



PORTUGAL

2018 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT;
AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR PORTUGAL

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Recent Developments



Recent Developments

Consumer prices have been rising, though price competitiveness has stabilized recently

- Headline inflation rose to 2 percent y-o-y in June 2018
- Unit Labor costs continue to increase
- Imports of goods have increased strongly, resulting in a reduction of more than one percentage point of GDP
- Growth in exports of services has, however, been strong too since late 2016, led by booming tourism.
- As a result, current account balance was essentially unchanged in 2017.

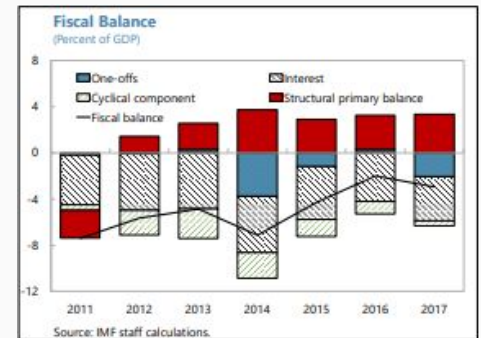




Recent Developments

The Underlying fiscal balance improved in 2017

- The fiscal performance in 2017 was robust, reflecting strong economic growth, prudent budget execution, and falling interest costs.
- Nevertheless, the headline fiscal deficit widened to 3.0 percent of GDP owing to one-off payments (2.0 percent of GDP), mainly associated with bank recapitalization costs

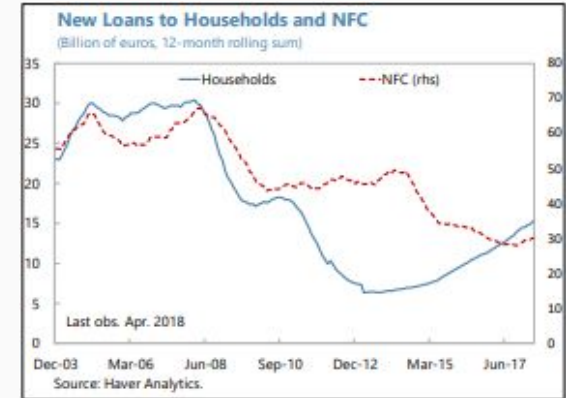




Recent Developments

- **The sovereign's improved access to market financing has contributed to more favorable borrowing terms throughout the economy.**
- **Credit continues to lag the recovery, although new lending is increasing**

- The contraction in bank credit has essentially halted, with rising new loans, especially to households,
- In the nonfinancial corporate (NFC) sector, new loans to firms in dynamic tradable sectors with better risk profiles have accelerated.





Recent Developments

Banks' balance sheets strengthened in 2017

- The average CET1 ratio rose to 13.9 percent at the end of 2017. During the same period
- Non-performing loans (NPLs) fell by EUR 9.4 billion, largely driven by write-offs and sales of business loans, and debt recovery (cures) for household loans.
- Most banks posted profits.



Recent Developments – Authorities View

Output growth has been generally strong, and that the deceleration in 2018:Q1 was temporary

- Growth has been accompanied by strong employment creation, boosting social security contributions and reducing unemployment claims.
- Deceleration registered in the first quarter was largely due to temporary factors.
- Data for April and May 2018, they stressed, already indicated an acceleration of exports.



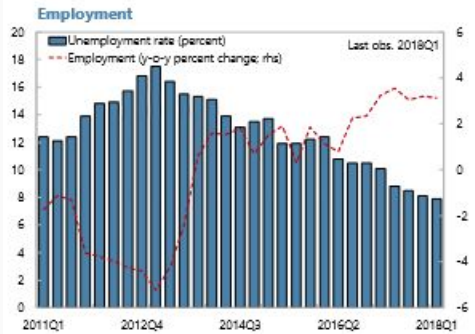
Outlooks and Risks



Outlooks and Risks

Growth is expected to ease in 2018

- Growth expected to tone down from its cyclical peak and gradually stabilize medium term;
- Investments and Exports ease;
- Private consumption decreases;
- Labor markets Tight;
- Employment rate growth decelerates;



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

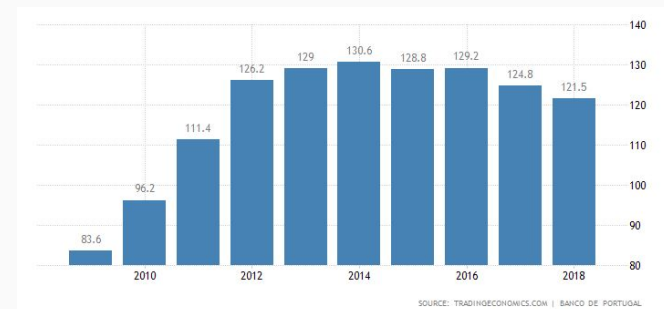
	2014	2015	2016	2017	Projections					
					2018	2019	2020	2021	2022	2023
Real GDP	0.9	1.8	1.6	2.7	2.3	1.8	1.5	1.4	1.4	1.3
Total domestic demand	2.2	2.7	1.6	2.8	2.8	2.3	2.0	1.7	1.6	1.6
Private consumption	2.3	2.3	2.1	2.3	1.9	1.6	1.3	1.2	1.2	1.2
Public consumption	-0.5	1.3	0.6	-0.2	1.9	1.0	1.1	0.7	1.3	1.0
Gross fixed investment	2.3	5.8	1.5	9.2	7.6	6.3	5.0	4.2	3.4	3.3
Private	4.1	4.3	6.9	7.9	6.1	6.6	5.2	4.3	3.4	3.3
Government	-7.9	15.9	-30.9	21.2	19.6	4.2	3.8	3.6	3.4	3.2
Exports	4.3	6.1	4.4	7.9	6.2	4.7	4.2	4.1	4.1	4.1
Imports	7.8	8.5	4.2	7.9	6.8	5.5	4.9	4.4	4.3	4.3



Outlooks and Risks

Fiscal Deficit should fall in 2018

- Fiscal Deficit expecting to fall assuming no changes in the Fiscal Balance;
- Trajectory of public debt subject to risks;
- No major one off expenditures;

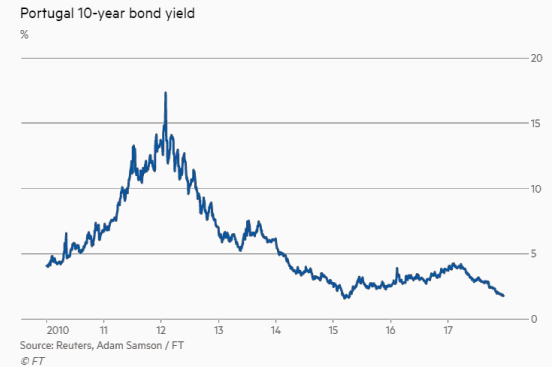




Outlooks and Risks

External Risks to the outlook appear to be tilting downward

- Weaker-than-expected global growth;
- Loss of investors confidence (affected by bond yields);
- Rising protectionism;
- Unsustainable macroeconomic policies;
- Sharp Tightening of global financial conditions (affect levered firms);





Outlooks and Risks – Authorities View

Stability program saw steady growth of economy, EU development is the main risk

- Portugal improved ability to manage shocks;
- Recent non-price competitiveness gain;
- Exports affected by global tightening;
- NPLs although high, decreasing trend is noticed

Years	Proportion - %	
	Enterprises with non-performing loans (%)	Amounts of non-performing loans to enterprises (%)
2009	19.5	4.2
2010	20.4	4.6
2011	24.7	6.9
2012	28.9	10.5
2013	30.3	13.5
2014	30.8	15.1
2015	28.6	15.5
2016	27.2	15.2
2017	25.1	13.5
2018	21.1	9.4



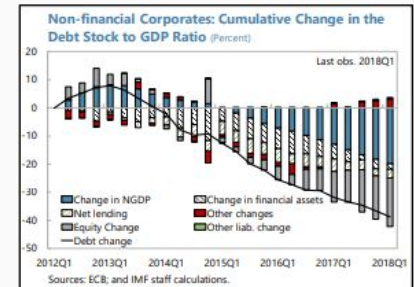
A: Macro-Financial Issues and Policies



A: Macro-Financial Issues and Policies

The pace of deleveraging is slowing amid benign financial conditions

- In 2017, the net flow of loans to households turned positive for the first time since 2011, driven by consumer loans and mortgages.
- Regarding NFCs, the positive net flow of financial debt was due to intra-group lending by non-residents, while NFCs continued to reduce their borrowing from the domestic banking system.
- Household saving rates were low at 5.4 percent of disposable income in 2017. Private indebtedness, however, remains high.





A: Macro-Financial Issues and Policies

Banco de Portugal deployed macroprudential measures to prevent the financial sector from taking excessive risk

- Early in July, banks started to implement limits on maturities and LTV and debt-service-to-income (DSTI) ratios, when credit standards were starting to ease.
- The introduction of tighter LTV, DSTI, and loan maturities will contain such easing, bolstering the resilience of financial institutions and households to variations in real estate prices, interest rates, and incomes.



A: Macro-Financial Issues and Policies

Stock of NPLs remain a concern

- At end-2017, the stock of NPLs stood at EUR 37 billion (13.3 percent of total loans)
- The elevated stock of NPLs is tying up resources in the economy, and holding back bank profitability.
- Three pillars:
 - ✓ Supervisory actions (under the SSM);
 - ✓ Legal, judicial and fiscal reforms to remove impediments to NPL resolution;
 - ✓ Measures to improve management of NPLs and develop secondary markets for troubled loans.

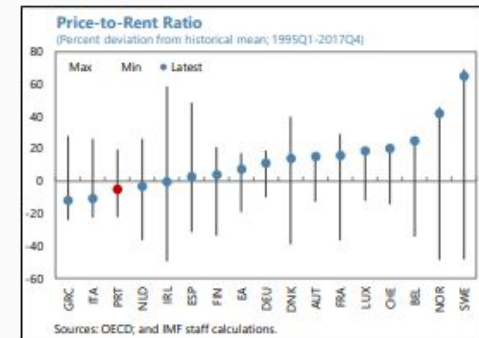
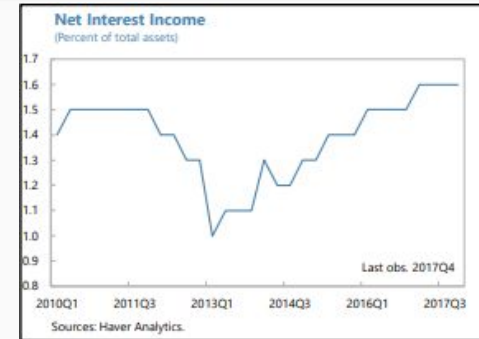


A: Macro-Financial Issues and Policies

Generating strong and sustained bank profitability will be challenging

- High non performing assets are still a drag on profitability, and the updating of business models can involve upfront costs, as when closing brick-and-mortar branches.

Housing prices continue to increase, but there is no significant overvaluation yet





A: Authorities View

Deleveraging in the non-financial private sector

Addressing NPLs

- At the EU level, the implementation of the Action Plan to Tackle Non-Performing Loans in Europe is underway.
- At the national level, the measures include:
 1. Continuous improvement of the legal, judicial and tax framework;
 2. Enhancement of in-court restructuring and insolvency frameworks;
 3. Introduction of several measures to speed up out-of-court settlement procedures;
 4. Ongoing actions to put in place an early warning mechanism and the development of a simplified regime to facilitate the transfer of NPL portfolios.



A: Authorities View

Ensuring strong and sustained bank profitability

- Banks' determined implementation of their strategies to cut costs and diversify income sources, alongside the improved economic outlook, would help ease pressure on profitability from low interest rates and increased competition

Mispricing of risk and excessive-risk taking

- No signs of a systematic mispricing of risk and excessive risk-taking by banks
- New mortgage and consumer loans are indications to prevent that from happening



B: External Balance and Policies



B: External Balance and Policies

External position weaker than in the previous year 2017

Current Accounts

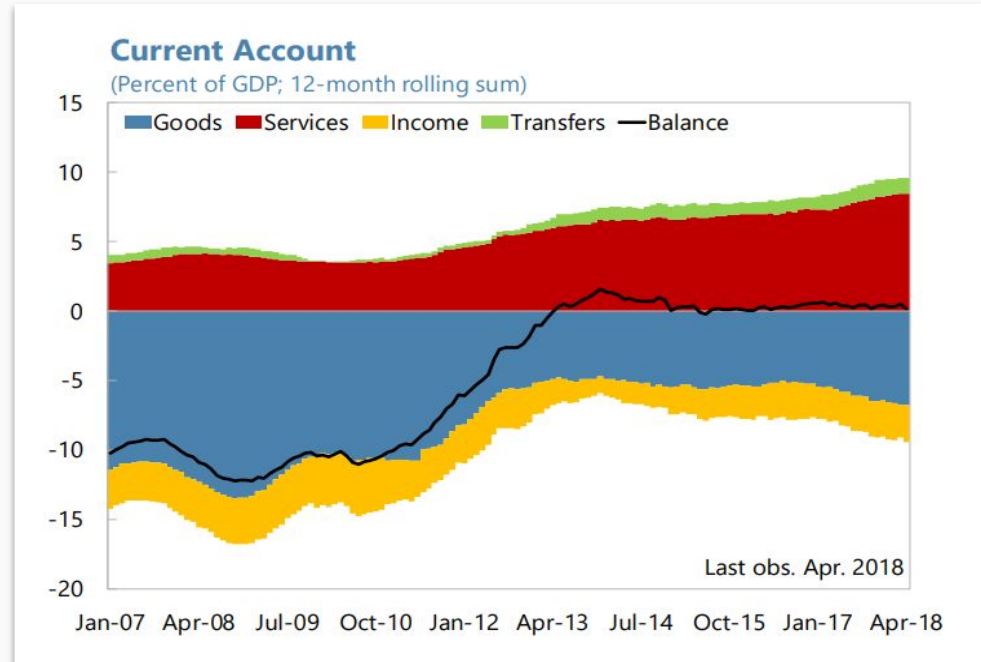
NIIP
(Net International
Investment Position)



B: External Balance and Policies

□ Current Account improved by

- rising goods exports
- tourism

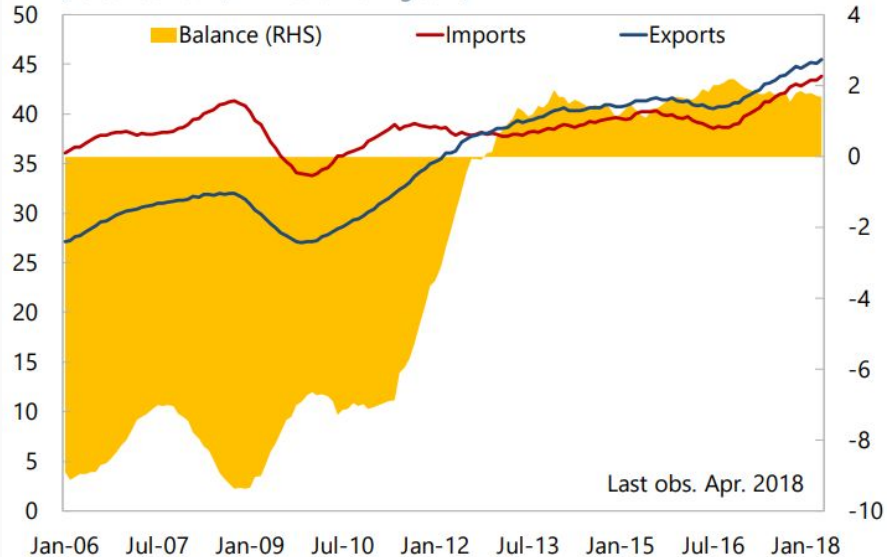




B: External Balance and Policies

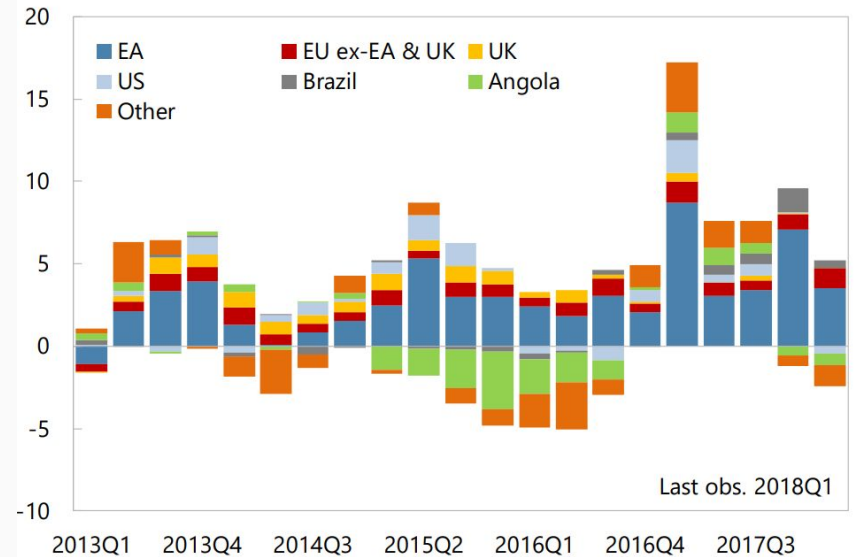
Trade in Goods and Services

(Percent of GDP; 12-month rolling sum)



Contribution to Growth in Exports of Goods, by Destination

(Percentage points; y-o-y)

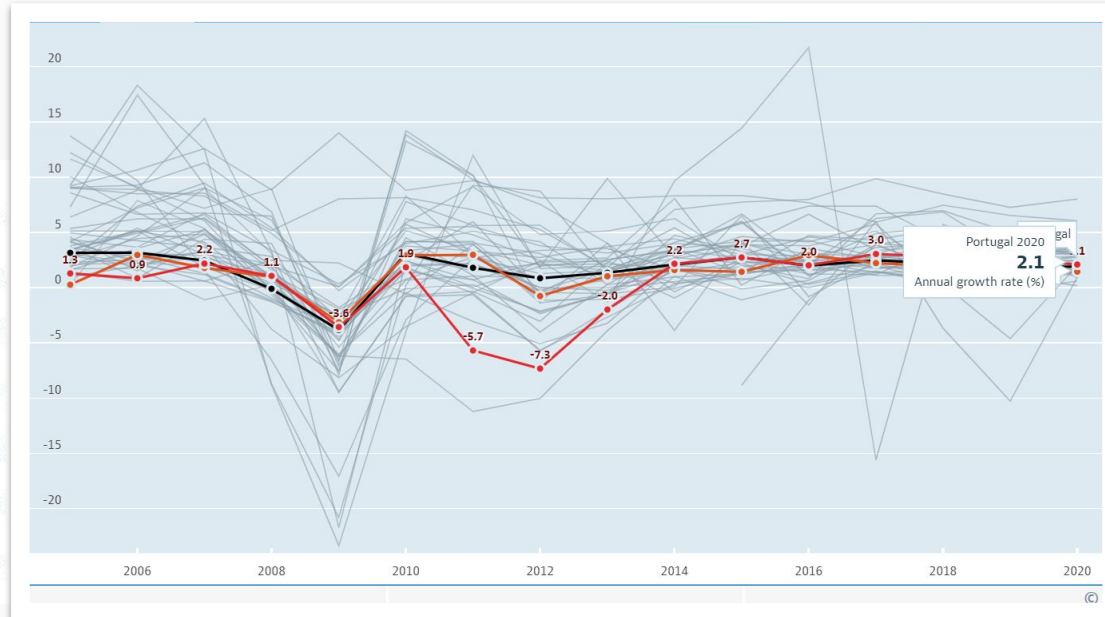
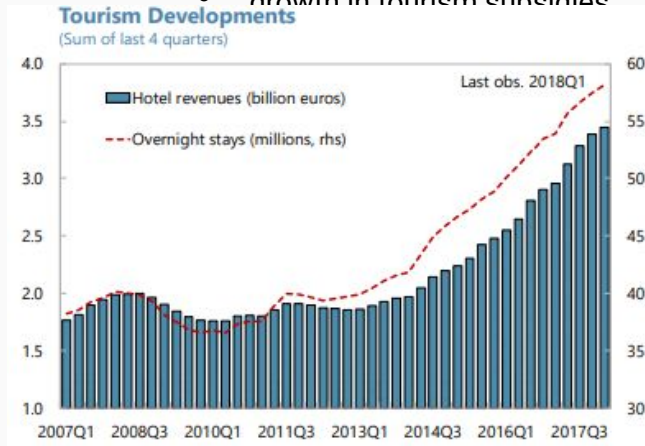




B: External Balance and Policies

Current Account □ Staff projects moderate deficit over next several years due to:

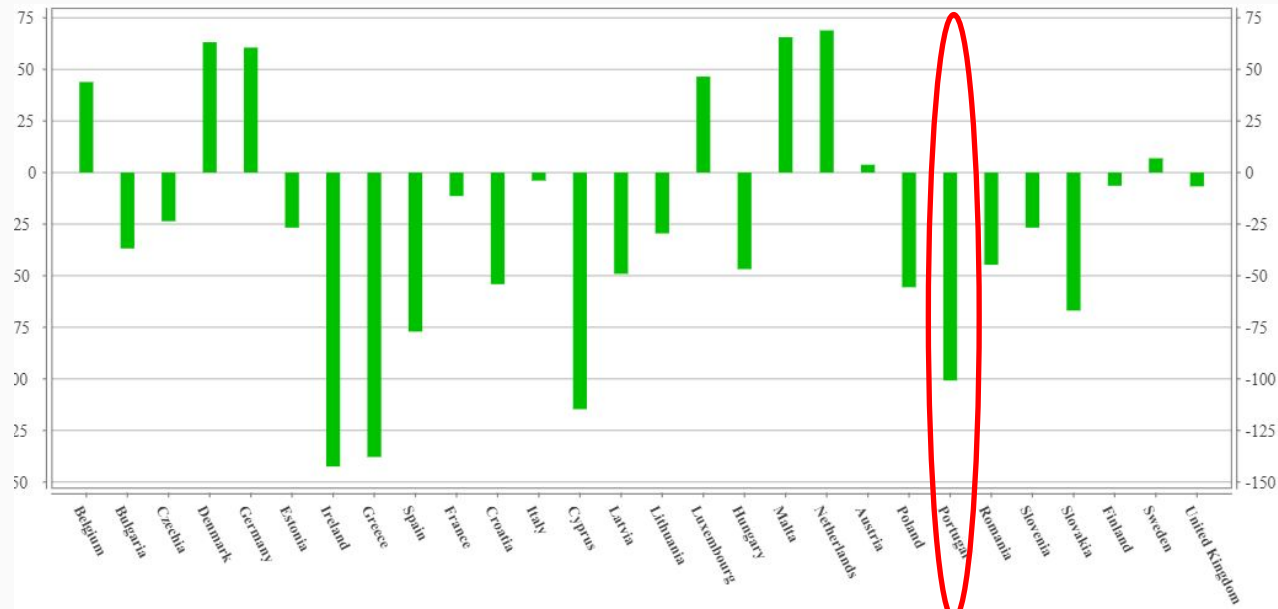
- domestic demand increases
- growth in tourism subsidies





B: External Balance and Policies

□ NIIP (Net International Investment Position)

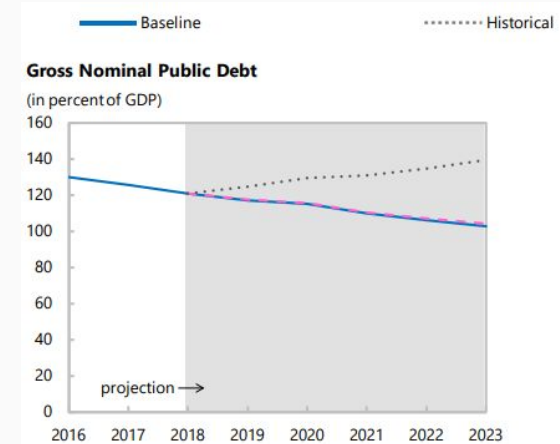




B: External Balance Assessment (EBA)

Foreign Assets + Liabilities position & trajectory

- **NIIP** declined -> driven by positive current account balances (after crisis improving external debt valuations)
- **Gross debt remains high**
 - both expected to decline at decelerating rate
- **Assessment:** negative NIIP □ external vulnerabilities
- past debt management: reducing sovereign external risk by redemptions & lengthening average maturity





B: External Balance Assessment (EBA)

Current Accounts

- Surplus driven by balance of trade □ shift to deficit as import growth outstrips export growth
- **Assessment:** suggesting cyclically adjusted account balance □ EBA asses current account shortfall of 2-4% of GDP to bring strong medium term improvement in NIIP
- Key to strengthen external position: sustained fiscal adjustment + structural reform (support growth & investment & address financial sector challenges)



B: External Balance Assessment (EBA)

Real Exchange rate

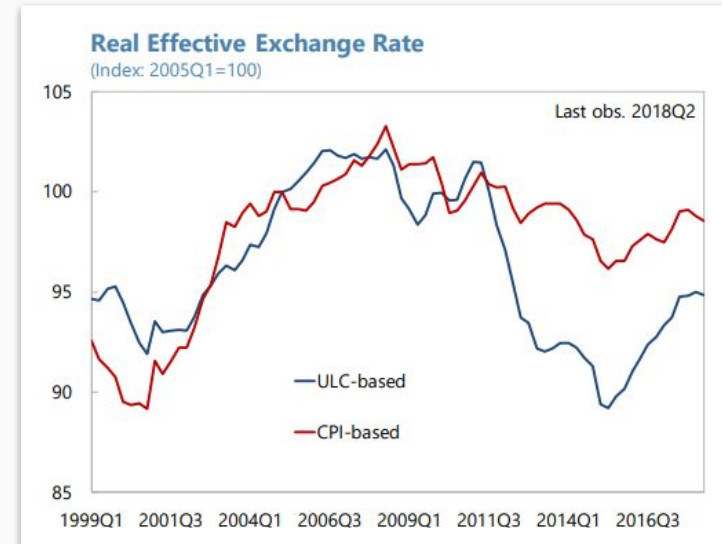
- REER (real effective exchange rate) below pre-crisis peak
- ULC (unit labor cost) below pre-crisis

□ Assessment:

- EBA □ overvaluation
- REER □ undervaluation
- Index model □ overvaluation



- Adjustment less through price competitiveness □ more through quality upgrades + innovation to improve non-price competitiveness





B: External Balance Assessment (EBA)

Capital and financial accounts: flows and policy measures

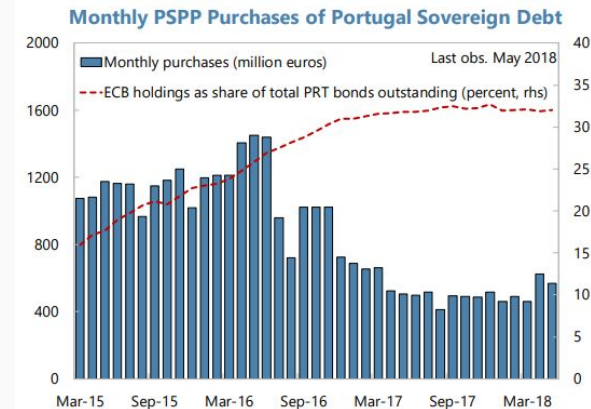
- Financing conditions eased + credit rating upgraded (stronger GDP growth + improved fiscal progress (banking sector) + support from ECB purchase)

- **Assessment:** current account surplus + improved macro conditions □ support external financing rollover needs for near-time + further necessary

Foreign Exchange intervention and reserves level

- € status of global reserve currency

- **Assessment:** reserves held by euro area typically low but free floating





B: External Balance Assessment (EBA)

Overall Assessment

- More sustainable NIIP position requires sustained current account surpluses for a long period

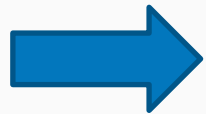
Potential policy responses

- Sustained fiscal consolidation + structural reforms -> improve competitiveness & potential growth
- Enhancing business conditions, streamlining regulations, increasing flexibility/responsiveness of institutions/markets (□ incentives for investment)
- Decreasing stock of NPLs while maintaining adequate capital buffer



B: Authorities View

- **current account surpluses** for a long period required to **improve NIIP -> desirable**
- **non-cost competitiveness gains** as driving factor behind strong **export growth + rise in market shares**
- increased **innovation** + well-educated **labor force** improving non-cost competitiveness



improving non-cost competitiveness



improving External Position



C: Fiscal Issues and Policies



C: Fiscal Issues and Policies

Authorities adopted a more ambitious fiscal target than predicted in the state budget

Budget closed with overall deficit of 0,9% of GDP, lower than the approved 1,1%. Hence, more ambitious target was set of 0,7%.

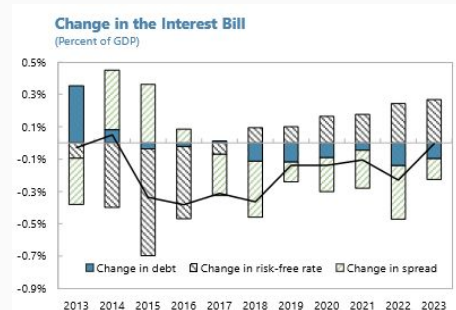
Driven by:

- Smaller expected one offs;
- Favorable effect of cycle;
- Declining interest bill

Furthermore, Public Debt to GDP ratio is expected to decline to 103% by 2023 and without temporary factors structural primary balance would deteriorate about 0.3% of GDP.

	Fiscal Balance (Percent of GDP)			
	2016	2017	Staff Forecast 2018	2019
Overall balance	-2.0	-3.0	-0.7	-0.3
One-offs	0.3	-2.0	-0.3	0.0
Adj. overall balance	-2.3	-0.9	-0.4	-0.3
Cyclical component	-1.1	-0.4	0.0	0.2
Output gap	-2.5	-0.9	0.1	0.5
Structural balance	-1.1	-0.5	-0.5	-0.5
effort in 2018			0.6	0.0
Interest	4.2	3.9	3.5	3.4
S. primary balance	3.0	3.4	3.0	2.9
effort in 2018			0.4	-0.2

Source: Staff calculations.





C: Fiscal Issues and Policies

Authorities should take advantage of economic environment and front load fiscal consolidation plans

- All the proposed adjustments would have to occur from 2021-2023, with the envisioned 1,5% of GDP adjustment in primary balance and its loosening by a cumulative 0,5% of GDP in 2018-2019. Authorities could aim to tightening the GDP of the structural balance cumulatively over 2018-2019
- Frontloading would also provide a valuable policy space (short and long term need). It would reduce the time required to reduce public indebtedness to a safer and closer level to regional averages. This debt levels makes Portugal depend on growth and interest rate assumptions



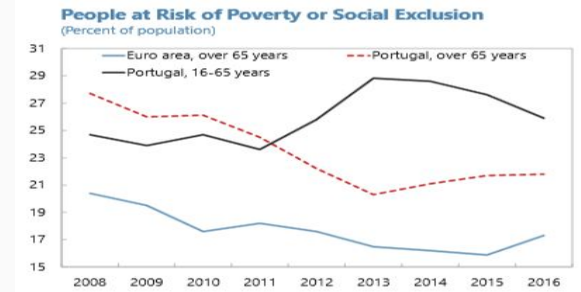
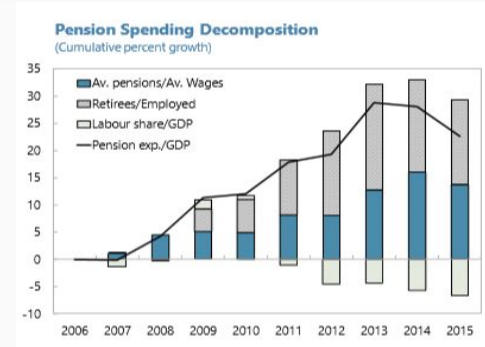
C: Fiscal Issues and Policies

Structural fiscal consolidation should be based on durable expenditure

Main focus should be the current balance and ongoing spending review while complemented with structural reforms to public employment and pensions to achieve lasting consolidation.

The need for a well-designed reform to the civil service that should be aimed at improving the level and composition of public employment comes from:

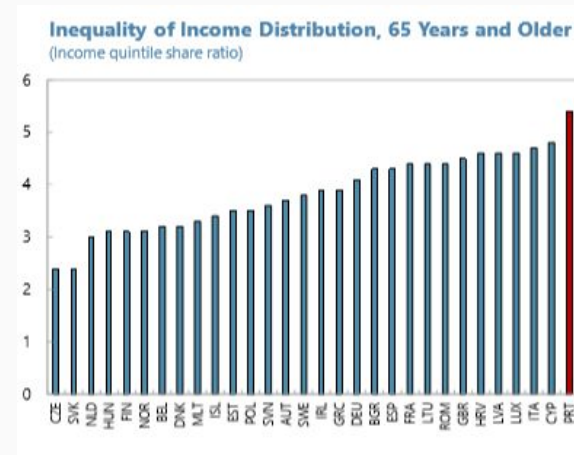
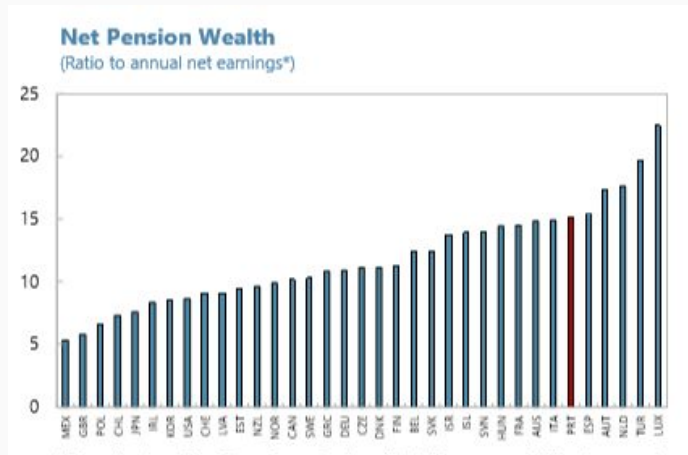
- Move to 35 hour week and ongoing unfreezing of career progression;
- Revision of pension system (ongoing penalization of early retirement) ;





C: Fiscal Issues and Policies

Structural fiscal consolidation should be based on durable expenditure





C: Fiscal Issues and Policies

Structural fiscal consolidation should be based on durable expenditure

Injecting public funds in the health sector to clear arrears unlikely to turn into durable results if the root cause of it is not addressed.

Main causes:

- Underbudgeting;
- Weaknesses in monitoring;
- Bad enforcement practice;



Steps in right direction

- Joint unit by the health and finance minister ;
- Local governments not delaying transition to integrated accrual based public accounting system;



C: Authorities View

- **Targets set out in Stability Program are realistic and appropriately paced**
- **Emphases in committing to advance expenditures reform**

Reduction strategy main focus:

- Restraint on public sector wages and employment;
- Efficiency saving from ongoing spending review;
- Falling interest payments;

Enhancing efficiency and improving inclusion of vulnerable group through measures like:

- Providing finance of pensions;
- Online pension benefit calculator;
- Improve fairness of system (raising lower pensions and reducing penalties of early retirement);

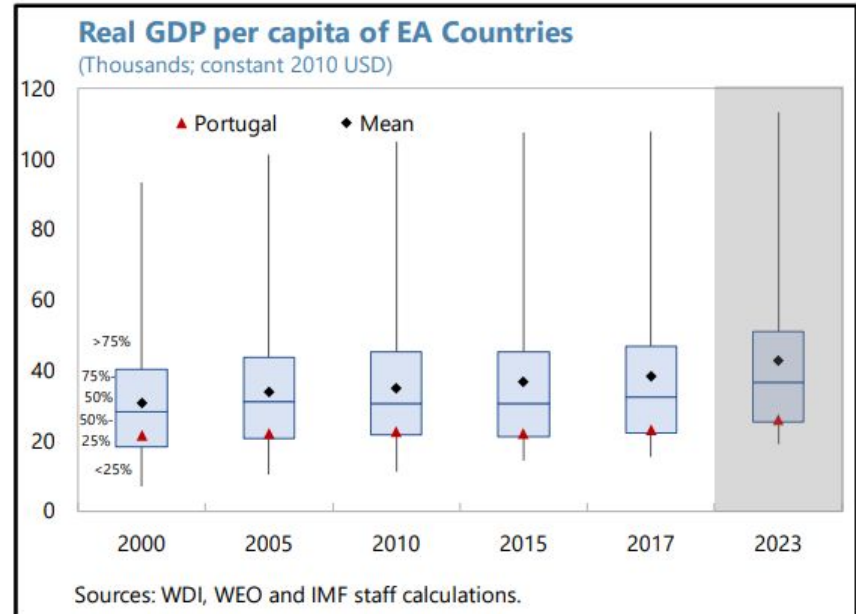


D: Structural Issues: Investment and Growth



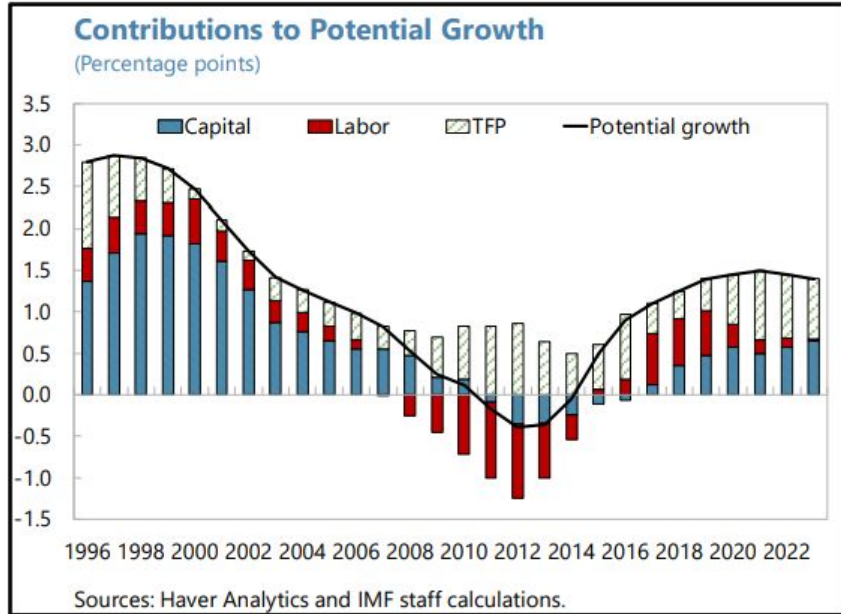
D: Structural Issues: Investment and Growth

1 - Improving medium term growth prospects is necessary for Portugal to converge to euro area standards of living and reduce vulnerabilities





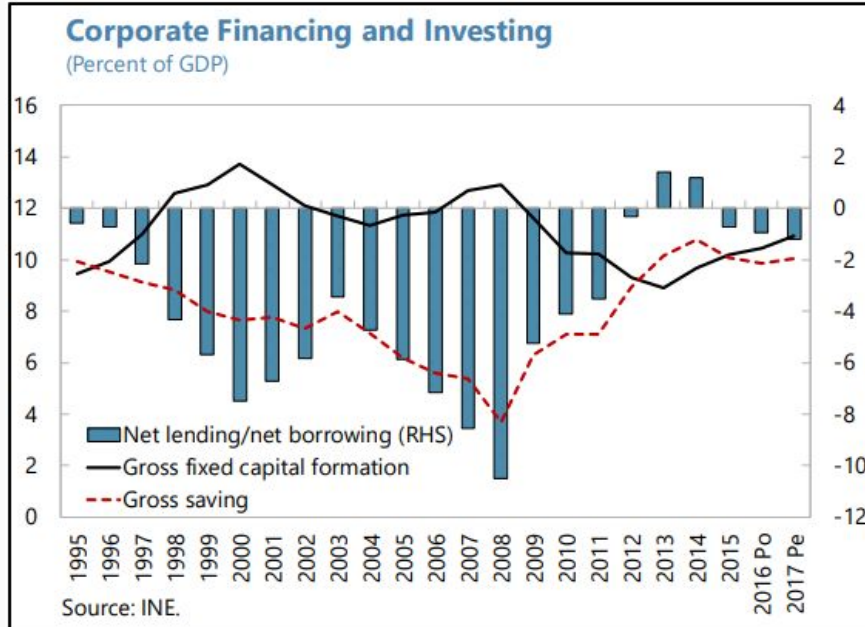
D: Structural Issues: Investment and Growth



2 - Potential growth in the medium term will remain moderate.



D: Structural Issues: Investment and Growth



3 - Increasing growth over the medium-term will require stronger domestic saving to finance additional private investment



D: Structural Issues: Investment and Growth

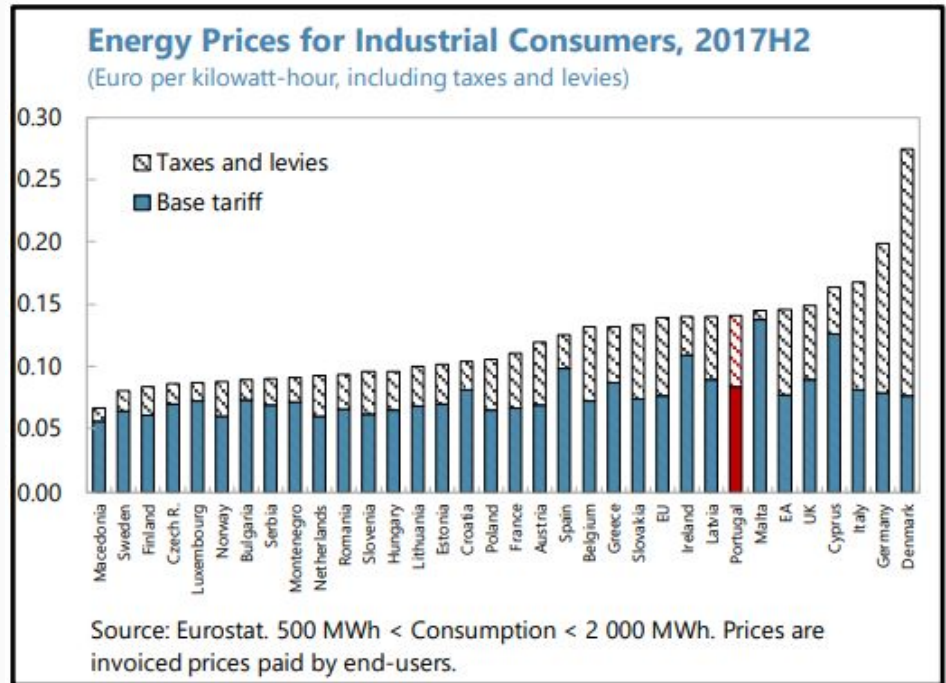
4 - Portugal needs to overcome significant structural challenges to boost investment and raise productivity, building on past reforms.

- Uncertainty and regulation. Ensuring a stable regulatory and tax environment would contribute to limit uncertainty, an important deterrent to investment



D: Structural Issues: Investment and Growth

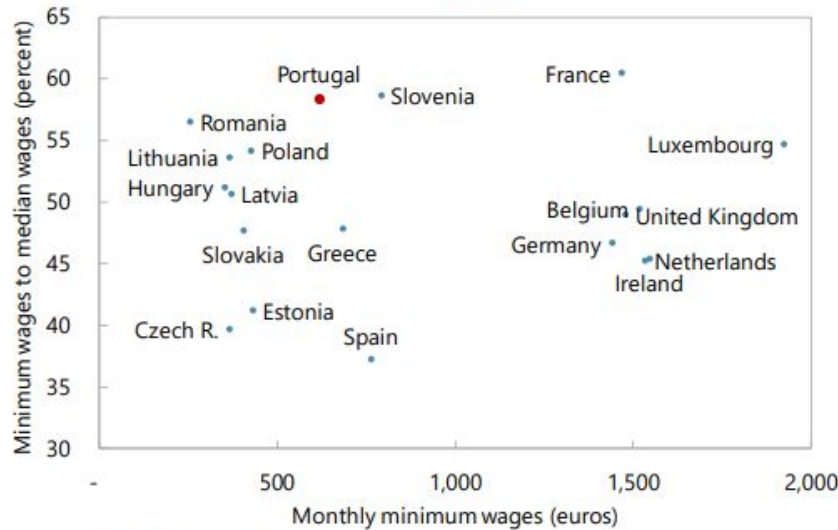
- Energy prices.





D: Structural Issues: Investment and Growth

Minimum to Median Wages, 2016



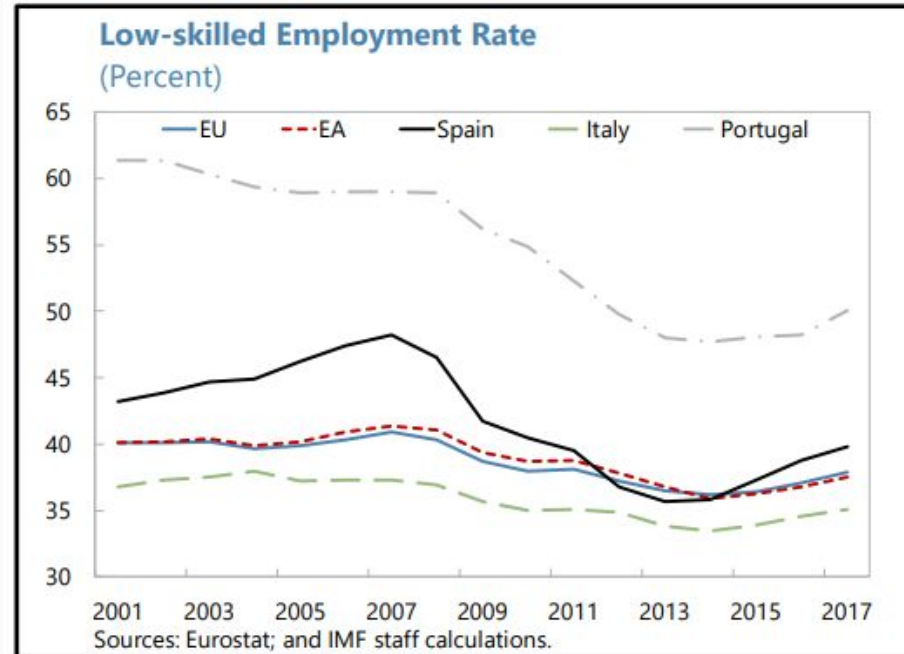
Source: Eurostat.

- **Wage growth and productivity**



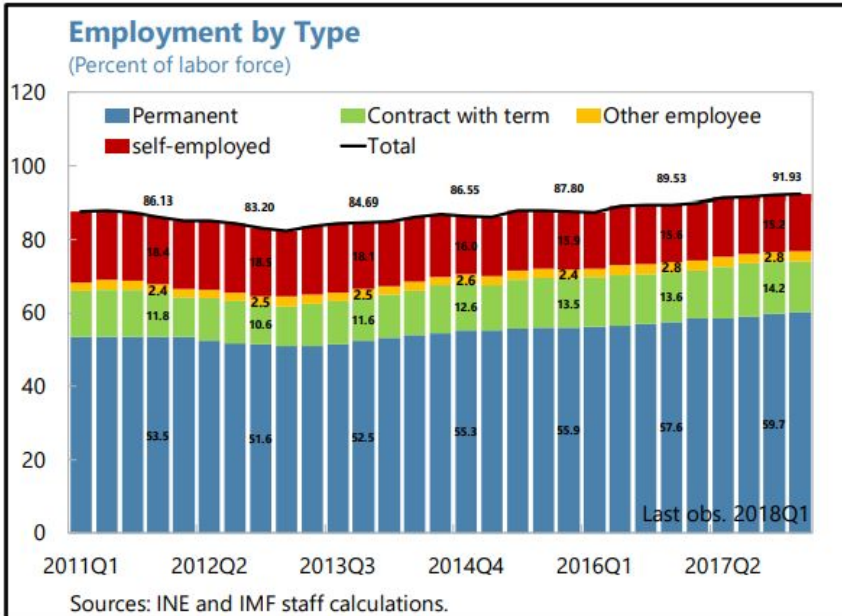
D: Structural Issues: Investment and Growth

- **Human capital development.**





D: Structural Issues: Investment and Growth

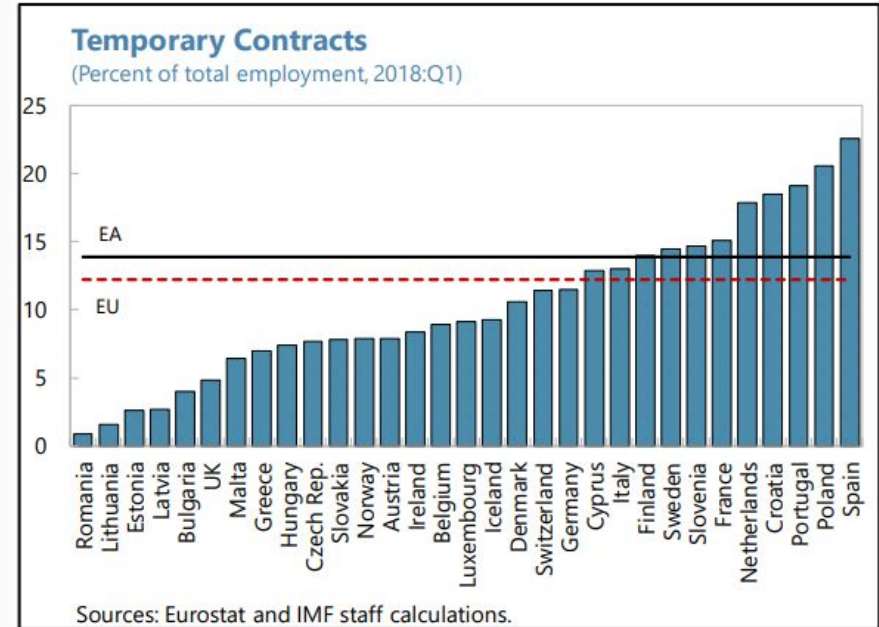


- **Legal and institutional framework for debt enforcement and insolvency**



D: Structural Issues: Investment and Growth

5 - Preserving labor market flexibility is important for the economy to adapt to future shocks and to support productivity growth.





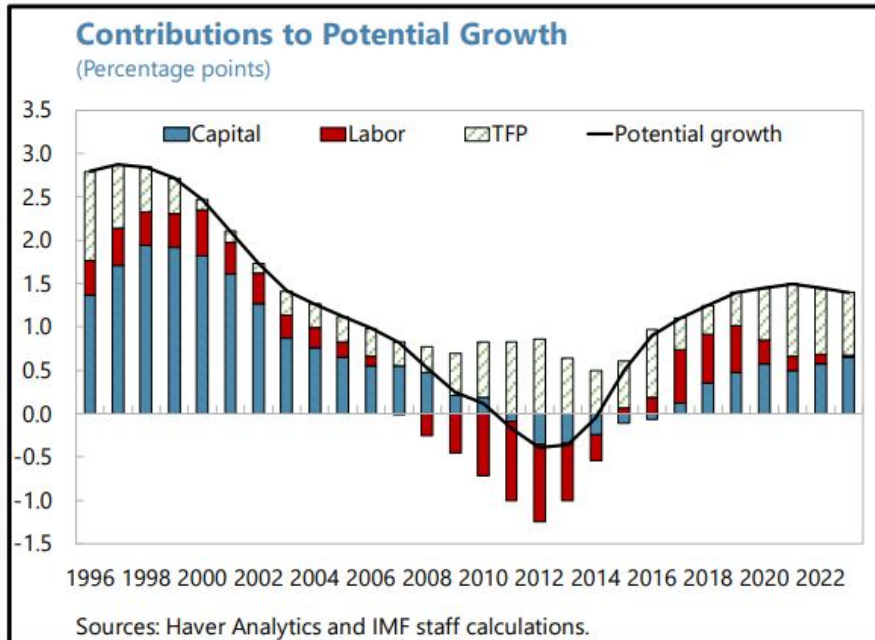
D: Structural Issues: Investment and Growth

Authorities View:

- The authorities in their Stability Program 2018–2022 see stronger potential growth of around two percent over the medium-term, grounded in structural improvements in skills, investment allocation, and export-orientation.
- The authorities stressed the importance of their multi-faceted strategy to boost investment and innovation



Labor Market Developments and Productivity

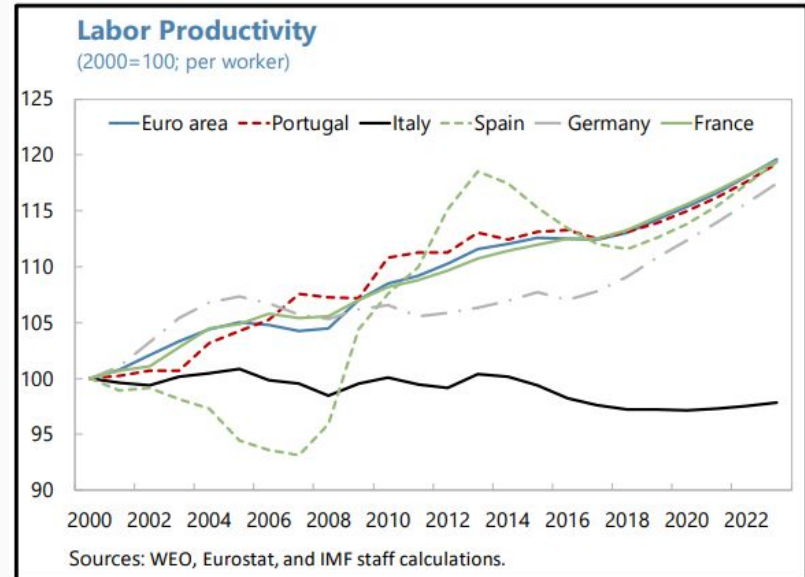


1. Labor factor growth is expected to support potential growth in the short term.



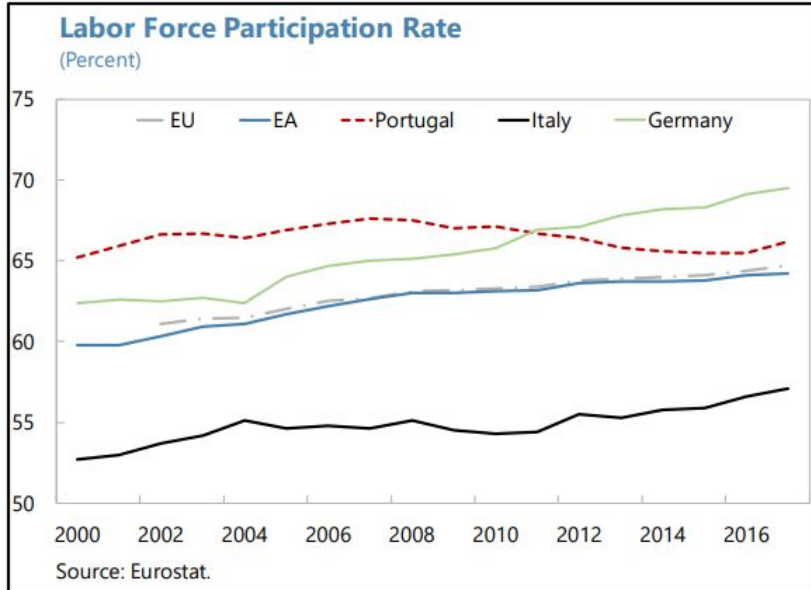
Labor Market Developments and Productivity

2. Continuing improvements in educational attainment and a reduction of self-employment underpin the medium-term projections for labor productivity and total factor productivity





Labor Market Developments and Productivity

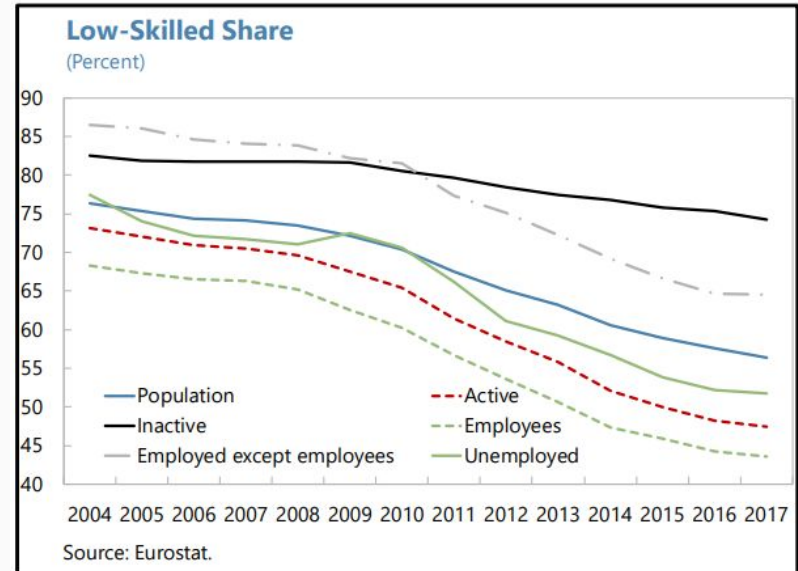


3. Labor force participation started to recover in 2017, increasing by 0.8 percent.



Labor Market Developments and Productivity

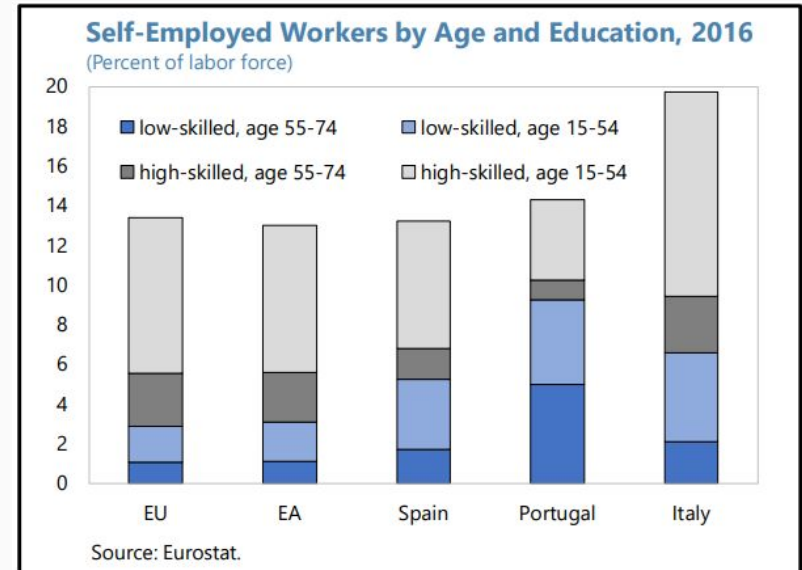
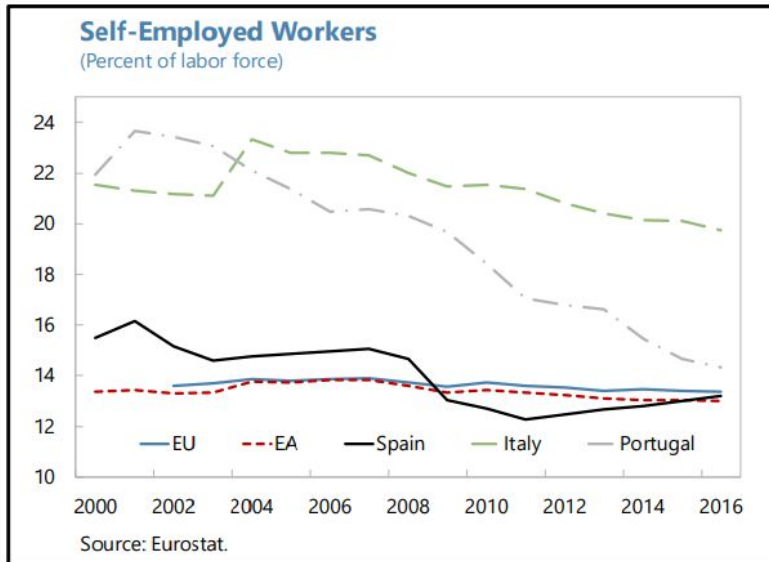
4. Although the share of low-skilled workers in Portugal (47 percent in 2017) remains significantly higher than the EU average (18 percent), it has declined markedly since the mid-2000's





Labor Market Developments and Productivity

5. Another notable development is the continuous reduction of self-employment.





Labor Market Developments and Productivity

6. Labor market reforms and human capital development would help to address demographic pressures going forward.



Executive Summary and Staff Appraisals



Executive Summary and Staff Appraisals

The Portuguese economy performed strongly in 2017.

- **Investment and exports** being the key drivers of growth. Labor market conditions continued to improve, with falling unemployment and broad-based employment creation.
- Thanks to buoyant economic growth, controlled budget execution, and falling interest costs, **the underlying fiscal balance** improved. This improvement contributed to more favorable financing terms throughout the economy.
- **Stability and confidence** in the banking system strengthened following successful efforts by banks to raise capital and reduce NPLs, and the sale of Novo Banco



Executive Summary and Staff Appraisals

Prospects remain positive, but downside risks have increased.

- **Growth** is expected to ease in 2018 from its recent cyclical peak and gradually moderate over the medium term. The **overall fiscal deficit** is likely to fall in 2018, helping reduce public debt ratios.
- A significant weakening of growth in the euro area or a turn in the global economy toward protectionism could impact Portugal because of its **linkages** to other European countries.
- **Policies need to remain strong in the face of heightened external risks, and of pressures to erode past reforms.**



Executive Summary and Staff Appraisals

Strong macroeconomic policies have worked and should be sustained.

- **Frontloading** the fiscal consolidation would avoid procyclicality by taking advantage of current favorable cyclical conditions to adjust. It would be prudent given future uncertainties, and would also help further **differentiate Portugal** at a time of potential bond market volatility.
- While systemic risks appear to be contained, the elevated stock of NPLs and low bank profitability remain **concerns**. To avoid NPL build-up, supervisors should continue to press banks to strengthen their **risk management** and **corporate governance**. Authorities should also continue to pay attention to credit standards and be ready to adjust the macroprudential measures.



Executive Summary and Staff Appraisals

Faster sustainable growth is needed to continue to reduce vulnerabilities and converge towards the average levels of productivity and income of the EU.

- Strengthening growth will require **fostering** soundly financed investment and continuing improvements in **productivity and skills**.
- Investment can be spurred by enhancing business conditions, streamlining regulations, and increasing the flexibility and responsiveness of institutions and markets, building on past reforms.
- **Sustainable financing** of investment requires continuing efforts to strengthen domestic saving and the financial intermediation system.



Executive Summary and Staff Appraisals

Portugal's external position remains weaker than that consistent with medium-term fundamentals and desirable policy settings.

- The strengthening in the **current account** since the crisis helped change the trajectory of the country's net international investor position.
- Significantly improving the **country's external position** in the future requires larger-than-forecast current account surpluses over the medium term, which calls for policies geared at boosting **domestic saving**.



Executive Summary and Staff Appraisals

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



Thank You!