emigration, must, and will, be adequately tackled.

Structural reforms will continue to be implemented, based on the lessons learned from previous efforts, with fine-tuning as needed, and with the launching of new initiatives in order to achieve a competitive and balanced economy. Time and stability are required in order for the reforms – implemented before, under and after the Economic and Financial Adjustment Program − to produce the desired effects.

The Portuguese authorities look forward to the fifth PPM mission, which will constitute a good opportunity to closely work with the IMF, deepening our dialogue and promoting a closer mutual understanding.