INTERNATIONAL MONETARY FUND

IMF Country Report No. 19/221

PORTUGAL

July 2019

2019 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 2019 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 July 8, 2019 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 July 8, 2019, following discussions that ended on May 17, 2019, 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 June 19, 2019.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Portugal.

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

Selected Issues

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International Monetary Fund
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INTERNATIONAL MONETARY FUND
COMMUNICATIONS DEPARTMENT

Press Release No. 19/275
FOR IMMEDIATE RELEASE
July 12, 2019

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

IMF Executive Board Concludes 2019 Article IV Consultation with Portugal

On July 8, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Portugal.

Growth in 2018 eased compared to 2017 in part due to weaker economic activity in Europe. Unemployment is at a 14-year low, driven by strong employment growth, especially among the long-term unemployed. Growth in 2019 is expected to moderate to 1.7 percent and converge in the following years to its medium-term potential. Consumer price inflation remains subdued but is expected to gradually increase in coming years as wages picks up. The current account is expected to post moderate deficits in coming years.

The headline fiscal deficit improved in 2018, reflecting smaller one-off expenses, cyclical tailwinds, and a tight budgetary execution. It is expected that the government will meet it's 2019 budget deficit target, despite higher than expected transfers to Novo Banco, as a result of lower-than-budgeted capital spending and strong revenues. The Medium-Term Objective under the Stability and Growth Pact is expected to be met in 2020. Public debt is on a firm downward trajectory and is projected to reach close to 100 percent of GDP by 2024.

Banks have made significant progress in strengthening their balance sheets, with non-performing loans falling significantly in recent years. Nevertheless, troubled legacy assets remain high by European standards and profits moderate. No significant acceleration in credit growth is expected.

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

Executive Board Assessment[2]

Executive Directors welcomed Portugal's improved fundamentals, noting that the current real GDP level has now surpassed its pre-crisis levels, the unemployment rate declined to its lowest level in more than a decade, and that structural reforms have paid off. Directors, however, agreed that downside risks have increased amidst a less favorable global environment. They, therefore, stressed the need for continued efforts to strengthen the resilience of the economy and the financial system, including addressing the still elevated public debt level and non-performing bank loans. Implementation of further structural reforms to support potential growth, raise domestic savings and improve the business climate remains a priority.

Directors commended the authorities' commitment to sound public finances and fiscal consolidation, which resulted in reductions in the fiscal deficit and debt ratio in recent years, the repayment of the IMF loan ahead of schedule, credit rating upgrades, and substantially lower borrowing costs. Notwithstanding these achievements, Directors generally stressed the need for accelerated debt reduction to rebuild fiscal buffers to protect against unanticipated shocks as well as to address the fiscal impact of Portugal's aging population. In that context, Directors particularly welcomed the authorities' commitment to use revenue windfalls to accelerate public debt reduction. While acknowledging numerous efforts already taken to improve the efficiency of public spending, Directors called for further examination of the quality and composition of spending, with a view to shift spending toward greater public investment. Expenditures on pensions, wages, and health also deserve closer examination.

Directors agreed that banks' balance sheets had improved significantly in recent years, and especially commended the marked decline in non-performing loans. They noted, however, that modest profitability remains a concern, and encouraged further efforts to improve asset quality, efficiency, and governance. Directors also called for continued vigilance of mortgage market developments and for the authorities to stand ready to adjust macroprudential policies if needed. With respect to the financial supervision reform bill, Directors encouraged the careful consideration in Parliament of the concerns raised by the ECB, Banco de Portugal, and other domestic supervisors, and a continuing search for consensus, to ensure that the bill guaranteed the independence of supervisors, it was consistent with the European institutional framework, it would ensure timely and well-informed decision making, and it was cost-effective.

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[2] 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.

Directors emphasized the need to boost potential growth and productivity, to both reduce balance sheet risks and accelerate the pace of convergence to euro area living standards. They noted that to meet this goal, investment spending needs to increase, supported by an improved business environment, greater competitiveness and innovation, and a more efficient use of labor. To avoid the re-emergence of external imbalances, domestic savings will need to increase as well. In this regard, Directors suggested that the authorities explore ways to encourage complementary second- and third-pillar pension schemes.

Portugal: Selected Economic Indicators

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

		Projections	
	2018	2019	2020
Real GDP	2.1	1.7	1.5
Private consumption	2.6	2.1	1.6
Public consumption	0.8	2.4	1.2
Gross fixed capital formation	4.5	7.0	4.1
Exports	3.7	4.1	4.1
Imports	4.9	6.0	4.6
Contribution to growth (Percentage points)			
Total domestic demand	2.8	2.7	2.0
Foreign balance	-0.7	-1.1	-0.4
Resource utilization			
Employment	2.3	1.4	1.0
Unemployment rate (Percent)	7.0	6.2	5.7
Prices			
GDP deflator	1.4	1.5	1.7
Consumer prices (Harmonized index)	1.2	1.1	1.5
Money and credit (End of period, percent change)			
Private sector credit	-1.0	0.1	0.8
Broad money	8.5	2.8	2.7
Fiscal indicators (Percent of GDP)			
General government balance	-0.5	-0.2	0.1
Primary government balance	3.0	3.1	3.4
Structural primary balance (Percent of potential GDP)	3.4	3.6	3.6
General government debt	121.5	118.8	116.0
Current account balance (Percent of GDP)	-0.6	-0.6	-0.5
Nominal GDP (Billions of euros)	201.6	208.2	215.0

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

INTERNATIONAL MONETARY FUND

PORTUGAL

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

June 18, 2019

EXECUTIVE SUMMARY

After a strong performance in 2017, economic activity has moderated. The second half of 2018 was marked by a deceleration, coinciding with weaker economic activity in Europe. The headline fiscal balance improved, with a small increase in the structural primary balance reflecting a strict budget execution. The current account turned negative in 2018 in conjunction with a deterioration of the balance of trade in goods and services. Total credit to the nonfinancial private sector continued to decline in 2018. Nevertheless, over the last 4 years the Portuguese banking system has been strengthening its balance sheet and its performance.

The economy is projected to decelerate further in the near and medium term. In 2019, output growth is projected at 1.7 percent, and subsequently to ease towards its estimated medium-term potential of 1.4 percent. The fiscal deficit should fall again in 2019; on constant policies, and absent unforeseen shocks, public debt should decline to close to 100 percent of GDP by 2024. As a small open economy, Portugal would directly feel the negative consequences of weaker-than-expected global growth, and rising protectionism. Strong domestic policies would mitigate external risks.

Strong macroeconomic policies should be sustained. Pushing forward with the multi-year fiscal consolidation effort would help reduce vulnerabilities. In the event of a material downturn, a neutral fiscal stance would be appropriate, allowing the nominal deficit to widen as automatic stabilizers operate, as long as the public debt ratio remains on a downward trajectory. Supervisors should ensure that banks follow through with their NPL reduction targets and strengthen their corporate governance, internal controls, and risk management. Strengthening domestic saving rates is necessary to continue deleveraging and sustain higher investment rates without creating new external imbalances. The authorities should consider steps to encourage complementary second-and third-pillar pension schemes to boost private saving.

Approved by
Mahmood Pradhan (EUR) and Seán Nolan (SPR)

Discussions took place in Lisbon during May 7–17. The staff team comprised A. Cuevas (head), K. Kirabaeva, A. Pienkowski, A. Santos (all EUR); and M. Koulet-Vickot (MCM). D. Fanizza and I. Lopes (OED) participated in the key meetings. Y. Cai, R. Dumo, and V. Bezerra de Menezes (all EUR) supported the mission from headquarters.

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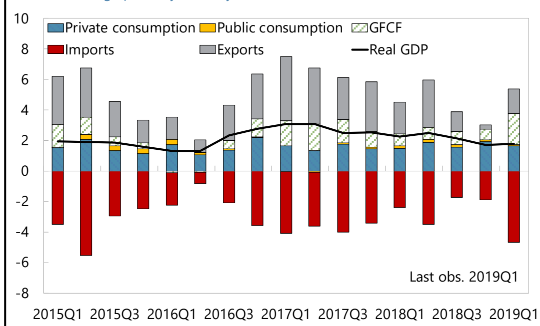
RECENT DEVELOPMENTS

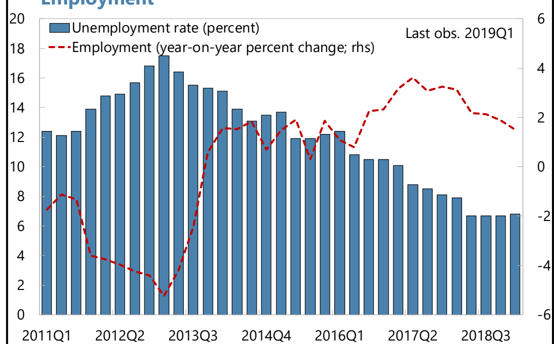
1. After a strong performance in 2017, economic activity has eased. The economy grew 2.1 percent in 2018 after posting 2.8 percent in 2017, consistent with cyclical moderation as the output gap closed. The second half of the year was marked by a deceleration, reflecting lower growth of exports and of investment expenditure. The 2019:Q1 outturn (1.8 percent y-o-y) confirmed the more moderate growth pace, with a stronger contribution from investment offset by rising imports. After a five-year decline, the unemployment rate reached 6.5 percent (s.a.) in 2019:Q1. Employment growth moderated to 2.3 percent in 2018 (from 3.3 percent in 2017). Labor underutilization continues to decline, and the job vacancy rate is at historically high levels as illustrated by the Beveridge curve.

Contribution to Real GDP Growth
(Percentage points, year-on-year)



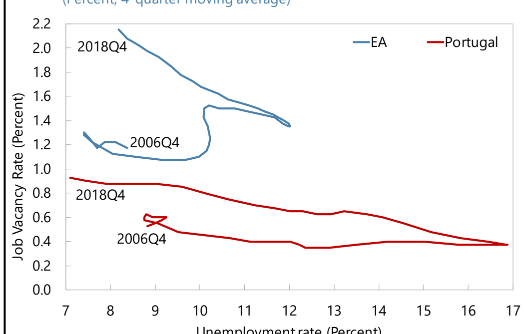
Source: Haver Analytics.

Employment



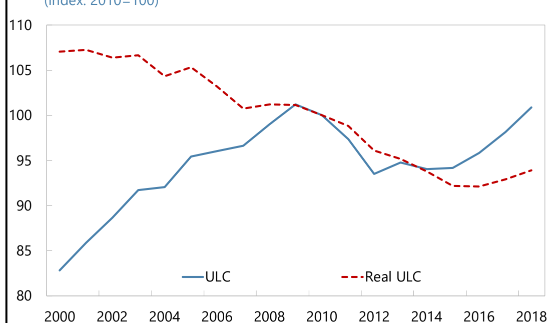
Source: Haver Analytics.

Beveridge Curve, 2006:Q4-2018:Q4
(Percent, 4-quarter moving average)



Source: Eurostat.

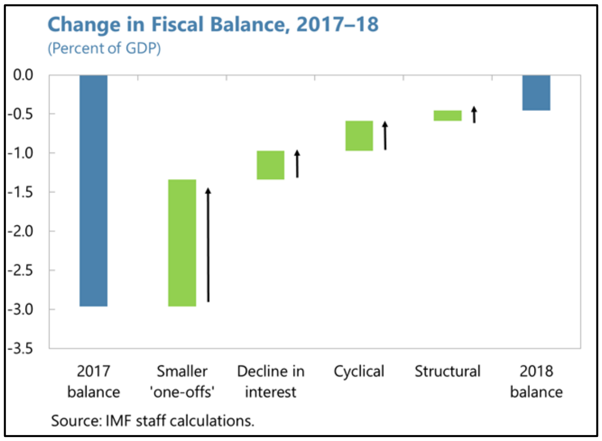
Unit Labor Costs
(Index: 2010=100)

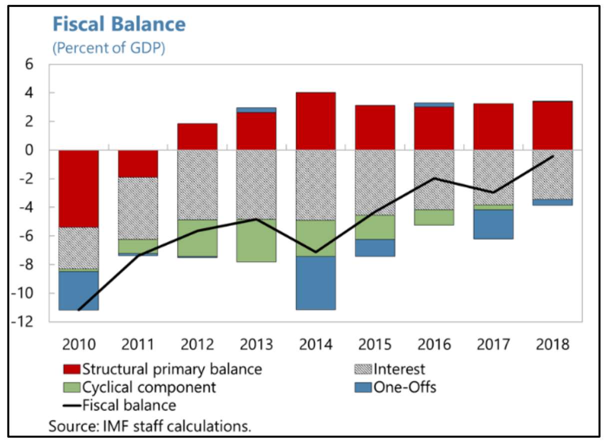


Sources: IMF WEO and staff calculations.

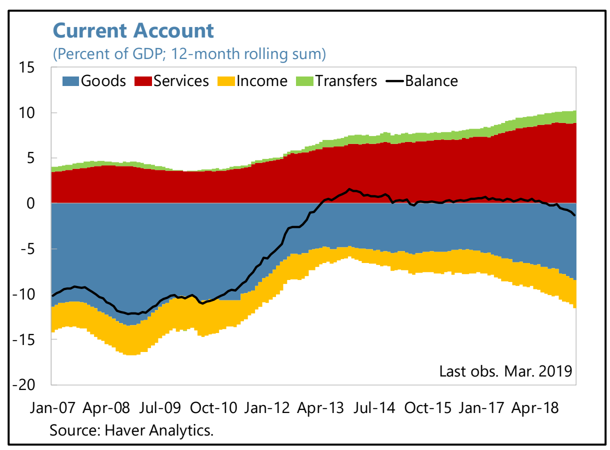
2. Consumer prices remained subdued in 2018. Headline inflation averaged 1.2 percent in 2018 and slowed to 0.9 percent in April 2019, below Euro Area rates of 1.8 and 1.7 percent, respectively. Core inflation slightly increased to 0.8 percent in April 2019 from 0.7 percent in 2018. Unit labor costs (ULCs) increased in nominal terms in 2018, but remained broadly stable in real terms. Real labor productivity declined slightly in 2018 (-0.2 percent year-on-year).

3. The headline fiscal balance came back down in 2018. The nominal fiscal balance in 2018 was -0.5 percent of GDP, a marked improvement since 2017 (-3.0 percent). While 'one-off' costs[1] were unusually high in 2017, the improvement in the nominal balance was also driven by a declining interest bill, a cyclically stronger position relative to 2017 (when the output gap was still negative), and a modest improvement in the structural primary balance, reflecting the government's tight budget execution. Despite some turbulence in May 2018 stemming from events in Italy (see Annex I, Box A1), Portugal's spreads over German 10-year bonds reached 1 percent one year later (Figure 3). Portugal is now deemed 'investment grade' by all major rating agencies. At the end of 2018, Portugal paid off the balance of its IMF credit, five years ahead of schedule (Annex II).





4. After remaining in balance or positive for several years, the external current account turned negative in 2018. Reflecting lower export growth, the current account balance deteriorated by 1.1 percent of GDP to -0.6 percent of GDP, with the balance of trade in goods and services declining by about 0.8 percentage points of GDP in 2018. Tourism receipts remained strong, although the growth of the sector slowed in 2018. The net international investment position (NIIP) rose modestly to -100 percent of GDP in 2018, and is expected to continue to improve gradually as a ratio to GDP. Both the CPI and the ULC-based real effective exchange rate (REER) have been quite stable over the last year and remain slightly below pre-crisis levels (Figure 4).

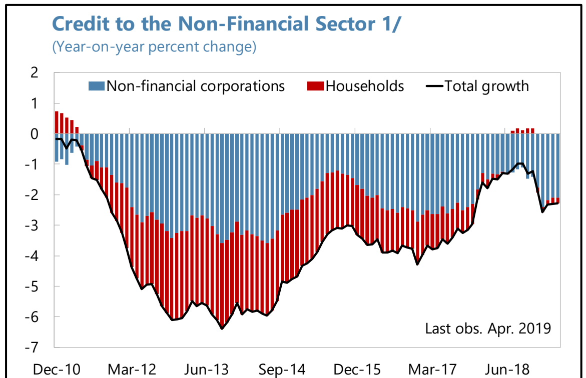


5. The stock of loans to the nonfinancial private sector continued to decline in 2018 and early 2019, with NFCs and households deleveraging further. The stock of loans to nonfinancial corporates declined 5.7 percent y-o-y in April 2019, driven by the reduction in the stock of loans to

[1] In 2017, one-off costs were 2.0 of GDP, largely reflecting the recapitalization of CGD; in 2018, one-offs were 0.4 percent of GDP, largely reflecting the capital transfer to Novo Banco.

most activities (except to firms in the agrobusiness and hospitality sectors). After growing modestly in the second half of 2018, the stock of loans to households declined y-o-y during December 2018–April 2019. Growth in consumer loans has not offset the decline in mortgage loans as households have continued to deleverage.

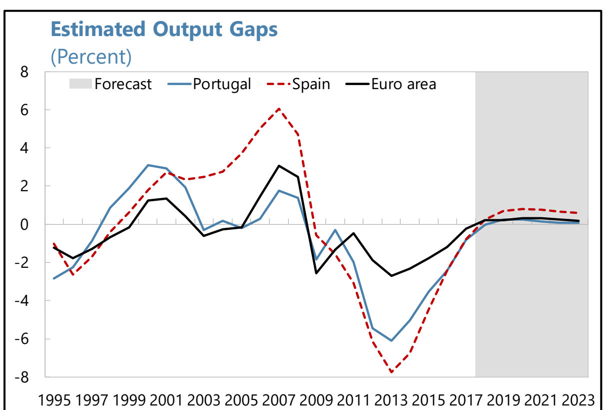
6. **The Portuguese banking system has continued to repair its balance sheets and strengthen its fundamentals.** Capital ratios have been boosted by capital augmentations, with the Common Equity Tier 1 capital ratio edging up to 13.2 percent in 2018:Q4 from 11.3 percent at end-2014. Asset quality has improved, with the NPL ratio declining 8.4 percentage points from its June 2016 peak to 9.4 percent in 2018:Q4. At the same time, the impairment coverage ratio increased to 51.9 percent from 40.8 percent at end-2015. The banking system has reported positive profits since the beginning of 2017 reflecting lower impairments and operational costs, stable income from services and commissions, and other factors.



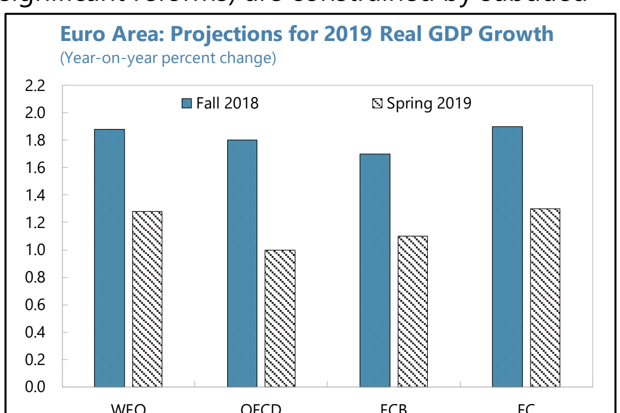
Source: Banco de Portugal.
1/ Total loans granted by the financial sector.

OUTLOOK AND RISKS

7. **The economy is projected to decelerate towards its medium-term potential.** Real GDP growth is projected to ease further to 1.7 percent in 2019, reflecting a less supportive external environment and moderating growth in domestic demand. In particular, growth in the Euro Area is forecast at 1.3 percent in 2019 in the April 2019 World Economic Outlook, down 0.6 percentage points from six months earlier. Nevertheless, growth in Spain, Portugal's main trading partner, is expected to hold up better than the Euro Area as a whole. Investment and exports should continue to be important drivers of growth, albeit offset in part by imports, while private consumption growth should moderate somewhat. Staff project consumer price inflation of 1.1 percent for 2019 and 1.5 percent in 2020. The labor market will remain tight, with unemployment declining further to 6.2 percent in 2019. A slightly positive output gap is projected for 2019. Medium-term growth prospects (1.4 percent under a baseline with no new significant reforms) are constrained by subdued



Source: WEO April 2019.



Sources: IMF, OECD, ECB and EC.

productivity growth, insufficient investment, and unfavorable demographic trends. The estimate of potential growth is subject to high uncertainty, including because of difficulties in separating structural and cyclical factors in the post-crisis recovery.

8. The fiscal deficit should fall in 2019, despite a greater-than-expected Novo Banco capital transfer. The government targets a near-balanced budget in 2019 (-0.2 percent of GDP), an improvement compared to 2018. The greater-than-expected cost of the Novo Banco capital transfer will increase spending commitments by 0.4 percent of GDP over the amount budgeted for this purpose. Nevertheless, staff expect that the -0.2 percent of GDP target will be achieved, largely through lower-than-budgeted capital investment and buoyant revenue. Further out, a falling interest bill (see the DSA in the Staff Report for the 2018 Article IV Consultation) will continue to support an improvement in the nominal fiscal balance, likely leading to a surplus in 2020, assuming unchanged policies. If the structural fiscal surplus is maintained, and barring unanticipated adverse developments, public debt should decline from 122 percent of GDP in 2018 to around 100 percent by 2024 (Annex I), a clearly positive prospect.

Fiscal Comparison
(Percent of GDP)

	2018	2019		
	Actual	Budget	Stab. Prog.	IMF
Revenue	43.5	43.3	43.8	43.6
Expenditure	44.0	43.5	43.9	43.9
GFCF	2.0	2.3	2.1	2.1
Interest	3.4	3.3	3.3	3.4
Balance	-0.5	-0.2	-0.2	-0.2

Source: Staff calculations.

9. The risks to the growth outlook have shifted to the downside reflecting a moderating cyclical position, the European deceleration of 2018H2, and a range of financial, economic, and geopolitical risks (Annex III).

- Portugal would directly feel the negative consequences of weaker-than-expected global growth, especially in the Euro Area. Figure 1 illustrates the transmission of a hypothetical shock to external demand. This would reopen the output gap in Portugal, bringing the fiscal deficit close to 0.7 percent of GDP in2019–2020 as automatic stabilizers operate, delaying significant reductions in public debt ratios until 2021.
- A disorderly Brexit could cause market disruptions and negative spillovers; in this case, the direct impact through trade in goods is expected to be moderate, while the effects through tourism could be more significant.[2] Other risks include rising protectionism and the intensification of security risks, with socio-economic and political disruptions, particularly in Europe.
- Likewise, a sharp tightening of global financial conditions, especially if combined with domestic policy slippages, could have repercussions on Portugal in terms of higher bond yields and interest rates, straining public and private sector balance sheets. In fact, in the last year vocal stakeholders have been advocating for the relaxation of policies or the reversal of past reforms, in some cases resorting to strikes. External risks could be mitigated or amplified by domestic policy choices: weaker policies would undermine investor confidence, while strong macro-

[2] Tourism could also be affected by a return of visitor flows to competing destinations (some of which have been recently unattractive owing to geopolitical reasons), or delays in addressing supply constraints and costs (e.g. congestion in Lisbon airport).

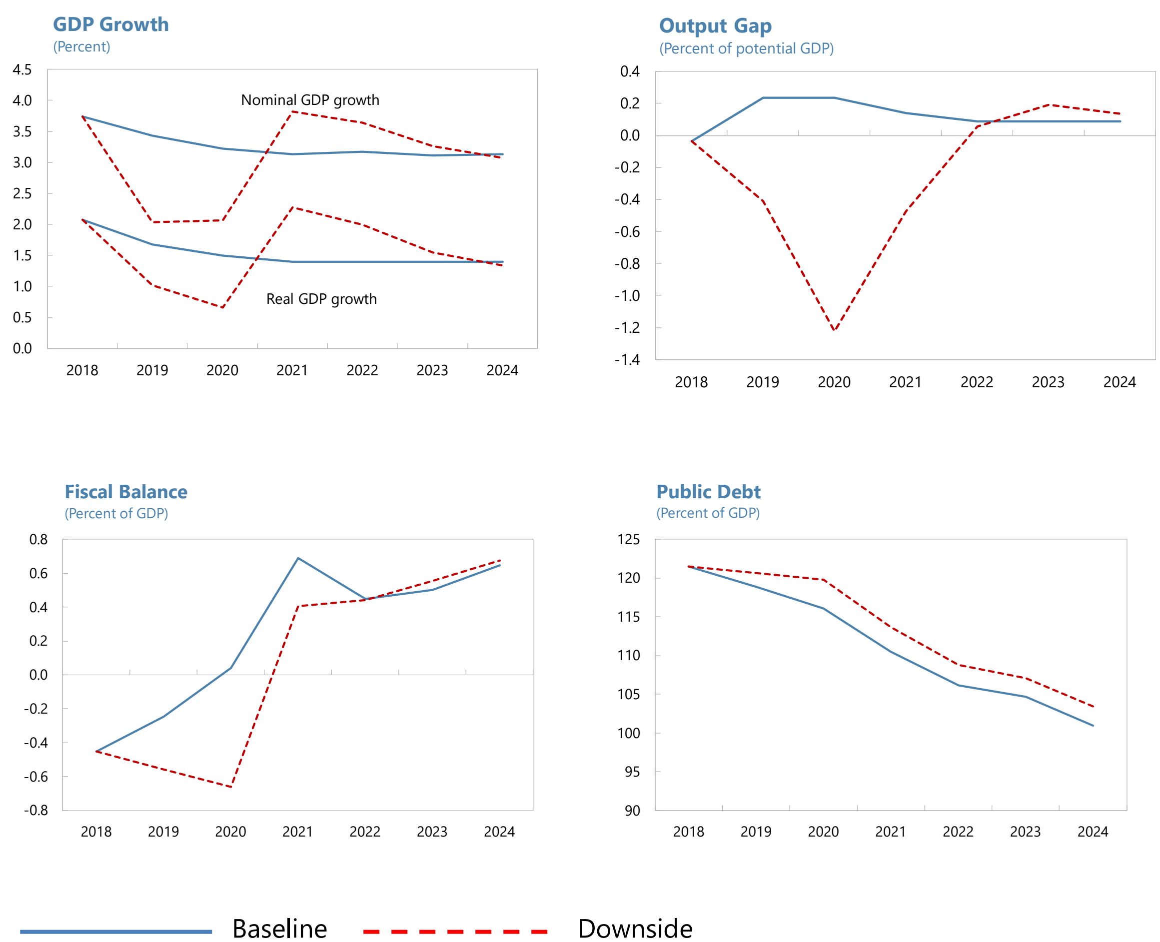
financial and structural policies would strengthen both the outlook and Portugal’s resilience to adverse events.

- On the positive side, the external economic environment could be better than expected, including Euro Area growth and stronger global trade relations and activity.

Authorities’ Views

10. The government forecasts annual GDP growth of 1.9 percent in 2019–2020, rising to 2.0 percent in 2021–2022 and 2.1 percent in 2023. The authorities indicated that the GDP outturn in the first quarter and the evolution of labor market and other data was consistent with their near-term forecasts, and that their medium-term growth projections were justified by structural changes in the economy, including the rise in education levels. They stressed that the most relevant risks for Portugal are external, given the openness of the economy and its integration in European and global trade.

Figure 1. Portugal: Baseline and Downside Scenarios: Key Macroeconomic Variables



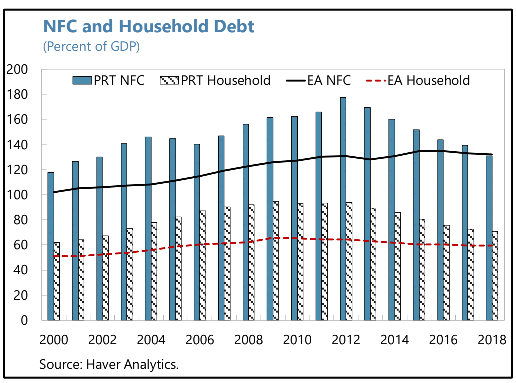
Notes: The downside scenario consist of weaker than expected growth for four quarters, including a technical recession in Portugal, with negative real growth for two quarters— of about -0.2 percent, qoq, which would be milder than the average recession in recent decades in Portugal (see Fiscal Council (2018) *Riscos Orçamentais e Sustentabilidade das Finanças Públicas*). The impact on macroeconomic and fiscal variables is derived from a semi-structural model to be published in a forthcoming working paper.

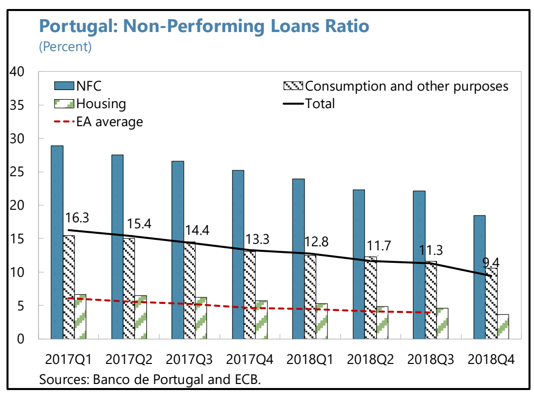
POLICY DISCUSSIONS

Portugal's economy has seen marked improvements in the labor market, the current account and the fiscal balances in the last several years, and its banking sector is undergoing repair. Growth is now moderating as the cycle matures, and in the near term, external risks are elevated, as elsewhere. The key issues are related to the stock legacies from the past—including high public and private indebtedness, and still sizeable bad assets in the banks—coupled with challenges to long-term growth from low investment, adverse demographics, and weak productivity. Staff's policy recommendations are directed toward further strengthening banks; increasing private and public saving to continue to advance deleveraging and increase resilience; and boosting productivity of available resources.

A. Macro-Financial Issues and Policies

11. Household and nonfinancial corporates continued to deleverage, but their debt stock remains elevated. Household debt-to-GDP declined 1.8 percentage points to 70.6 percent in 2018, but remains above the Euro Area average. Household deleveraging has moderated since 2017 due to a strong increase in new consumer loans and, to a lesser extent, mortgages, on the back of low interest rates and increased confidence relative to previous years. In the nonfinancial corporate (NFC) sector, the debt-to-GDP ratio declined by 8.1 percentage points to 131.1 percent of GDP in 2018, driven by both a net reimbursement of loans and write-offs, and the rise in nominal GDP. Meanwhile, NFC capital continued to increase, particularly for SMEs, with equity-to-capital asset ratio surpassing its 2006 level. Still, at such debt levels, Portuguese households and NFCs remain exposed to negative shocks to income and spikes in interest rates. Boosting saving rates, especially in the household sector, where they are low by historical standards, would help deleveraging.





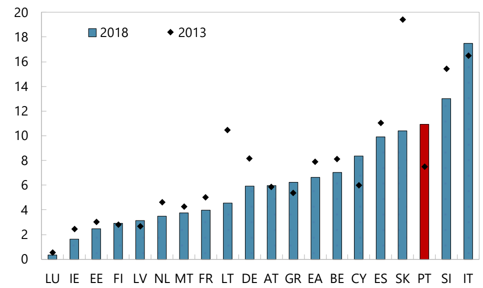
12. Supervisors should ensure banks continue to address their still large stock of legacy assets and low profitability. Consistent with the NPL reduction strategy pursued by the authorities, Portuguese banks have been reducing their legacy assets with a mix of cures, write-offs, sales, and foreclosures. However, NPL ratios are still among the highest in the Euro Area. Low interest rates, high operating costs, and impairments continue to weigh on profitability, which is also subject to headwinds from heightened competition in the provision of financial services by nonbank financial institutions (payment systems and financing) and the need to obtain costlier "bail-in-able" MREL resources (Minimum Requirement for own funds and Eligible Liabilities). Supervisors should ensure that banks continue to follow through their NPL reduction targets and strengthen their corporate governance, internal controls, and risk management. They should also encourage banks to continue to step up efforts to improve operational efficiency and profitability.

Legacy Asset Reductions in Portuguese Banks

	2016	2017	2018	2019	2020	2021
CGD						
NPL ratio target (in percent) 1/		12.5	10.0	7.0	5.0	
NPL ratio (in percent)	15.8	12.0	8.5			
BCP						
NPE target (in € billion) 2/						3.0
NPE (in € billion)		7.7	5.5			
Novo Banco						
Legacy asssets (in € billion)		14.7	10.7			
CCAs asset (in € billion) 3/	7.9	5.4	4.0			

1/ Strategic Plan 2017-2020.
2/ Strategic Plan 2018-2021.
3/ Net book value.
Source: Banks' quarterly reports.

Bank Claims on Domestic Government Debt
(Percent of total banking assets)



Sources: ECB and IMF staff calculations.

13. Supervisors should ensure that banks' capital ratios are resilient to a potential weakening of the economy and changes in risk premia. The 2017–2018 capital augmentations have helped banks absorb losses from their legacy asset reductions and improve buffers (in conjunction with provisions) against a deterioration in asset quality. Nevertheless, a weaker-than-expected economy could worsen asset quality and bring renewed pressure on profits. In addition, as elsewhere in Europe, banks in Portugal exhibit high concentrated exposures to the real estate market and to the sovereign. In December 2018, the holdings of domestic government securities by the banking system stood at 8.8 percent of total assets, up 0.5 percentage points from a year earlier.[3] This exposure means that Portuguese banks are vulnerable to abrupt rises in sovereign risk premia. According to a simulation exercise presented in the IMF's April 2019 Global Financial Stability Report, sharp rises in government bond yields could generate substantial losses for Portuguese banks in the EBA Transparency Exercise due to mark-to-market accounting rules. Under the severe scenario (benchmarked June 2018) in which yields on BBB rated bonds increase by 250 basis points, Tier 1 capital ratios would decline by about 1.5 percentage points to levels slightly lower than in 2010.[4] A solution to home bias in sovereign exposures, however, is an issue which is best addressed at the level of the Euro Area, with gradual transition periods for any new measures that might be introduced. Meanwhile, supervisors should ensure that capital buffers provided by the 2017–2018 capital augmentations are not eroded.

14. House prices are still rising, but no immediate policy action is needed. House price rises have continued, but they vary considerably by region. In addition, most real estate transactions have not been financed with mortgages (see Box 1). Still, if strong price rises were to persist, this could encourage mortgage lending (including through refinancing operations), further increasing banks' high exposures to real estate (38 percent of total assets as of December 2018) and household leverage. The Portuguese authorities should therefore closely monitor developments in mortgage markets and be ready to adjust macroprudential measures if needed.[5]

[3] Banco de Portugal, 2019, Financial Stability Report, June.
[4] Banco de Portugal estimated the direct negative impact of a 100-basis-point rise in domestic public debt yields on banks' capital ratios at 58 basis points (see June 2018 Financial Stability Report).
[5] Banco de Portugal reported broad compliance with the February 2018 borrower-based macroprudential measures. Available data for some financial institutions revealed stricter LTV ratios, collateral requirements, and other limits to volume and maturity (December 2018 Financial Stability Report).

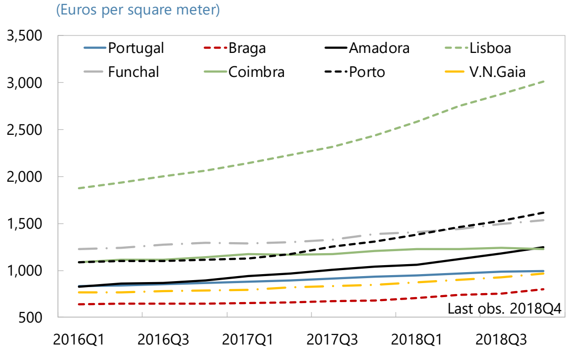
Box 1. Real Estate Prices in Portugal

Growth of the Portuguese House Price Index (HPI) decelerated to 9.3 percent y-o-y in 2018:Q4 from its 12.2 percent y-o-y peak in 2018:Q1. Price increases have been more pronounced for existing dwellings, rising 9.5 percent y-o-y in 2018:Q4 and, in particular, in Lisbon and Porto, with the median value per square meter increasing more than 23 percent y-o-y in 2018:Q4.[1] Data from the OECD (see Figure 5) indicate that the price-to-rent and price-to-income ratios are slightly above their 2000:Q1–2018:Q3 averages, which suggests that housing markets are not significantly overvalued.[2]

A significant part of the transactions driving real estate prices up in key locations are linked to the strong growth in the tourism sector and direct investments by non-residents. The share of purchases by nonresidents in the total number of transactions has strengthened from 2014 (see picture). Nonresidents were especially active in the higher end of the property market, with the share of nonresident purchases in the total value of transactions in the >€500k segment exceeding 35 percent during 2013–17. These indicators may understate the participation of foreign investors in the real estate market, because some buyers acquire resident status when they buy a property.

Median Value of Dwellings Sales

(Euros per square meter)



Source: INE.

Nonresident Real Estate Transactions, 2017

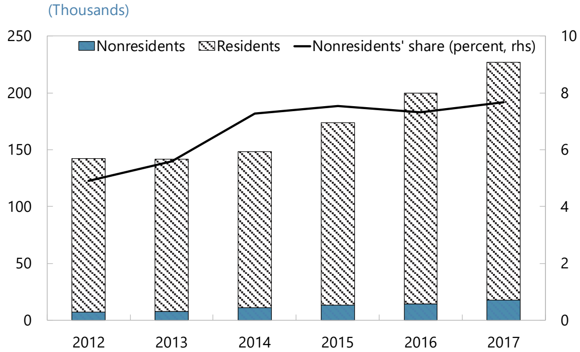
(In percent of the volume of real estate transactions)

	Share
Portugal	11.5
Norte	5.0
Of which:	
Alto Minho	10.9
Porto metropolitan area	4.5
Center	9.0
Of which:	
West	16.4
Lisbon metropolitan area	8.0
Alentejo	6.9
Of which:	
Alentejo Litoral	14.6
Algarve	40.9
Açores	5.4
Madeira	12.0

Source: INE.

Number of Real Estate Transactions

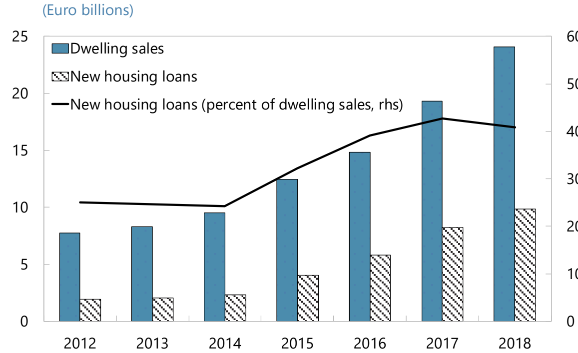
(Thousands)



Source: INE.

Dwelling Sales and New Housing Loans

(Euro billions)



Sources: INE and Banco de Portugal.

1/ The increase in the media value per square meter in other cities ranged from 1.7 percent to 20.2 percent y-o-y in 2018:Q4.

2/ The Banco de Portugal indicated in its December 2018 Financial Stability Report that house prices are not substantially misaligned (based on the ECB's calculation and metrics). The Fund's module for assessing misalignment in the residential real estate market, using three metrics (real house price model, price-income ratio, and price-rent ratio), reaches a similar conclusion.

15. The government has sent to Parliament a bill to reform the financial sector supervisory and resolution frameworks, but further discussion is needed on several aspects of the proposed reform.

- Some of the bill's main objectives are to improve coordination among supervisors, and to limit the risk of conflicts of interest related to assigning supervision and resolution functions to the same entity. The bill would give a permanent structure and legal personality to the mechanism for coordination of supervisors, vesting it with new powers, including in the macroprudential policy area, and create a new resolution authority separate from supervisors; in addition, the bill would modify some aspects of the governance of existing supervisory bodies (see Annex IV).

- Although the bill was submitted after a process of consultation among the government and the financial supervisors, it does not represent a consensus. The three sectoral supervisors whose functions would be affected (Banco de Portugal, the Securities and Exchange Commission, and the Insurance and Pension Funds Regulator) have communicated substantive concerns to Parliament. These include concerns over the way the newly created entities would interact with the sectoral supervisors, the potential implications of the new framework for these supervisors' independence and effectiveness, and the new entities' funding costs. Banco de Portugal and the ECB also see some provisions in the bill as inconsistent with the European institutional framework.

- Staff is of the view that different architectures can achieve core policy objectives; but to deliver on those objectives, any chosen architecture should guarantee the independence of the supervisory authorities, be cost efficient, and ensure that sensitive decisions can be made soundly and quickly, especially when time is of the essence. Staff would also recommend that the Banco de Portugal retain a central role in macroprudential policy, in view of its expertise and the relatively small size and bank-dominated character of Portugal's financial system.[6] In Portugal, any framework should, additionally, be consistent with the Euro Area institutional framework.

- The comments on the bill issued by the three national supervisors and the ECB raise legitimate concerns in all these respects. These concerns deserve full examination in Parliament before the bill is turned into law. The proposed reform will be highly consequential for the stability of the financial system for a long time, so it is important to get it right.

Authorities' Views

16. The Portuguese authorities stressed that banks' health continued improving in the last year. The total capital ratio stabilized in 2018, benefitting from the issuance of AT1 and Tier 2 instruments. Banking system profitability continued to recover with lower credit impairment losses and higher operational efficiency, resulting in a ROA slightly above EA average during 2018 Q1–Q3.

[6] See IMF Guidance Note on Macroprudential Policies.

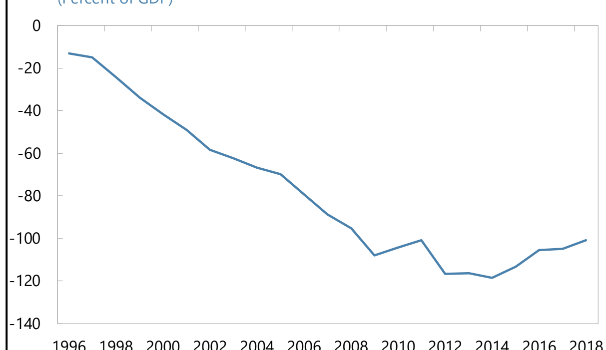
Non-performing loans continued to decline significantly (€25 billion corresponding to a decrease of around 50 percent in volume since its peak in June 2016) while impairment coverage ratios increased, leading to a net NPL ratio below 5 percent by the end of 2018 (4.5 percent). Finally, in 2018, banking system's total assets increased for the first time since 2010 while the liquidity position remained at comfortable levels. The Portuguese authorities noted a high degree of compliance by banks, during July 2018–March 2019, with the borrower-based macroprudential measures, announced in February and implemented in July 2018, resulting in a gradual improvement in the borrowers' risk profile associated to mortgage and consumer loans. The Portuguese authorities also highlighted that Portuguese firms (especially SMEs) and households continued to deleverage—with household leverage now not far above the Euro Area median level. Corporate credit growth was broad based across sectors and concentrated on low and medium-risk firms, which continued to benefit from relatively more favorable interest rate spreads on bank loans. New credit granted to households stabilized amid tightening bank credit standards. Finally, the Portuguese authorities also noted that, while residential real estate prices might have been above fundamentals since 2018:Q1, mortgage lending has been stable at 40 percent of real estate transactions, significantly below pre-crisis levels

17. The Ministry of Finance underscored that, with the banking system undergoing fast recovery, it had become possible to finalize the reform of the financial supervision and resolution institutional framework based on lessons learned from the past. This includes the need for a stronger coordination among sectoral supervisors, while preserving their independence. Banco de Portugal stressed that they were not opposed in principle to an updating of the existing frameworks, but had major concerns over key elements of the proposed legislation, which they see as potentially undermining their independence, complicating the discharge of their functions, and/or being inconsistent with the European institutional framework. The European authorities took the view that several elements of the proposed law are either incompatible with the European institutional framework or inconsistent with the Basel Core Principles for Effective Banking Supervision, and should be reconsidered. The Ministry of Finance considered that some of these concerns were already accommodated in the draft law submitted to the Parliament, following the consultations with the sectorial supervisors, and provided justification on the remaining, while Banco de Portugal considered that major concerns remain.

B. External Balance and Policies

18. Portugal's external position was moderately weaker than consistent with medium-term fundamentals and desirable policy settings in 2018 (Annex V). The strong improvement in the external position since the crisis reflects in large part rising goods exports and tourism, resulting in a positive or balanced current account in the last several years. In 2018, however, the current account moved into deficit

Portugal: NIIP
(Percent of GDP)



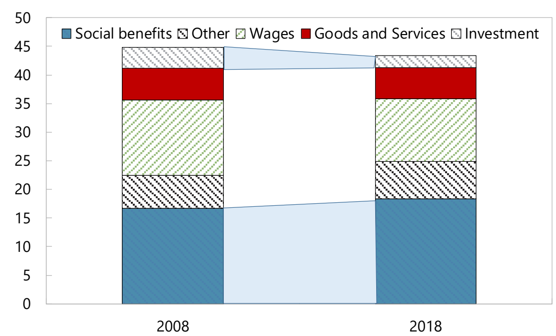
Source: Haver Analytics.

as domestic demand grew faster than Portugal's external markets. Staff project a current account deficit over the next several years as domestic demand increases and the growth in tourism moderates. In the baseline scenario, this results in a projected reduction in the large negative NIIP that is broadly commensurate with the expected deleveraging in the public sector. To see a faster reduction in the negative NIIP, a current account with a small surplus would be needed. Staff thus see a current account shortfall of about 1-3 percent of GDP in the medium term. (This is broadly consistent with EBA results on the REER suggesting an overvaluation of about 5 percent.) A key to achieving stronger external positions is to foster domestic saving, including by invigorating second and third pillar pension schemes.

Authorities' Views

19. The authorities indicated that a continued improvement of the NIIP as a share of GDP was both desirable and possible. They underscored the structural transformation that had ended the period of large current account deficits, with non-cost competitiveness gains as a main driver of export growth and rising export market shares. They expect Portugal's external position to maintain an improving trend based on fundamentals such as innovation, movement up the quality ladder, and the up-skilling of the labor force, which reinforce Portugal's competitiveness. In addition, they pointed to the projected positive balances in the capital account, which would keep net lending to the rest of the world positive, helping strengthen the NIIP.

Non-Interest Expenditure
(Percent of GDP)



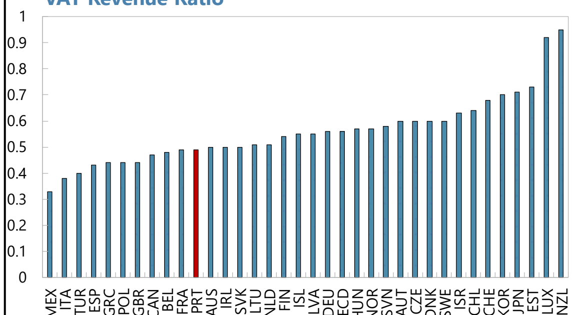
Source: Staff calculations.

C. Fiscal Issues and Policies

20. The headline balance will be close to zero in 2019. Staff project the nominal balance to fall from -0.5 percent of GDP in 2018 to -0.2 percent in 2019. Working to improve the nominal balance are falling interest payments, output moving above potential and some structural adjustment. Debt will fall under this scenario, to 119 percent of GDP this year, and to 101 by 2024, assuming unchanged policies and no major adverse surprises. This will mark a significant decline, but does not sufficiently reduce the risks associated with such a public debt overhang.

21. Greater fiscal effort now will pay off in the future. The target for the structural balance under the SGP—the "medium-term objective (MTO)"— will be lowered to 0.0 percent of GDP in 2020 (from 0.25 percent of GDP). Staff recommend that the revised MTO be treated as a floor, with overperformance in coming years to accelerate the pace of debt reduction. Taking advantage of a still favorable environment, including supportive monetary conditions (Annex VII), it would be prudent to tighten policy in the near term to: (i) speed up the pace of debt reduction and build policy space for the future; (ii) avoid tightening in later years that could be pro-cyclical; and (iii) further differentiate Portugal from other high-debt countries. Specifically, Staff recommend a 1 percent of GDP tightening of the structural primary balance (relative to 2018) over 2019–2020. This could be achieved, for example, by reducing the number of exemptions and preferential rates on VAT: a shift to the OECD average could increase revenues by over 1 percent of GDP. Such an overshooting of the MTO would free up resources to help accommodate unanticipated shocks in the near term, and the fiscal impact of an aging population over the medium and long term. In fact, the government projects the *annual* social security balance to deteriorate by 0.9 percent of GDP within 10 years, and the Fiscal Council estimates that annual spending on health and long-term care will increase by 1.3 percent of GDP over the next 20 years. Portugal will need to continually improve its underlying policies to keep its structural balance unchanged in the face of these developing pressures.

VAT Revenue Ratio [1/]

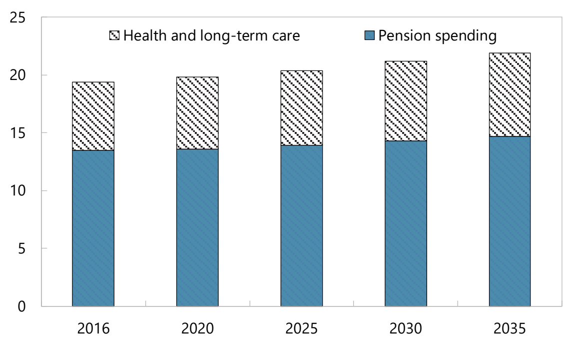


Source: OECD

[1/] Ratio between the actual value-added tax revenue collected and the revenue that would theoretically be raised if VAT was applied at the standard rate to all final consumption. Data is for 2016.

Age-Related Expenditure

(Percent of GDP)



Source: Portuguese Fiscal Council.

22. In the event of a faster-than-expected slowdown, a neutral fiscal stance would be appropriate, as long as debt reduction continues (Figure 1). The sovereign's improved access to markets, including its investment grade rating, are the result of placing public debt on a clearly downward trajectory. In the event of a moderate slowdown driven by weak demand, automatic stabilizers should be allowed to work and structural adjustment could be temporarily delayed. But policies would have to remain consistent with continued debt reduction over the medium term in any downside scenario.

23. From a structural perspective, issues of expenditure composition need attention. Some recent spending cuts, particularly in capital and intermediate consumption, may not be durable, requiring some adjustments within the expenditure envelope in coming years, and the wage and the pension bills need to be reexamined.

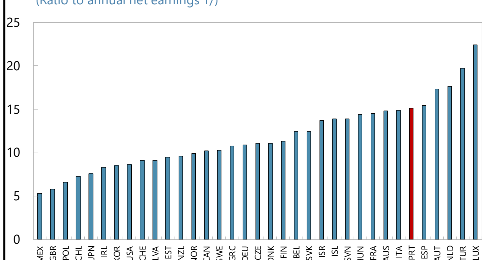
- Capital spending is well below pre-crisis and EU averages (Figure 3) and will have to increase to maintain the level of public capital stock, which is needed to support potential growth. In terms of intermediate consumption, there have been some important efficiency gains associated with the renegotiation of PPPs and from the Spending Review. [7] However, some service delivery indicators have worsened and the scope for further cuts could be limited.

[7] According to the 2019 Budget, the Spending Review generated recurrent efficiency savings of €240 million in 2018.

- Relatedly, financial management in the public health system continues to face significant challenges including on account of the recurrent accumulation of hospital arrears (€520 million in March 2019). Against this backdrop, the authorities have introduced an enhanced governance framework for public hospitals coupled with increases in budget allocation linked to efficiency savings. The root causes of arrears accumulation (i.e., under-budgeting, weak monitoring and enforcement practices) need to be addressed to put hospitals' finances on a sustainable footing.

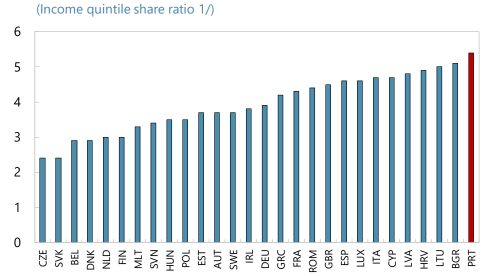
- Over the past decades, the Portuguese public pension system underwent several important changes aimed at enhancing its sustainability, including by increasing the legal retirement age and linking it to the average life expectancy, and by reducing the benefits of new retirees after 2007. However, the system remains expensive, generous by OECD standards and does little to correct old-age income inequality. Also, a generous PAYG first pillar supported with general revenue may be discouraging private saving. It is recommended that the outcomes of past reforms be re-examined, with the view to identify possible actions, focused on the highest pensions, to enhance equity in the system and keep a tight control on the trajectory of pension spending. For instance, the accrual rates for the largest earning brackets could be reduced in order to gradually converge to EU average replacement rates.

Net Pension Wealth
(Ratio to annual net earnings 1/)



Source: OECD.
1/ Present value of the flow of pension benefits, taking account of the taxes and social security contributions, expressed as a multiple of annual net earnings.

Inequality of Income Distribution, 65 Years and Older
(Income quintile share ratio 1/)



Source: Eurostat.
1/ The ratio is the income of the richest 20 percent divided by the income of the poorest 20 percent.

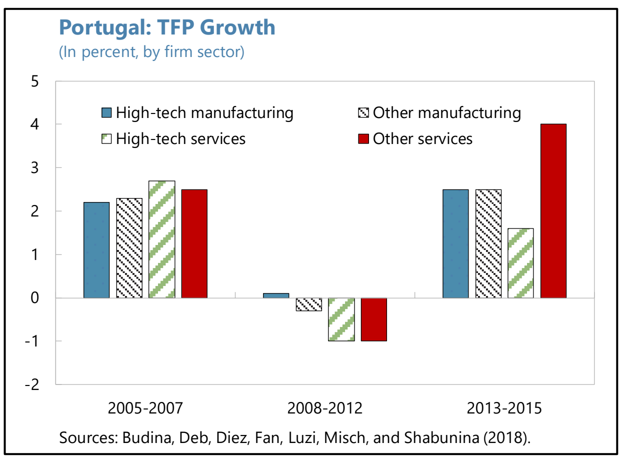
- Pressure on the wage bill is also mounting. Despite a commitment to reduce public employment in the 2018 budget, this grew by over 2 percent, partly reflecting increased needs from moving to a 35-hour week. And the gradual unfreezing of career progressions is putting additional pressure on the wage bill. The stop-and-go cycle of career progressions since 2005 (years before the program period) has been disruptive for both the government and public servants, and raises questions about the sustainability of these frameworks in the face of economic fluctuations. A comprehensive review of the level, composition and rules of public employment would help identify ways to control increases in the wage bill without affecting service delivery.

Authorities' Views

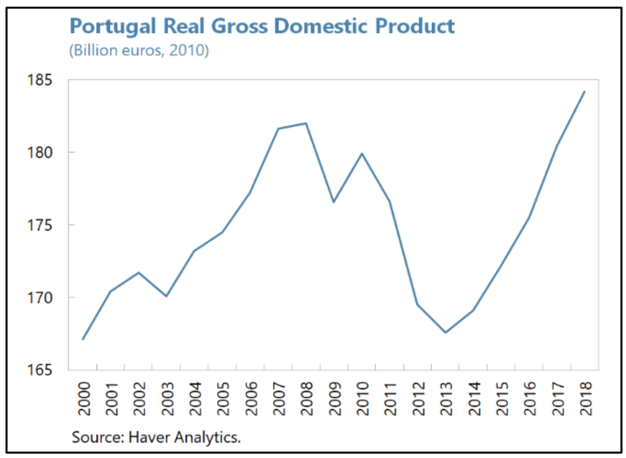
24. The authorities expect the fiscal balance to overachieve the MTO in coming years. The Stability Program 2019–2023 envisages that the structural balance will exceed the MTO in 2020, stabilizing at 0.3 percent of potential GDP. This will provide a buffer against temporary shocks and keep debt on a firm downward trend. This will be achieved by the continuation of efficiency gains stemming from the spending review, a declining interest bill, and the moderation in the public sector wage bill. Such a stance will also provide space to significantly expand investment, which has been increasing in recent years from a relatively low base. In the event of a slowdown, their view is that there is sufficient fiscal space to allow automatic stabilizers to fully operate, supporting growth without jeopardizing debt sustainability. In parallel, the authorities seek to continue improving efficiency in the public sector whilst supporting the most vulnerable. There remains still scope to rationalize spending and modernize practices, as illustrated by the ongoing reforms in the health sector. Past reforms to the pension system are mitigating the fiscal effects of an ageing population, but more effort will be needed in coming years. Nevertheless, in the near term, the government will further reduce the penalty on early retirement for very long careers, which is currently excessively high and unfair—this measure will have a minimal fiscal impact.

D. Structural Issues

25. Following a five-year expansion, real GDP returned to pre-crisis levels in 2018. Although real GDP is broadly at the same level as 10 years ago, the structure of the economy has improved notably. A significant depreciation of the real exchange rate, a tourism boom, and a fiscal consolidation have led to a significant rebalancing towards the tradable sector. Tradable services supported productivity growth in recent years; facing some capacity constraints, tourism has focused on improving quality and value of services. Nevertheless, GDP per capita remains 40 percent lower than the Euro Area average, with no significant convergence envisaged over the next five years. Despite a notable recovery, including the decline in the unemployment rate to levels not seen in more than a decade, employment and labor force participation in 2018 are still below their respective pre-crisis peak levels.

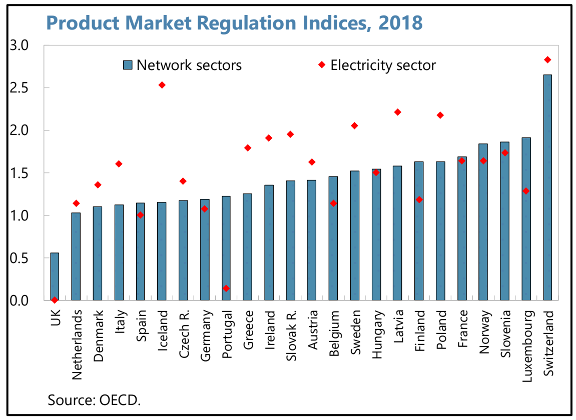


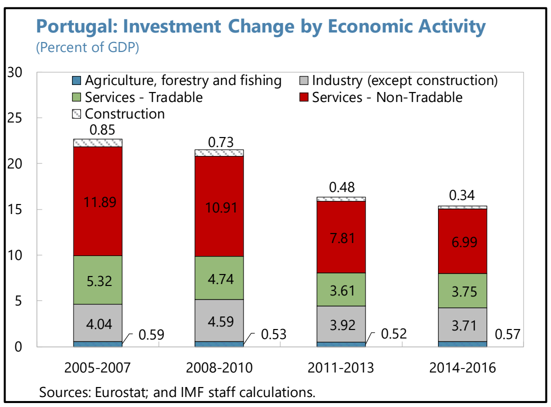
Sources: Budina, Deb, Diez, Fan, Luzi, Misch, and Shabunina (2018).

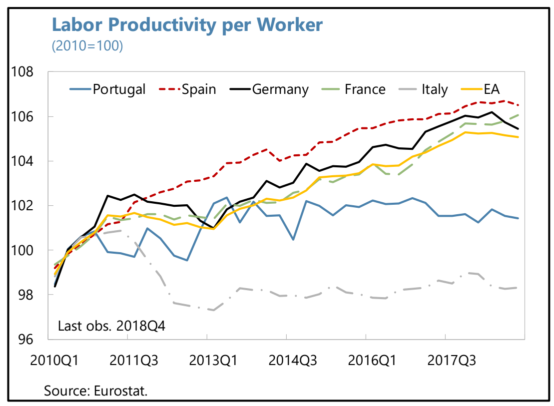


Source: Haver Analytics.

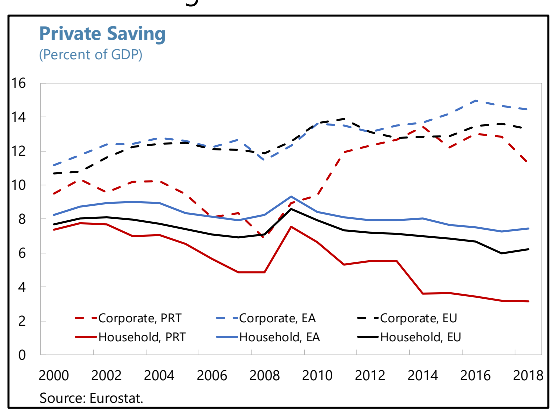
26. Strengthening medium-term growth will require fostering soundly financed investment and raising productivity of firms and labor. Despite its ongoing recovery,[8] investment remains relatively low as a ratio to GDP (17.5 percent in 2018 vs the EA average of 21 percent); however, its composition has improved compared to the pre-crisis period, with a higher share of tradable sectors. To spur investment and productivity, policy efforts should focus on improving the regulatory environment, strengthening competitiveness, and making more efficient use of labor, building on past reforms (Figure 6). Further progress in promoting competition in network industries is important for external competitiveness. Portugal ranks well compared to its European peers in the OECD Product Market Regulation Indices; however, energy continues to be characterized by relatively high prices, affecting the competitiveness of firms in tradable sectors.







27. Stronger domestic saving rates are needed to sustain higher investment rates without creating new external imbalances. Corporate and household savings are below the Euro Area averages. While corporate savings have been recovering since the crisis (to around 13 percent of GDP in 2017), household savings have been on a protracted declining trend, reaching 3.2 percent of GDP in 2017. The divergent trends of corporate and household savings in Portugal are not unique, but they are more marked than elsewhere.[9] Thus, the Portuguese household saving rates (to disposable income and GDP) are among the lowest in Europe. In addition to demographic and

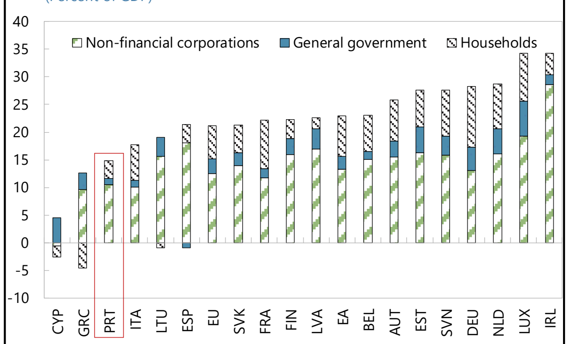


[8] The recent growth in investment has been financed through a mix of retained corporate earnings and debt.

[9] Chen, Karabarbounis and Neiman, 2017

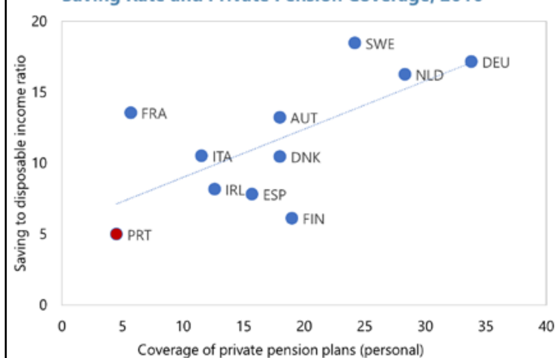
macroeconomic variables, country-specific factors negatively associated with the saving ratios include household debt, and government spending on social protection benefits and pensions (see Selected Issues Paper). The authorities should thus explore options to encourage complementary second- and third-pillar pension schemes, which are underdeveloped in Portugal. The authorities should also enact the regulations needed for the complementary second-tier occupational pension schemes mandated in the pension law, as private pension coverage could be a major determinant of saving behavior.

Saving, 2017
(Percent of GDP)



Source: Eurostat.

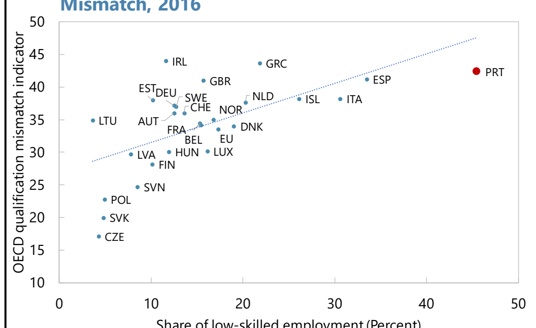
Saving Rate and Private Pension Coverage, 2016



Sources: Eurostat and OECD.

28. To raise productivity, Portugal needs to continue increasing skill levels. Educational attainment continues to improve; but the share of low-skilled workers is still one of the highest in Europe (46 percent in 2017 vs. 17 percent in the EU). The difference is much smaller for younger age groups, suggesting continuing improvements through cohort replacement. Skills might, moreover, be underutilized, although the evidence is mixed. While the OECD's over-qualification mismatch indicator for Portugal is one of the highest among advanced economies, Banco de Portugal staff found lower levels of over-qualification, concluding that, when comparing Portugal to other European countries, no significant differences arise.[10] At the same time, skill-shortages are reported as one of the main obstacles to Portuguese firms' operations and investment, pointing to the need for initiatives to facilitate the development of the skills demanded by industry both on and off the job. Raising the quality of education and training in vocational schools would help align the skills of young workers with business needs. Exchanges between universities and industry such as those centered in the Porto and Coimbra regions should be fostered. In addition, increasing education tends to be associated with higher household saving, implying a positive side effect of skilling.[11]

Low-skilled Employment and Qualification Mismatch, 2016



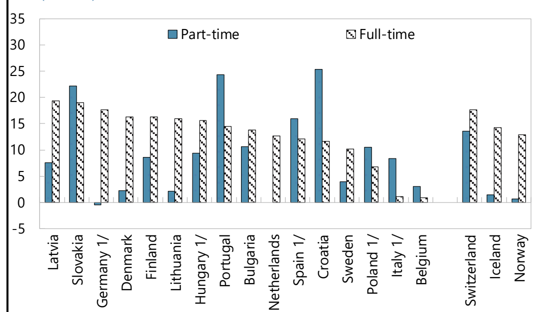
Sources: OECD and Eurostat.

[10] Catarina Pimenta and Pereira, 2019

[11] Portugal Selected Issues Paper, 2019.

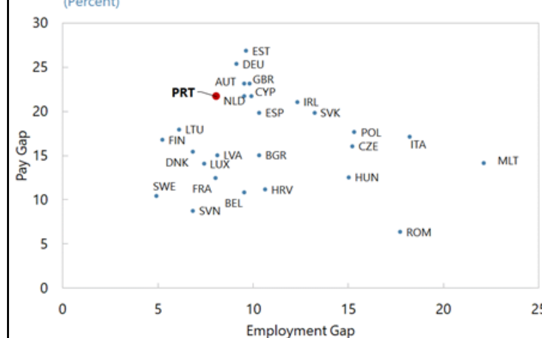
29. The gender gap in labor force participation is smaller than the European average and has been narrowing; but further progress would help the economy. Portugal ranked 37 among 149 countries in the WEF 2018 Global Gender Gap Report, and the gender pay gap is above the European averages. Reportedly, women tend to be under-represented in positions requiring higher qualifications and associated with higher pay but over-represented in low-paying clerical and service occupations. Women are more likely than men to be part-time workers and work on fixed-term contracts, which have been characterized by a higher gender pay gap. Developing strategies to reduce this segregation would help not only to close gender pay gaps but would also reduce overqualification mismatches, thus improving productivity and mitigating the impact of population ageing. For example, while Portugal has high enrollment rates of children under the age of 3 in formal childcare and high participation intensity (average hours per week) compared to other OECD countries, the share of public funding for early childhood services is relatively low. The recently adopted law on equal pay, which provides assessment and correction mechanisms to promote equal pay for the same work or work of equal value, as well as measures aimed at promoting more balanced gender representation at the managerial positions are much welcome.

The Unadjusted Gender Pay Gap by Working Time, 2017
(Percent)



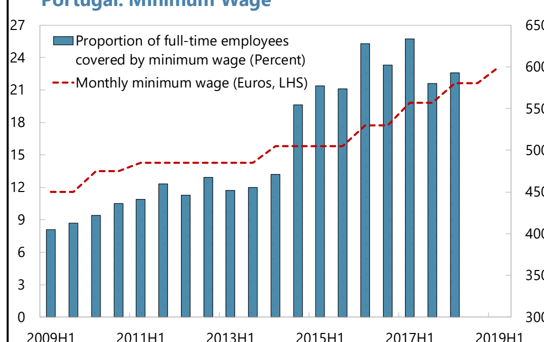
Source: Eurostat.
1/ Provisional data.

Gender Employment and Pay Gap, 2017
(Percent)



Sources: Eurostat and IMF staff.

Portugal: Minimum Wage



Source: Eurostat.

30. Labor regulations exhibit some rigidities that may affect adaptability and competitiveness of businesses. The employment protection for permanent contracts remains one of the strongest in the Euro Area, resulting in labor market segmentation. The share of temporary employment in Portugal has been stable at around 19 percent (the second largest in the Euro Area). The reform of the labor code initiated in 2018 is still in the Parliament. Enhancing the flexibility of the labor market by making permanent contracts more flexible rather than making temporary contracts costlier would help Portugal process adverse shocks. The minimum-to-median wage ratio is one of the highest in Europe, and it covers a significant share of new and total employment. In the first half of 2018, 40.2 percent of new employment contracts were created at the minimum wage; overall, 22.6 percent of total employment contracts are at the minimum wage. If growth declines, some of these rigidities may become more binding. Maintaining competitiveness requires wage growth consistent with developments in productivity.

31. Despite significant progress, continued refinement of the legal and institutional framework for debt enforcement and insolvency is warranted. Despite marked improvements in the last several years, restructuring and liquidation processes remain slow, trapping real and financial capital that should be released for productive uses. Staff recommends further actions in two areas: (i) enable public creditors to participate more fully in debt restructuring, preferably on the same footing as other creditors, subject to clear and transparent guidelines; and (ii) identify and address conditions that allow non-viable insolvent businesses to delay liquidation.

Authorities' Views

32. The authorities concurred with the need for strong growth to accelerate income convergence with the Euro Area economies. In the government's view, potential growth of around 2 percent a year is justified by the reforms already undertaken and the trend increase in educational achievements. They noted that Portugal has achieved macroeconomic stability, especially notable in the evolution of the labor market, but agreed that further efforts were required for faster convergence to Euro Area living standards. The authorities pointed to ongoing policies aimed at increasing productive investment, improving the efficiency of the public sector, and supporting the development of human and social capital. They also stressed that continuing gains in Portuguese exporters' market share were supported by improvements in non-price competitiveness, including higher quality products and services. The authorities argued that ongoing improvement in education should provide a significant boost to productivity and growth in the long-term.

STAFF APPRAISAL

33. Portugal's recovery has continued, reaching some welcome milestones in the last year. The economy's expansion is in its sixth year, with real GDP now above, and unemployment below, their pre-crisis levels. Banks' NPL ratios are now in single digits, the government has repaid all its credit to the IMF, and indicators of private and public leverage have improved again. Growth is expected to ease in 2019 and to move towards its estimated medium-term potential in the following years. The legacy of the past, however, still demands continuing strong macroeconomic policies, while renewed efforts at structural reform are called for to boost potential growth.

34. Risks to the downside, largely external, have increased since last year. As a small open economy, Portugal would directly feel the negative consequences of weaker external growth, rising protectionism, or a disorderly Brexit. Domestically, vocal groups are pressing for more spending. Maintaining strong domestic policies is essential to mitigate external risks and ensure a continuing reduction of vulnerabilities.

35. Greater fiscal effort would help build more resilience while the composition of public spending would need rebalancing to prioritize public investment. The authorities should aim to consider additional fiscal efforts in 2019 and 2020 to build policy space by reducing still-high public debt more rapidly. In the event of a material downturn in economic activity, a neutral fiscal stance, allowing the nominal deficit temporarily to widen, would be appropriate as long as the public debt ratio remains on a downward trajectory. Investment is well below pre-crisis and EU averages and will have to increase to support potential growth. A comprehensive review of the level, composition, and rules of public employment would lay the basis for better controlling the trajectory of current spending, without sacrificing service delivery.

36. Supervisors should maintain the focus on furthering the ongoing bank balance sheet repair. Supervisors should ensure that banks continue to follow through on their NPL reduction targets, strengthen their corporate governance, internal controls, and risk management, and improve their operational efficiency and profitability.

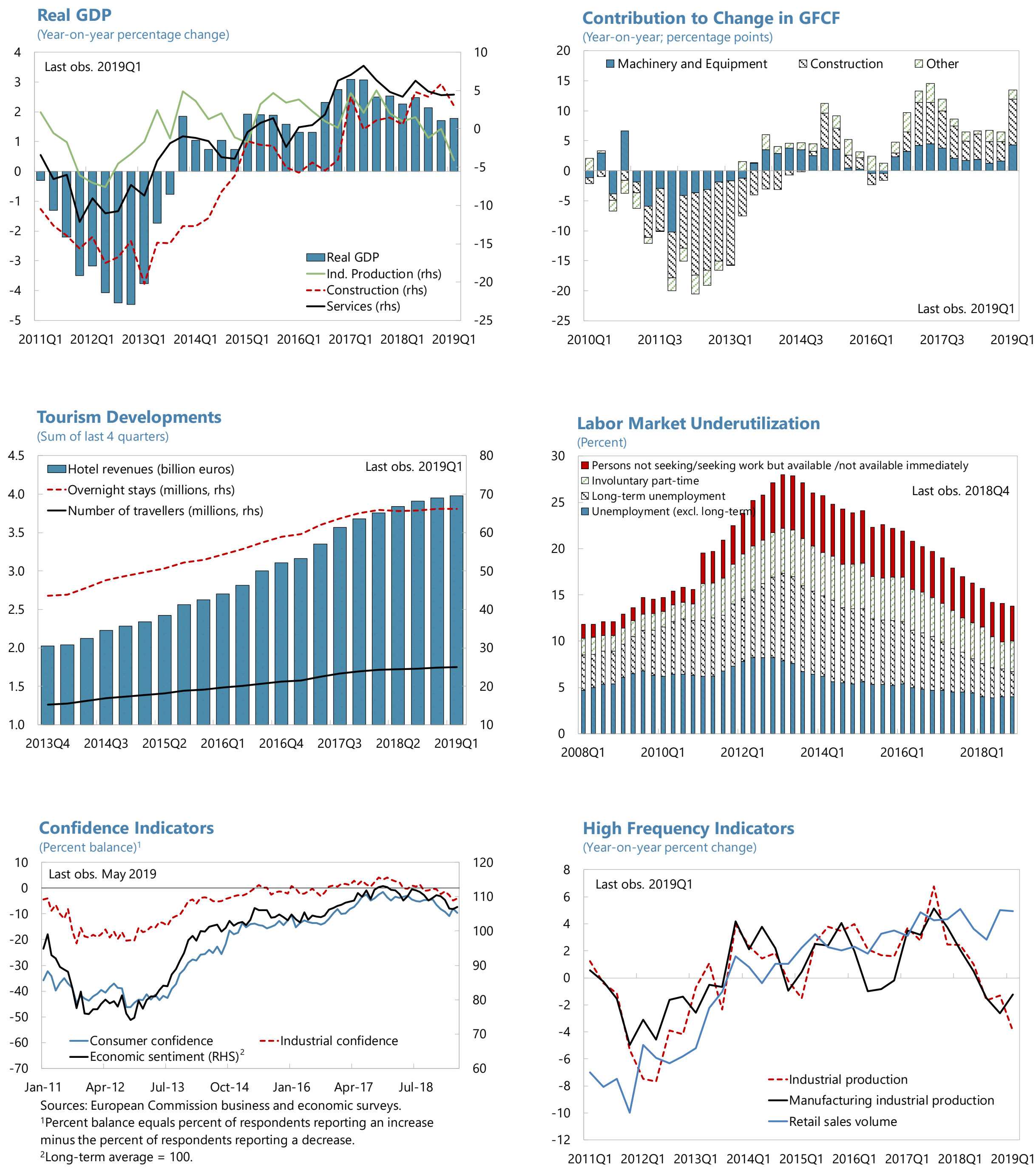
37. A sound financial supervision model ensures the independence of supervisors, fosters timely and well-informed decision making, and is cost efficient. In Portugal's case, it also should be consistent with the European institutional framework. The financial supervision reform bill has some positive elements and objectives. Nevertheless, the Banco de Portugal, the securities market and insurance supervisors, and the ECB have raised legitimate concerns regarding several aspects of the bill that merit careful consideration in Parliament before this bill is finalized.

38. Portugal's external position is moderately weaker than consistent with medium-term fundamentals and desirable policies. The net international investment position has been improving in recent years. To keep the momentum, maintaining a positive current account balance in coming years would be helpful, which calls for stronger domestic saving.

39. Strengthening medium-term growth will require fostering investment and raising productivity. Reducing red tape, fostering product market competition, continuing to improve skills, and facilitating the efficient use of labor are key to raising productivity and investment. Stronger domestic saving rates are needed to sustain higher investment rates without creating new external imbalances. To this effect, the authorities should enact the regulations still needed for the complementary second-tier occupational pension schemes and explore options to encourage them.

40. It is proposed that the next article IV consultation take place on the standard 12-month cycle.

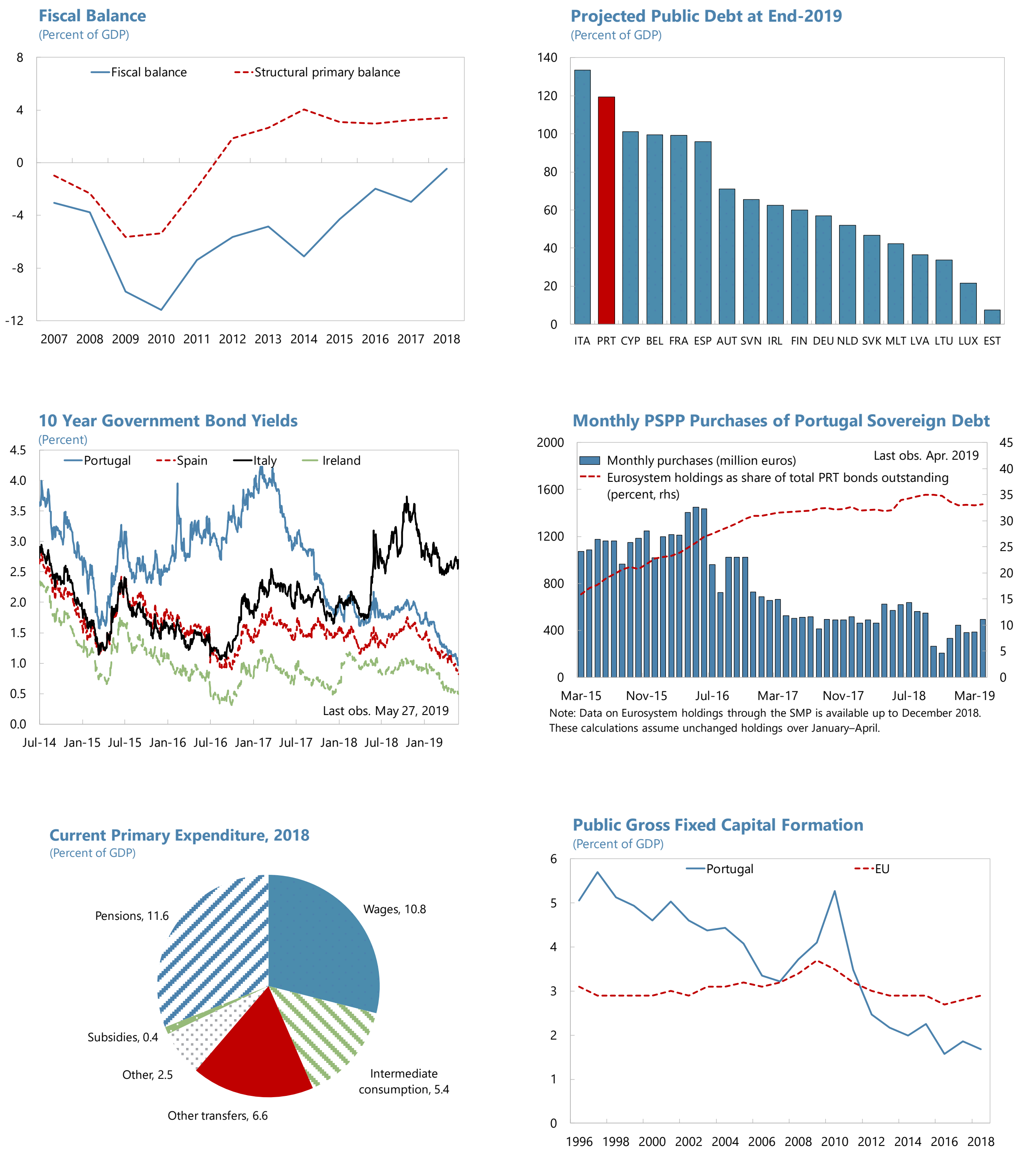
Figure 2. Portugal: Real Sector Indicators



Sources: European Commission business and economic surveys.
[1]Percent balance equals percent of respondents reporting an increase minus the percent of respondents reporting a decrease.
[2]Long-term average = 100.

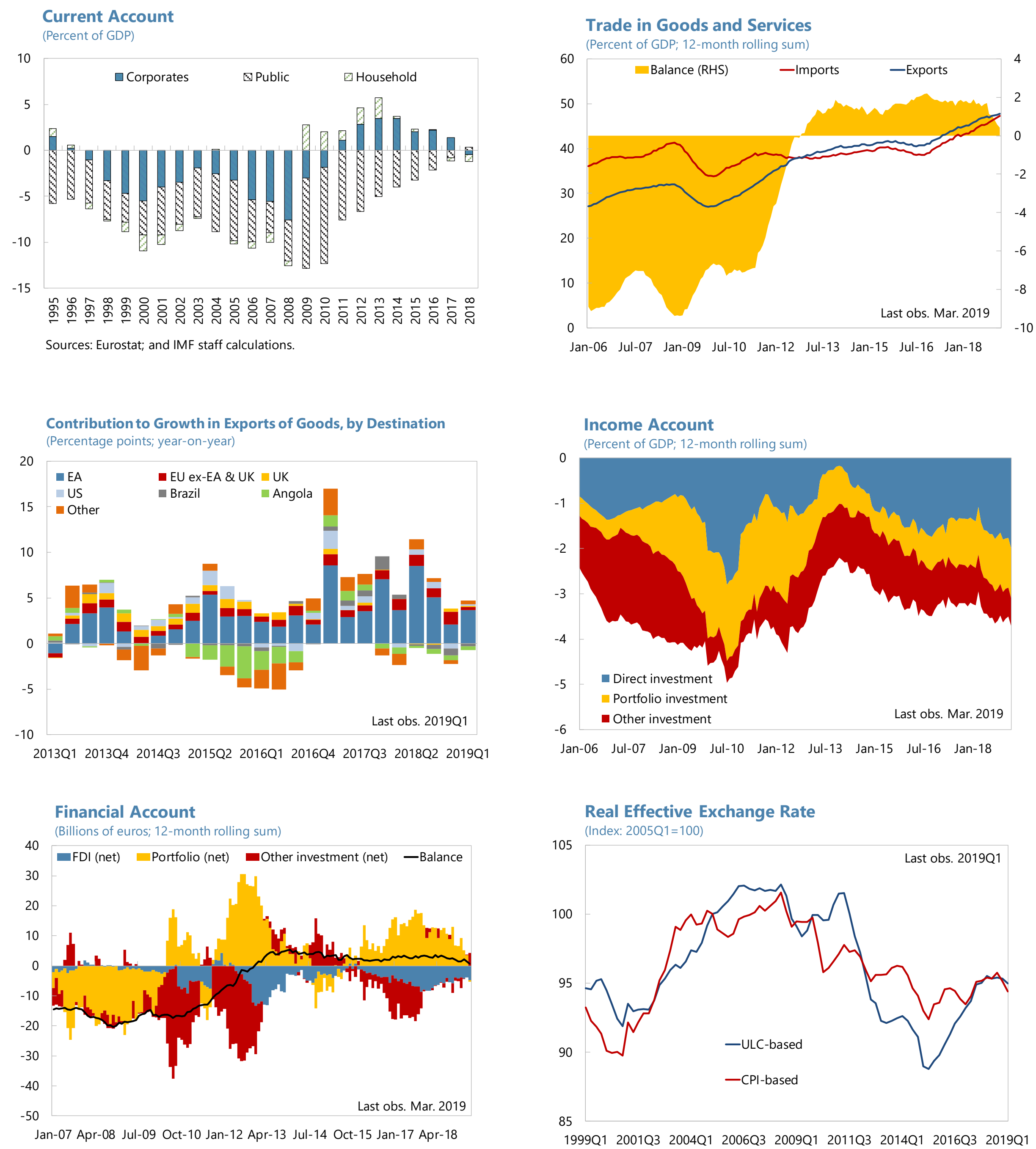
Sources: INE; Haver Analytics; and IMF staff calculations.

Figure 3. Portugal: Fiscal Sector Indicators



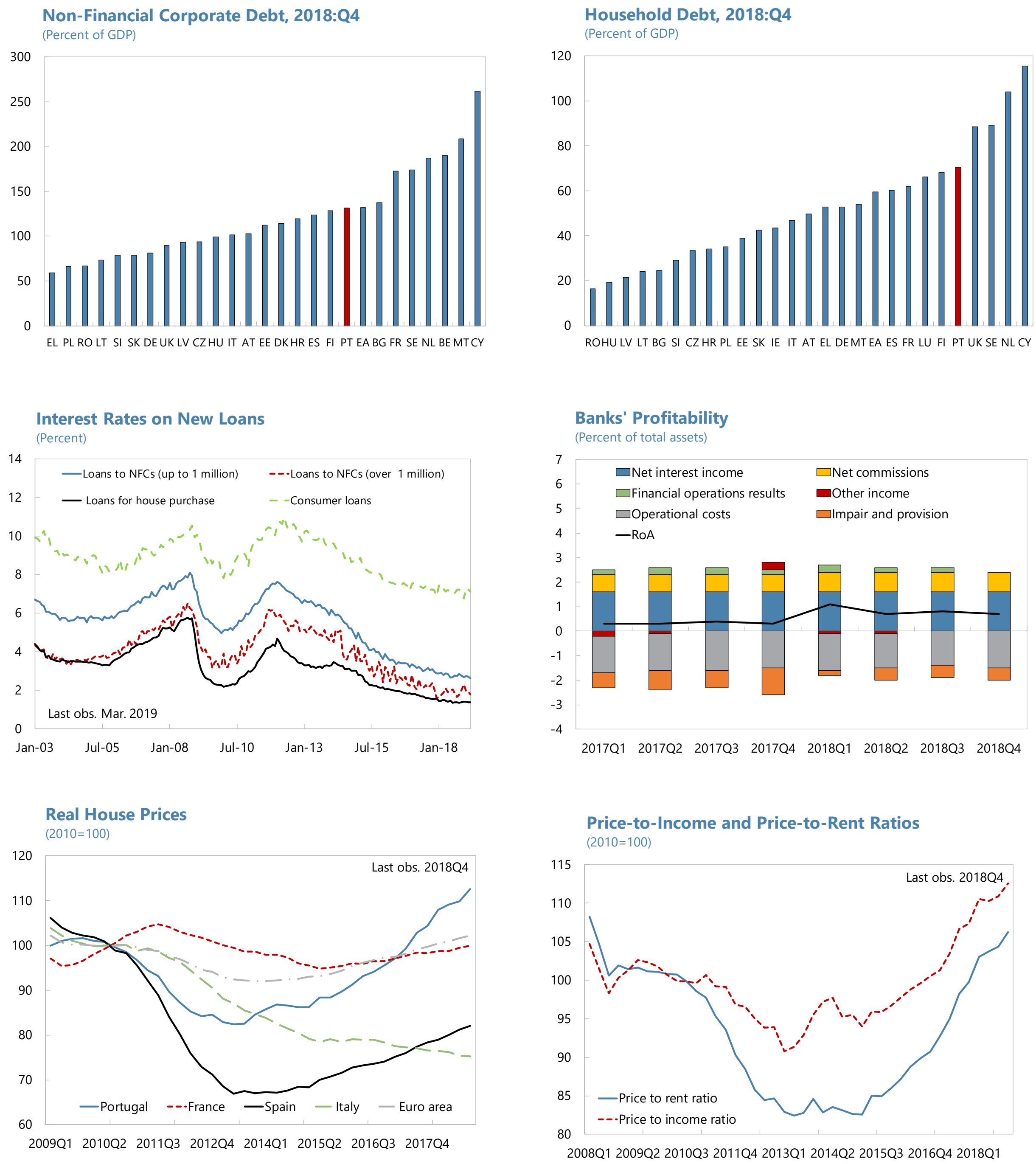
Sources: Haver Analytics; IGCP; ECB; and IMF staff calculations.

Figure 4. Portugal: External Sector Indicators



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

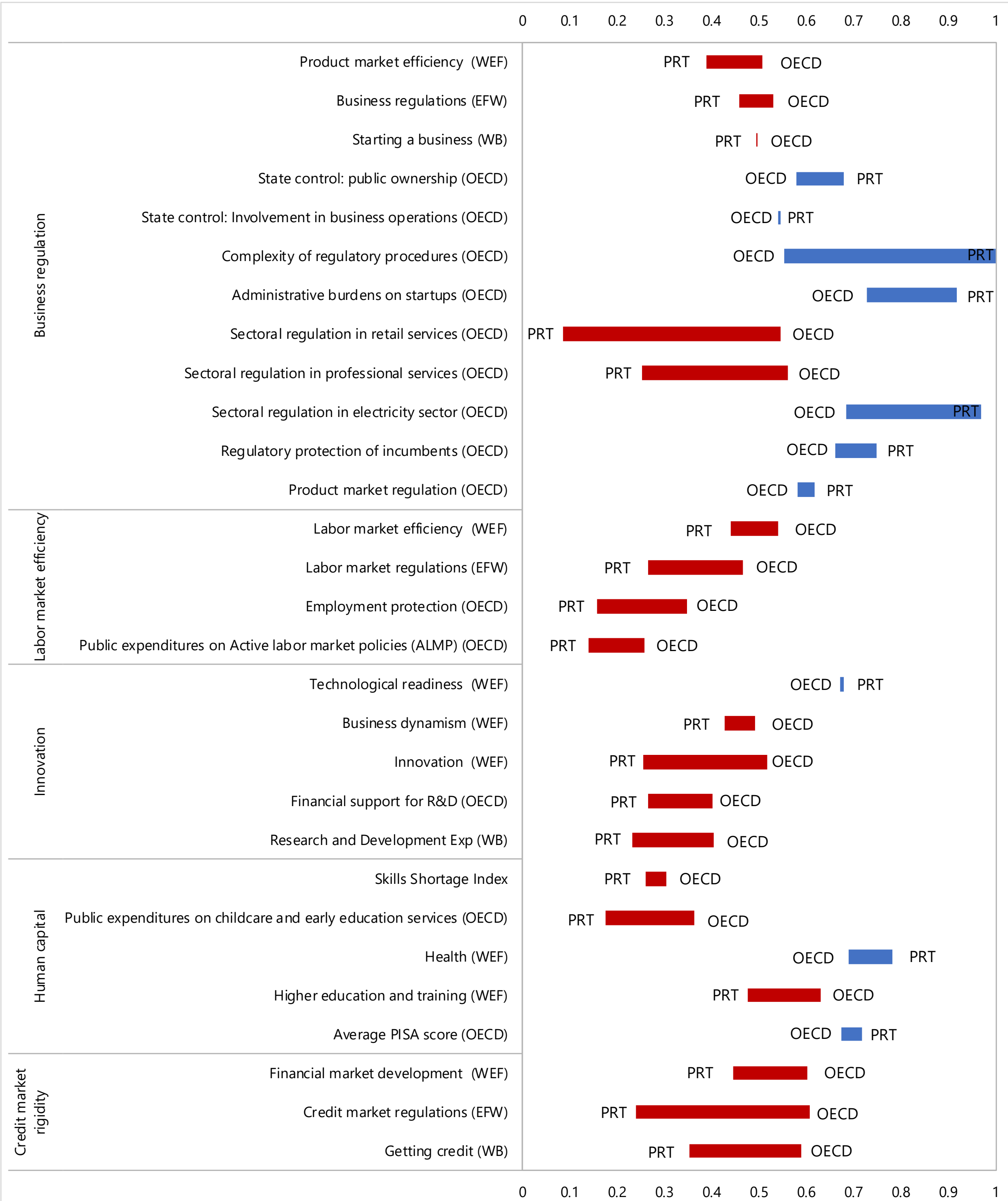
Figure 5. Portugal: Financial Stability Indicators



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

Figure 6. Portugal: Structural Reform Gaps

The table below shows Portugal's position vis-à-vis OECD countries on a number of structural indicators. All indicators are normalized to take values between 0 (min) and 1 (max), with higher values indicating better outcomes. The blue bars correspond to indicators where Portugal exceeds the OECD average, while red bars correspond to indicators where Portugal falls below the OECD average.



Sources: OECD, World Bank, WEF, IEF, EFW, and IMF staff calculations.

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

				Projections					
	2016	2017	2018	2019	2020	2021	2022	2023	2024
Real GDP	1.9	2.8	2.1	1.7	1.5	1.4	1.4	1.4	1.4
Total domestic demand	2.0	3.0	2.8	3.0	2.0	1.7	1.7	1.7	1.7
Private consumption	2.4	2.3	2.6	2.1	1.6	1.4	1.4	1.4	1.4
Public consumption	0.8	0.2	0.8	2.4	1.2	1.3	1.2	1.1	1.2
Gross fixed investment	2.3	9.2	4.5	7.0	4.1	3.6	3.1	3.2	3.2
Private	7.6	7.9	3.9	7.3	4.4	3.6	2.9	3.1	3.3
Government	-28.6	20.7	10.1	4.8	1.2	3.6	4.5	3.9	3.0
Exports	4.4	7.8	3.7	4.1	4.1	3.8	3.7	3.7	3.7
Imports	4.7	8.1	4.9	6.0	4.6	4.2	4.1	4.1	4.1
Contribution to Growth									
Total domestic demand	2.0	3.1	2.8	2.7	2.0	1.8	1.8	1.8	1.8
Private consumption	1.6	1.5	1.7	1.4	1.1	0.9	0.9	0.9	0.9
Public consumption	0.2	0.0	0.2	0.4	0.2	0.2	0.2	0.2	0.2
Gross fixed investment	0.4	1.5	0.8	0.9	0.8	0.7	0.6	0.6	0.7
Foreign balance	-0.2	-0.3	-0.7	-1.1	-0.4	-0.4	-0.4	-0.4	-0.4
Savings-investment balance (Percent of GDP)									
Gross national savings	15.9	17.1	16.7	17.3	17.7	17.5	17.4	17.4	17.5
Private	16.5	16.1	14.4	15.4	15.5	14.6	14.6	14.5	14.4
Public	-0.6	1.0	2.3	1.9	2.2	2.9	2.8	2.9	3.1
Gross domestic investment	15.7	16.9	17.5	18.1	18.4	18.4	18.5	18.6	18.7
Private	14.1	15.0	15.5	16.0	16.3	16.2	16.2	16.3	16.4
Public	1.6	1.9	2.1	2.2	2.2	2.2	2.3	2.3	2.3
Resource utilization									
Potential GDP	0.8	1.1	1.3	1.4	1.5	1.5	1.4	1.4	1.4
Output Gap (Percent of potential)	-2.4	-0.8	0.0	0.4	0.4	0.3	0.2	0.2	0.2
Employment	1.6	3.4	2.3	1.4	1.0	0.5	0.4	0.3	0.2
Unemployment rate (Percent; average)	11.1	8.9	7.0	6.2	5.7	5.5	5.4	5.3	5.3
Prices									
GDP deflator	1.8	1.5	1.4	1.5	1.7	1.7	1.7	1.7	1.7
Consumer prices (Harmonized index)	0.6	1.6	1.2	1.1	1.5	1.6	1.7	1.8	1.9
Total labor compensation (Whole economy)	4.1	5.3	5.0	2.3	2.9	2.9	3.1	3.1	3.1
Money and credit (End of period, percent change)									
Private sector credit	-3.7	-3.1	-1.0	0.1	0.8	1.6	1.6	1.6	1.6
Broad money	9.0	7.6	8.5	2.8	2.7	2.6	2.6	2.6	2.6
Interest rates (Percent)									
Short-term deposit rate	0.4	0.3	0.2	…	…	…	…	…	…
Government bond rate, 10-year	3.2	3.1	1.8	…	…	…	…	…	…
Fiscal indicators (Percent of GDP)									
General government balance	-2.0	-3.0	-0.5	-0.2	0.1	0.8	0.5	0.6	0.8
Revenues	42.8	42.7	43.5	43.6	43.7	44.2	43.9	43.9	44.0
Expenditures	44.8	45.7	44.0	43.9	43.7	43.5	43.3	43.3	43.1
Primary government balance	2.2	0.9	3.0	3.1	3.4	3.8	3.3	3.3	3.3
General government debt	129.2	124.8	121.5	118.8	116.0	110.3	106.0	104.4	100.6
External sector (Percent of GDP)									
Trade balance (Goods)	-5.2	-6.2	-7.3	-7.9	-8.2	-8.3	-8.6	-8.7	-9.0
Trade balance (Goods and Services)	2.0	1.8	1.0	0.5	0.7	0.7	0.7	0.7	0.6
Current account balance	0.6	0.5	-0.6	-0.6	-0.5	-0.5	-0.8	-0.9	-1.1
Savings-investment balance (Percent of GDP) 1/	0.1	0.2	-0.8	-0.9	-0.8	-0.9	-1.1	-1.2	-1.2
Net international investment position	-105.5	-104.9	-100.8	-96.2	-91.5	-87.6	-84.3	-81.6	-78.8
REER based on ULC (2010=100)	91.9	94.3	95.6	95.6	97.2	98.2	98.8	99.2	99.4
(Rate of growth)	2.5	2.6	1.4	0.1	1.6	1.0	0.7	0.3	0.3
REER based on CPI (2010=100)	96.7	96.8	97.7	97.2	97.0	96.7	96.4	96.3	96.1
(Rate of growth)	1.3	0.1	1.0	-0.5	-0.3	-0.3	-0.3	-0.2	-0.1
Nominal GDP (Billions of euros)	186.5	194.6	201.6	208.2	215.0	221.7	228.6	235.7	243.1

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

1/ National Accounts concept. Differences between the savings-investment balance and the current account in the balance of payments arise from a set of factors, including a different statistical treatment given to special purpose entities in the national accounts and the balance of payments.

Table 2a. Portugal: General Government Accounts [1/]
(Billions of euros)

				Projections					
	2016	2017	2018	2019	2020	2021	2022	2023	2024
Revenue	79.9	83.1	87.7	90.8	94.0	98.1	100.3	103.6	106.9
Taxes	46.4	48.8	51.9	53.2	54.9	56.7	58.5	60.4	62.3
Taxes on production and imports	27.3	29.0	30.9	31.9	32.7	33.8	34.8	35.9	37.0
Current taxes on income, wealth, etc. and capital taxes	19.1	19.7	21.0	21.3	22.2	22.9	23.7	24.5	25.2
Current taxes on income, wealth, etc.	19.1	19.7	21.0	21.3	22.2	22.9	23.7	24.5	25.2
Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	21.6	22.7	23.8	24.9	25.9	26.8	27.8	28.7	29.7
Grants and other revenue	11.9	11.7	12.0	12.8	13.2	14.6	14.1	14.5	14.9
Property income	1.2	1.3	1.4	1.4	1.4	1.5	1.5	1.6	1.6
Sales of goods and services	6.5	6.7	7.0	7.2	7.4	7.7	7.9	8.2	8.4
Other current revenue	3.0	2.9	2.8	3.3	3.4	3.5	3.6	3.7	3.8
Capital transfers and investment grants	1.1	0.8	0.9	0.9	0.9	1.9	1.0	1.0	1.1
Expenditure	83.6	88.9	88.6	91.3	93.9	96.4	99.1	102.1	104.9
Expense	85.9	91.0	90.5	93.1	95.6	98.1	100.7	103.6	106.5
Compensation of employees	20.9	21.3	21.8	23.0	23.5	24.3	25.1	25.8	26.4
Use of goods and services	10.3	10.6	10.9	11.1	11.4	11.8	12.1	12.5	12.9
Consumption of fixed capital	5.3	5.7	5.9	6.1	6.3	6.5	6.7	6.9	7.1
Interest	7.8	7.4	7.0	7.0	7.1	6.8	6.3	6.3	6.0
Subsidies	1.0	0.9	0.8	0.8	0.9	0.9	0.9	0.9	1.0
Social benefits	35.2	35.6	36.7	37.9	39.0	40.2	41.4	42.6	43.9
Grants and other expense	5.4	9.5	7.4	7.2	7.5	7.7	8.1	8.6	9.2
Other current expense	4.8	4.5	5.0	5.0	5.2	5.3	5.5	5.7	5.9
Capital transfers	0.7	5.0	2.4	2.2	2.3	2.4	2.6	2.9	3.3
Net acquisition of nonfinancial assets	-2.3	-2.1	-1.9	-1.7	-1.8	-1.8	-1.7	-1.6	-1.6
Gross fixed capital formation	2.9	3.6	4.0	4.4	4.5	4.8	5.1	5.4	5.5
(-) Consumption of fixed capital	-5.3	-5.7	-5.9	-6.1	-6.3	-6.5	-6.7	-6.9	-7.1
Acquisitions less disposals of other nonfinancial assets	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-0.8	-2.1	3.1	3.9	4.7	6.4	6.3	6.8	7.5
Net lending (+)/borrowing (–)	-3.7	-5.8	-0.9	-0.5	0.2	1.7	1.3	1.5	2.0
Net acquisition of financial assets	5.3	-2.9	-0.4	…	…	…	…	…	…
Monetary gold and SDRs	0.0	0.0	0.0	…	…	…	…	…	…
Currency and deposits	4.5	-2.6	-1.5	…	…	…	…	…	…
Debt securities	0.0	-0.6	0.5	…	…	…	…	…	…
Loans	-0.1	0.0	0.1	…	…	…	…	…	…
Equity and investment fund shares	-0.1	0.2	0.6	…	…	…	…	…	…
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	…	…	…	…	…	…
Financial derivatives and employee stock options	-0.5	-0.2	-0.3	…	…	…	…	…	…
Other accounts receivable	1.5	0.3	0.1	…	…	…	…	…	…
Net incurrence of liabilities	8.9	2.9	0.5	…	…	…	…	…	…
SDRs	0.0	0.0	0.0	…	…	…	…	…	…
Currency and deposits	4.0	2.7	1.4	…	…	…	…	…	…
Debt securities	11.3	10.3	7.4	…	…	…	…	…	…
Loans	-6.0	-10.5	-6.4	…	…	…	…	…	…
Equity and investment fund shares	0.0	0.5	0.0	…	…	…	…	…	…
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	…	…	…	…	…	…
Financial derivatives and employee stock options	0.0	-0.2	-0.6	…	…	…	…	…	…
Trade credit and advances	0.4	0.5	-0.7						
Other accounts payable	-0.7	-0.3	-0.6	…	…	…	…	…	…
Memorandum items:									
Primary balance	4.1	1.7	6.0	6.5	7.2	8.5	7.6	7.8	8.0
Debt at face value (EDP notification)	241.0	242.8	244.9	247.4	249.3	244.6	242.3	246.1	244.6
Nominal GDP	186.5	194.6	201.6	208.2	215.0	221.7	228.6	235.7	243.1

Sources: INE; Bank of Portugal; and IMF staff projections.

[1/] GFSM 2001 presentation.

Table 2b. Portugal: General Government Accounts [1/]

(Percent of GDP, unless otherwise noted)

	2016	2017	2018	2019	2020	2021	2022	2023	2024
				Projections					
Revenue	42.8	42.7	43.5	43.6	43.7	44.2	43.9	43.9	44.0
Taxes	24.9	25.1	25.7	25.6	25.5	25.6	25.6	25.6	25.6
Taxes on production and imports	14.7	14.9	15.3	15.3	15.2	15.2	15.2	15.2	15.2
Current taxes on income, wealth, etc. and capital taxes	10.2	10.1	10.4	10.2	10.3	10.3	10.4	10.4	10.4
Social contributions	11.6	11.7	11.8	11.9	12.1	12.1	12.1	12.2	12.2
Grants and other revenue	6.4	6.0	6.0	6.1	6.1	6.6	6.1	6.1	6.1
Property income	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Sales of goods and services	3.5	3.4	3.5	3.5	3.5	3.5	3.5	3.5	3.5
Other current revenue	1.6	1.5	1.4	1.6	1.6	1.6	1.6	1.6	1.6
Capital transfers and investment grants	0.6	0.4	0.4	0.4	0.4	0.9	0.4	0.4	0.4
Expenditure	44.8	45.7	44.0	43.9	43.7	43.5	43.3	43.3	43.1
Expense	46.1	46.7	44.9	44.7	44.5	44.3	44.1	44.0	43.8
Compensation of employees	11.2	10.9	10.8	11.0	10.9	11.0	11.0	10.9	10.8
Use of goods and services	5.5	5.4	5.4	5.3	5.3	5.3	5.3	5.3	5.3
Consumption of fixed capital	2.8	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9
Interest	4.2	3.8	3.4	3.4	3.3	3.1	2.8	2.7	2.5
Subsidies	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Social benefits	18.9	18.3	18.2	18.2	18.1	18.1	18.1	18.1	18.1
Grants and other expense	2.9	4.9	3.7	3.5	3.5	3.5	3.6	3.6	3.8
Other current expense	2.5	2.3	2.5	2.4	2.4	2.4	2.4	2.4	2.4
Capital transfers	0.4	2.6	1.2	1.1	1.1	1.1	1.2	1.2	1.4
Net acquisition of nonfinancial assets	-1.2	-1.1	-0.9	-0.8	-0.8	-0.8	-0.7	-0.7	-0.7
Gross fixed capital formation	1.5	1.8	2.0	2.1	2.1	2.1	2.2	2.3	2.3
(-) Consumption of fixed capital	-2.8	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9
Acquisitions less disposals of other nonfinancial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-0.4	-1.1	1.6	1.9	2.2	2.9	2.8	2.9	3.1
Net lending (+)/borrowing (–)	-2.0	-3.0	-0.5	-0.2	0.1	0.8	0.5	0.6	0.8
Net acquisition of financial assets	2.8	-1.5	-0.2	…	…	…	…	…	…
Monetary gold and SDRs	0.0	0.0	0.0	…	…	…	…	…	…
Currency and deposits	2.4	-1.3	-0.8	…	…	…	…	…	…
Debt securities	0.0	-0.3	0.3	…	…	…	…	…	…
Loans	-0.1	0.0	0.0	…	…	…	…	…	…
Equity and investment fund shares	-0.1	0.1	0.3	…	…	…	…	…	…
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	…	…	…	…	…	…
Financial derivatives and employee stock options	-0.3	-0.1	-0.1	…	…	…	…	…	…
Other accounts receivable	0.8	0.1	0.1	…	…	…	…	…	…
Net incurrence of liabilities	4.8	1.5	0.2	…	…	…	…	…	…
SDRs	0.0	0.0	0.0	…	…	…	…	…	…
Currency and deposits	2.1	1.4	0.7	…	…	…	…	…	…
Debt securities	6.1	5.3	3.7	…	…	…	…	…	…
Loans	-3.2	-5.4	-3.2	…	…	…	…	…	…
Equity and investment fund shares	0.0	0.3	0.0	…	…	…	…	…	…
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	…	…	…	…	…	…
Financial derivatives and employee stock options	0.0	-0.1	-0.3	…	…	…	…	…	…
Trade credit and advances	0.2	0.2	-0.3						
Other accounts payable	-0.3	-0.2	-0.3	…	…	…	…	…	…
Memorandum items:									
Primary balance	2.2	0.9	3.0	3.1	3.4	3.8	3.3	3.3	3.3
Structural balance (Percent of potential GDP)	-1.1	-0.5	-0.1	0.2	0.3	0.5	0.9	0.9	1.1
Structural primary balance (Percent of potential GDP)	3.0	3.2	3.4	3.6	3.6	3.6	3.6	3.6	3.6
Debt at face value (EDP notification)	129.2	124.8	121.5	118.8	116.0	110.3	106.0	104.4	100.6
Nominal GDP (Billions of euros)	186.5	194.6	201.6	208.2	215.0	221.7	228.6	235.7	243.1

Sources: INE; Bank of Portugal; and IMF staff projections.

1/ GFSM 2001 presentation.

Table 3. Portugal: Monetary Survey
(Millions of euros, unless otherwise indicated; end of period)

	2016	2017	2018	2019	2020	2021	2022	2023	2024
				Projections					
	Aggregated Balance Sheet of Monetary Financial Institutions (MFIs)1/								
Assets	368,146	366,800	365,204	371,035	374,380	375,941	378,962	381,750	384,679
Claims on Bank of Portugal	7,235	15,510	15,843	16,318	16,808	17,312	17,831	18,366	18,917
Claims on non-residents	55,396	50,367	53,627	54,163	54,705	55,252	55,804	56,363	56,926
Claims on non-monetary resident sector	285,502	282,364	278,585	282,700	285,014	285,758	287,551	289,272	291,121
General government	40,488	44,606	42,734	46,722	47,443	44,955	43,501	41,906	40,385
Central government	34,085	38,469	36,545	40,490	41,168	38,636	37,139	35,501	33,936
Loans	2,569	4,802	3,875	5,979	6,993	8,010	8,168	8,314	8,583
Securities	29,336	31,168	32,670	34,511	34,175	30,626	28,970	27,186	25,353
General government, excluding central government	6,403	6,137	6,189	6,232	6,276	6,319	6,362	6,406	6,449
Private sector	207,317	200,893	198,846	199,045	200,637	203,847	207,109	210,423	213,789
Non-financial corporations	91,608	86,201	83,528	85,428	86,638	87,768	88,794	89,877	91,039
Private individuals2/	115,709	114,692	115,318	113,617	113,999	116,079	118,315	120,545	122,751
Non-monetary financial institutions	37,697	36,863	37,003	36,933	36,933	36,956	36,941	36,943	36,947
Other assets	20,013	18,559	17,148	17,854	17,854	17,618	17,775	17,749	17,714
Liabilities	368,146	366,800	365,204	371,035	374,380	375,941	378,962	381,750	384,679
Liabilities to Bank of Portugal	25,450	25,604	22,361	21,690	21,039	20,408	19,796	19,202	18,626
Liabilities to non-residents	57,061	48,557	54,565	53,474	52,404	51,356	50,329	49,322	48,336
Liabilities to non-monetary resident sector	216,328	220,568	224,169	228,550	236,540	237,426	242,686	254,678	261,879
General government	9,475	10,247	6,935	6,230	8,729	3,729	2,729	8,002	8,002
Central government	4,151	5,182	2,581	2,729	3,824	1,634	1,196	3,506	3,506
General government, excluding central government	5,324	5,065	4,354	3,501	4,905	2,095	1,533	4,496	4,496
Private sector2/	172,185	177,083	185,488	190,634	196,125	201,991	208,264	214,981	222,179
Non-monetary financial institutions	34,668	33,239	31,746	31,686	31,686	31,706	31,693	31,695	31,698
Securities other than capital	12,946	12,895	10,291	10,600	10,918	11,245	11,583	11,930	12,288
Capital and reserves	56,362	59,175	53,818	56,722	53,479	55,505	54,568	46,618	43,550
	Money and Credit								
Broad money (M3)	167,000	179,666	194,944	200,352	205,846	211,247	216,790	222,479	228,319
Intermediate money (M2)	165,089	179,400	194,698	200,099	205,586	210,980	216,517	222,198	228,031
Narrow money (M1)	76,981	89,105	101,393	104,206	107,063	109,872	112,756	115,714	118,752
Private sector credit	207,317	200,893	198,846	199,045	200,637	203,847	207,109	210,423	213,789
Public sector credit	40,488	44,606	42,734	46,722	47,443	44,955	43,501	41,906	40,385
	(Percent of GDP)								
Broad money	89.6	92.3	96.7	96.2	95.8	95.3	94.8	94.4	93.9
Private sector credit	111.2	103.2	98.6	95.6	93.3	92.0	90.6	89.3	87.9
Public sector credit	21.7	22.9	21.2	22.4	22.1	20.3	19.0	17.8	16.6
	(Percentage change)								
Broad money	9.0	7.6	8.5	2.8	2.7	2.6	2.6	2.6	2.6
Private sector credit	-3.7	-3.1	-1.0	0.1	0.8	1.6	1.6	1.6	1.6
Public sector credit	1.4	10.2	-4.2	9.3	1.5	-5.2	-3.2	-3.7	-3.6
Memorandum items:									
ECB access (Percent of assets)	6.9	7.0	6.1	5.8	5.6	5.4	5.2	5.0	4.8
Credit to deposits (Percent)	114.6	111.3	107.8	107.5	104.9	104.8	103.3	99.1	97.1
Loan to deposits (Percent)	96.7	93.5	89.8	89.1	87.2	88.6	88.1	85.3	84.3
Wholesale market funding (Percent of assets)3/	13.4	10.9	11.5	11.6	11.9	12.2	12.4	12.7	13.0

Sources: Haver Analytics; Bank of Portugal; and IMF staff projections.

1/ Excludes Bank of Portugal.

2/ Including emigrants.

3/ Includes foreign interbank borrowing and securities issued.

Table 4. Portugal: Balance of Payments

(Billions of euros)

	2016	2017	2018	Projection 2019	2020	2021	2022	2023	2024
Current and Capital account	3.0	2.7	0.9	3.0	3.6	2.6	1.3	0.5	0.7
Current account	1.1	0.9	-1.2	-1.2	-1.2	-1.2	-1.9	-2.2	-2.6
Balance of goods and services	3.8	3.5	2.0	1.0	1.4	1.6	1.6	1.7	1.6
Trade balance	-9.6	-12.1	-14.7	-16.5	-17.6	-18.5	-19.6	-20.6	-21.8
Exports fob	49.1	54.0	57.0	59.4	61.5	63.4	65.2	67.5	70.4
Imports fob	58.8	66.2	71.7	75.9	79.2	81.9	84.8	88.1	92.2
Services, net	13.5	15.6	16.7	17.5	19.1	20.1	21.2	22.3	23.4
Exports	26.7	30.3	32.2	34.2	36.4	38.4	40.5	42.6	44.8
Imports	13.3	14.7	15.5	16.7	17.3	18.3	19.3	20.3	21.4
Of which:									
Tourism	8.8	10.9	11.9	12.9	14.2	15.3	16.1	16.9	17.8
Exports	12.7	15.2	16.6	18.0	19.6	21.1	22.2	23.4	24.6
Imports	3.8	4.3	4.7	5.1	5.4	5.8	6.2	6.5	6.8
Primary income, net	-4.4	-4.9	-5.7	-5.0	-5.3	-5.3	-5.8	-6.2	-6.4
Secondary income, net	1.6	2.2	2.5	2.7	2.7	2.5	2.3	2.3	2.3
Capital account	1.9	1.8	2.1	4.2	4.7	3.7	3.2	2.7	3.3
Financial account	3.0	3.1	1.5	3.0	3.6	2.6	1.3	0.5	0.7
Direct investment	-3.2	-8.3	-3.9	-6.6	-6.0	-5.8	-5.4	-5.2	-5.8
Direct investment assets	5.3	0.6	0.2	0.2	0.3	0.3	0.3	0.3	0.3
Direct investment liabilities	8.5	8.9	4.2	6.9	6.2	6.0	5.6	5.5	6.1
Portfolio investment, net	15.5	9.3	9.2	12.0	6.2	8.6	6.4	-0.1	6.0
Financial derivatives	0.5	0.0	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Other investment, net	-14.5	3.4	-3.6	-3.6	2.1	-1.6	-1.2	4.2	-1.1
Reserve assets	4.7	-1.2	-0.9	0.7	0.7	0.7	0.8	0.9	1.0
Errors and omissions	0.0	0.4	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items: (In percent of GDP)									
Current and capital account	1.6	1.4	0.4	1.4	1.7	1.2	0.6	0.2	0.3
Current account	0.6	0.5	-0.6	-0.6	-0.5	-0.5	-0.8	-0.9	-1.1
Of which: Balance of goods and services	2.0	1.8	1.0	0.5	0.7	0.7	0.7	0.7	0.6
Net international investment position[1/]	-105.5	-104.9	-100.8	-96.2	-91.5	-87.6	-84.3	-81.6	-78.8
Direct investment, net	-30.9	-35.4	-35.0	-37.0	-38.7	-40.1	-41.2	-42.2	-43.3
Portfolio investment, net	0.2	2.2	7.8	13.3	15.7	19.1	21.3	20.6	22.5
Financial derivatives	-0.1	-0.8	-0.6	-0.3	0.0	0.3	0.5	0.8	1.0
Other investment, net	-87.5	-82.0	-83.8	-82.8	-79.3	-77.6	-75.7	-71.6	-69.9
Reserve assets	12.8	11.2	10.8	10.8	10.8	10.7	10.8	10.8	10.9

Sources: Bank of Portugal; and IMF staff projections.

1/ End-of-period data.

Table 5. Portugal: Selected Financial Indicators of the Banking System

(Percent)

	2015				2016				2017				2018			
	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.
Capital adequacy																
Regulatory capital to risk-weighted assets	12.0	12.6	12.6	13.3	13.0	13.1	13.2	12.3	13.9	14.4	14.7	15.2	15.0	15.2	15.3	15.1
Common Equity Tier 1 capital to risk-weighted assets	11.1	11.7	11.6	12.4	12.1	12.1	12.3	11.4	12.6	13.2	13.5	13.9	13.5	13.4	13.5	13.2
Regulatory tier 1 capital to risk-weighted assets	11.2	11.8	11.7	12.6	12.3	12.4	12.6	11.7	13.2	13.8	14.0	14.5	14.2	14.1	14.1	13.9
Capital to assets 1/	6.5	6.8	6.9	7.2	7.0	7.0	7.1	6.5	7.1	7.3	7.4	7.7	7.6	7.4	7.4	7.0
Asset composition and quality																
Non-performing loans to total gross loans	12.3	12.7	12.9	17.5	17.9	17.9	17.6	17.2	16.3	15.4	14.4	13.3	12.8	11.7	11.3	9.4
Sectoral distribution of loans																
Residents	85.5	85.8	87.5	87.8	88.3	88.3	88.6	89.1	88.3	89.3	89.8	90.8	91.6	91.4	91.6	91.5
Nonresidents	14.5	14.2	12.5	12.2	11.7	11.7	11.4	10.9	11.7	10.7	10.2	9.2	8.4	8.6	8.4	8.5
Earnings and profitability																
Return on assets	0.5	0.5	0.3	0.2	0.2	0.0	0.1	-0.6	0.3	0.3	0.4	0.3	1.1	0.7	0.8	0.7
Return on equity	6.6	6.2	3.8	2.1	1.9	-0.1	1.0	-7.4	3.5	3.9	4.7	3.4	11.8	7.7	8.7	7.1
Interest margin to gross income	43.0	44.2	47.3	46.1	56.2	51.6	52.9	50.3	54.3	50.4	50.5	47.3	49.8	50.4	51.2	54.6
Noninterest expenses to gross income	55.4	57.4	61.6	63.0	68.1	65.6	65.0	62.2	70.4	64.5	64.4	57.6	60.0	61.1	59.5	62.6
Liquidity																
Liquid assets to total assets 2/	11.8	11.4	11.1	10.9	10.7	10.5	10.2	10.7	11.5	12.8	12.9	14.0	13.5	14.6	14.4	15.5
Liquid assets to short-term liabilities 2/	16.8	16.4	15.7	15.7	15.4	15.4	14.9	15.5	17.2	19.0	19.0	20.8	19.9	21.0	20.7	22.3
Loans to deposits 3/	101.7	101.0	98.8	96.1	95.2	95.4	94.2	95.3	94.4	93.6	94.0	92.5	92.4	89.1	89.4	88.9
Foreign-currency-denominated liabilities to total liabilities 4/	4.6	4.5	4.4	4.1	4.1	4.0	3.9	3.8	3.7	3.6	3.3	3.3	3.3	3.4	3.5	3.8

Source: Bank of Portugal.

1/ On accounting basis; consolidated.

2/ Data reflects the information from Instruction No 13/2009 of Banco de Portugal until 2015:Q3, which was adapted to be comparable with the latter data from ITS reporting framework (from 2015:Q4 onwards). This fact implied a slight change in the reporting universe of institutions.

3/ Data reflects the information from Instruction No 23/2004 of Banco de Portugal (until 2015:Q3). From 2015:Q4, data is based on the ITS reporting framework. The reported data follows EBA's proposal on the mapping from ITS on Supervisory Reporting to FSI.

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

Table 6. Portugal: External Debt Sustainability Framework

(Percent of GDP, unless otherwise indicated)

				Projections						
	2016	2017	2018	2019	2020	2021	2022	2023	2024	Debt-stabilizing non-interest current account 6/
Baseline: External debt	214.1	209.4	204.7	196.6	191.8	186.3	182.0	181.0	177.5	2.3
Change in external debt	-7.9	-4.8	-4.6	-8.1	-4.9	-5.5	-4.3	-1.0	-3.5	
Identified external debt-creating flows (4+8+9)	-8.2	-7.0	-2.3	-0.3	-0.1	0.0	0.1	0.1	0.3	
Current account deficit, excluding interest payments	-4.9	-4.3	-2.8	-2.8	-2.4	-3.0	-2.3	-2.3	-2.3	
Deficit in balance of goods and services	-2.0	-1.8	-1.0	-0.5	-0.7	-0.7	-0.7	-0.7	-0.6	
Exports	40.7	43.3	44.3	44.9	45.6	45.9	46.2	46.7	47.4	
Imports	38.6	41.5	43.3	44.4	44.9	45.2	45.5	46.0	46.7	
Net non-debt creating capital inflows (negative)	0.3	2.4	1.4	2.6	2.2	2.0	1.8	1.6	1.8	
Automatic debt dynamics 1/	-3.7	-5.1	-0.9	-0.1	0.1	0.9	0.6	0.7	0.7	
Contribution from nominal interest rate	4.3	3.9	3.4	3.4	2.9	3.5	3.2	3.2	3.2	
Contribution from real GDP growth	-4.1	-5.7	-4.3	-3.5	-2.9	-2.6	-2.5	-2.5	-2.5	
Contribution from price and exchange rate changes 2/	-3.8	-3.2	...	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	0.3	2.2	-2.3	-7.8	-4.8	-5.5	-4.3	-1.1	-3.8	
External debt-to-exports ratio (Percent)	526.6	483.3	462.6	437.5	421.0	405.5	393.8	387.5	374.8	
Gross external financing need (Billions of Euros) 4/	163.4	177.4	198.6	197.7	203.1	204.9	209.0	215.7	227.0	
Percent of GDP	87.6	91.2	98.5	94.9	94.5	92.4	91.4	91.5	93.4	
Scenario with key variables at their historical averages 5/			204.7	199.2	197.0	193.9	191.8	193.2	192.3	3.9
Key Macroeconomic Assumptions Underlying Baseline										
Real GDP growth (Percent)	1.9	2.8	2.1	1.7	1.5	1.4	1.4	1.4	1.4	
GDP deflator in Euros (Percent)	1.8	1.5	1.4	1.5	1.7	1.7	1.7	1.7	1.7	
Nominal external interest rate (Percent)	2.0	1.9	1.7	1.7	1.5	1.9	1.7	1.8	1.8	
Growth of exports (Euros, percent)	2.4	11.2	5.8	4.9	4.6	4.0	3.8	4.2	4.6	
Growth of imports (Euros, percent)	1.3	12.2	7.9	6.1	4.3	3.8	3.9	4.2	4.8	
Current account balance, excluding interest payments	4.9	4.3	2.8	2.8	2.4	3.0	2.3	2.3	2.3	
Net non-debt creating capital inflows	-0.3	-2.4	-1.4	-2.6	-2.2	-2.0	-1.8	-1.6	-1.8	

Source: Fund staff estimates.

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 [1/]

(Millions of SDR, unless otherwise indicated)

	2016	2017	2018	2019	2020	2021	2022	2023	2024
Disbursements	…	…	…	…	…	…	…	…	…
(Percent of quota)	…	…	…	…	…	…	…	…	…
(Projected debt service to the Fund, based on existing and prospective drawings)									
Total	4,065	8,608	4,661	2	3	3	3	3	3
Interest and charges	505	376	91	2	3	3	3	3	3
Repayments	3,560	8,232	4,571	0	0	0	0	0	0
Total debt service, in percent of									
Exports of goods and services	6.7	12.5	6.3	0.0	0.0	0.0	0.0	0.0	0.0
GDP	2.7	5.4	2.8	0.0	0.0	0.0	0.0	0.0	0.0
(Projected level of credit outstanding based on existing and prospective drawings)									
Outstanding stock	12,803	4,571	0	0	0	0	0	0	0
Percent of quota [2/]	621.5	221.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Percent of GDP	8.8	2.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum Items (Billions of SDR)									
Exports of goods and services	60	69	74	76	79	82	86	89	93
GDP	148	159	168	169	174	179	186	194	201

Source: IMF staff estimates.

1/ Exchange rates reflect actual exchage rates where available, otherwise historical and projected WEO annual averages for flows and end-of-period values for stocks.

2/ Quota Increase in 2016.

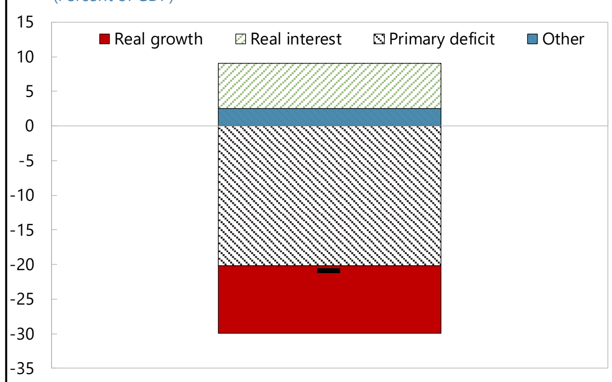
Annex I. Public Debt Sustainability Analysis (DSA)

Portugal's elevated level of public debt remains a vulnerability both to fiscal sustainability and the wider economy. In the baseline projections, based on current policy measures, public debt is on a clearly downward trajectory; however, this trajectory is vulnerable to a range of macroeconomic and financial shocks, which could undermine recent and projected progress. Market conditions are favorable, despite some turbulence in mid-2018. And moderate gross financing needs (relative to the DSA benchmark) and a large cash buffer mean that liquidity risks are less acute than in past years. Staff's baseline projections reflect the authorities' current fiscal policies. Further durable fiscal consolidation and structural reforms that increase potential output are needed to more quickly reduce debt to safer levels.

A. Baseline Scenario

41. Portugal's debt is likely to decline by an average of 3 percent of GDP a year over the next 5 years, driven by a sizable primary surplus. In 2019, the primary balance is expected to be 3.1 percent of GDP, with this surplus projected to persist on the assumption of no new fiscal measures over 2020–2024. Above-potential growth supported debt reduction in 2017 and 2018, but this effect is likely to wane in coming years, as growth is expected to moderate and converge towards its potential (1.4 percent). As monetary policy eventually tightens, the marginal cost of borrowing is expected to rise on Portuguese government debt. However, this will be more than offset by a fall in the effective interest rate driven by the rollover of high-yield historical debt issued over the last decade. As discussed in detail in the 2018 Article IV DSA, interest payments as a share of GDP are expected to decline from 3.4 percent of GDP in 2018 to 2.5 percent in 2024. These factors taken together imply that debt is expected to fall from 122 percent of GDP in 2018 to 101 percent in 2024.

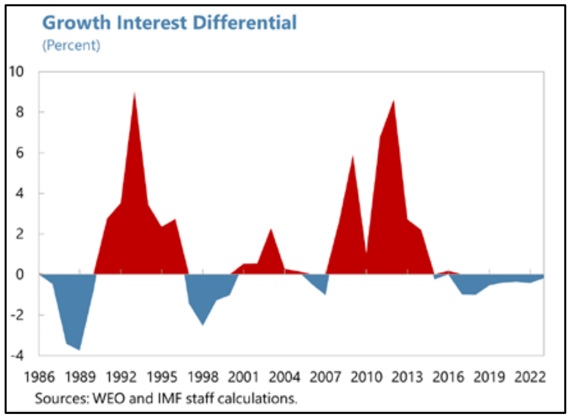
Projected Change in Debt, 2019–2024
(Percent of GDP)



Source: IMF staff calculations.

B. Risk Assessment

42. Public debt will remain too high over coming years, despite the downward momentum. Under current projections, debt will not fall below the MAC DSA 'high-risk' debt threshold of 85 percent of GDP until 2030. At such elevated levels, the ratio of debt to GDP can be sensitive to the evolution of the interest-rate—GDP growth differential (Annex VII). Portugal has experienced several steep spikes in the interest-rate-growth differential in the past, driven by deep recessions, sharp falls in inflation and/or a spike in the cost of borrowing. If such a shock were to occur today, the 'snowball effect' could reverse much of the progress made in recent years in reducing debt. The projected primary surplus and a relatively long average debt maturity, mean that gross financing needs remain below the relevant benchmark of 20 percent of GDP (Figure 1), and therefore pose less of a risk than the debt level. The government's large cash buffer also reduces rollover risks, at least during episodes of temporary market turbulence.[1] Large (economy-wide) external financing needs generate vulnerabilities from foreign risk appetite and financial conditions.



Sources: WEO and IMF staff calculations.

C. Realism of Baseline Assumption and Alternative Scenarios

43. The baseline assumes a constant primary structural balance after 2019 and modest potential growth. Historically, around one-third of countries have managed to maintain a cyclically adjusted primary balance at Portugal's current level or above for three years (Figure 2). Portugal will need to maintain this stance for considerably longer if it is to reduce debt to safer levels over the medium term – as such, the authorities should resist pressure to rollback past efforts, now that the crisis period has ended. The debt trajectory also assumes that growth will gradually return to trend over coming years, without recession. While the median forecast error for growth has been relatively low (Figure 2), if growth were to turn out lower than currently projected—for instance, as a result of reversal of structural reforms or shocks to external demand—the rate of debt reduction would significantly slow down.

44. The authorities' fiscal strategy under the Stability Program 2019–2023 shows a more ambitious pace of fiscal consolidation and stronger medium-term growth. This shows debt reaching 100 percent of GDP *in 2023* (Figure 5), compared to 105 percent in staff's baseline projection for that year. However, medium-term growth, at 2 percent, is substantially above staff's estimate (1.4 percent).

D. Stress Tests

45. The baseline remains sensitive to a range of macroeconomic and fiscal shocks (Figure 5):

- Of the macro-fiscal stress tests, the growth shock would have the largest impact on debt and GFNs. This scenario is more severe than that envisaged in Figure 1 of the Staff Report, and involves a recession in 2020 and 2021, with real growth rates of -0.9 and -1.0 percent, in each year respectively. In this scenario, inflation falls, interest rates rise (through the credit spread) and the primary balance deteriorates as automatic stabilizers kick in. These factors would lead to debt peaking at 122 percent of GDP, before gradually falling. GFNs would peak at 19 percent of

[1] At end-2018, the IGCP cash buffer stood at €9.3 billion, 4.6 percent of GDP.

GDP, just below the DSA debt burden threshold. Such a scenario would unlikely jeopardize market access.

- The combined macro-fiscal and contingent liability shocks (‘Additional Stress Tests’) would lead debt to peak at 130 percent of GDP and GFNs to peak at 24 percent of GDP. Such a scenario would significantly raise concerns over debt sustainability. The main driver of the macro-fiscal component of this scenario is the growth shock, described above. The contingent liability component involves a 10 percent of GDP increase in debt. The most likely source of such a shock would be through banking sector support – the magnitude would be comparable to the support provided during the crisis. One significant difference relative to the crisis, however, is the existence of the Single Resolution Mechanism. This should provide an important buffer to prevent financial sector shocks spilling over onto the public-sector balance sheet. On balance, such a scenario has a low probability of occurring.

Box 1. Interest Rate Sensitivity

Prior to the crisis, Euro Area sovereign bond yields were hardly distinguishable from one another and moved together in lock-step. This changed in 2008 when markets begun differentiating between countries, and spreads in some Euro Area countries (Portugal, Greece, Italy, Spain, Ireland) became more correlated with each other, and less correlated with so called 'core' countries (Germany, in this analysis). Spreads have since fallen, but the co-movement in 'non-core' country yields seems to have persisted, as witnessed by the increase in Portugal's yield apparently in response to events in Italy in May 2018. This box explores the sensitivity of Portuguese yields to those of the countries in these two groups.

The analysis follows a two-stage process. First, the daily change in Portuguese 10-year bond yields is regressed against those of Germany:

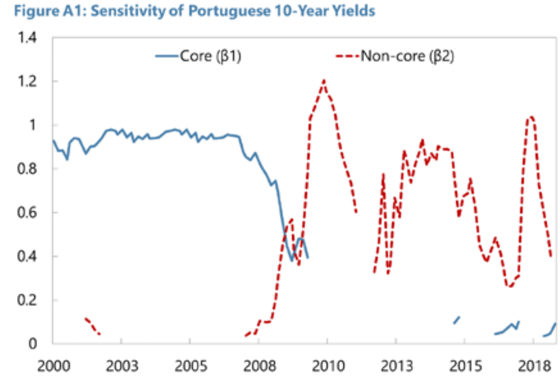
$$d.\ln(i_{prt}) = c_1 + \beta_1 . d.\ln(i_{deu}) + \varepsilon_1$$

β_1 measures the sensitivity of Portuguese yields to the core – this should provide a proxy for common shocks to the Euro Area (including on the neutral rate and potential growth) and any effect from monetary policy. Next, the residual – the component of Portuguese yields not explained by the core – is regressed against the average of non-core yields:

$$\varepsilon_1 = c_2 + \beta_2 . d.\ln(i_{per}) + \varepsilon_2$$

β_2 measures the sensitivity of Portuguese yields to these yields, and will include common shocks to this group, shifts in investor risk aversion and contagion effects. Figure A1 shows these equations based on rolling regressions (1-year sample, shifting 2 months per regression; statistically insignificant values not shown).

Figure A1: Sensitivity of Portuguese 10-Year Yields



Sources: Bloomberg Finance L.P. and staff analysis

Prior to 2008, virtually all movements in Portuguese yields can be 'explained' by changes in the core. When the crisis begins, Portugal decouples from the core and becomes more sensitive to changes in non-core yields. And as the crisis deepens, spreads in Portugal seem mainly to react to domestic events, and the sensitivity to external events diminishes for a period. Nevertheless, it is apparent that in recent years, Portugal has remained highly sensitive to developments in the non-core, and has not 'recoupled' with the core. In summary, despite the significant progress made by the authorities to strengthen fundamentals, external market developments clearly remain important for Portugal.

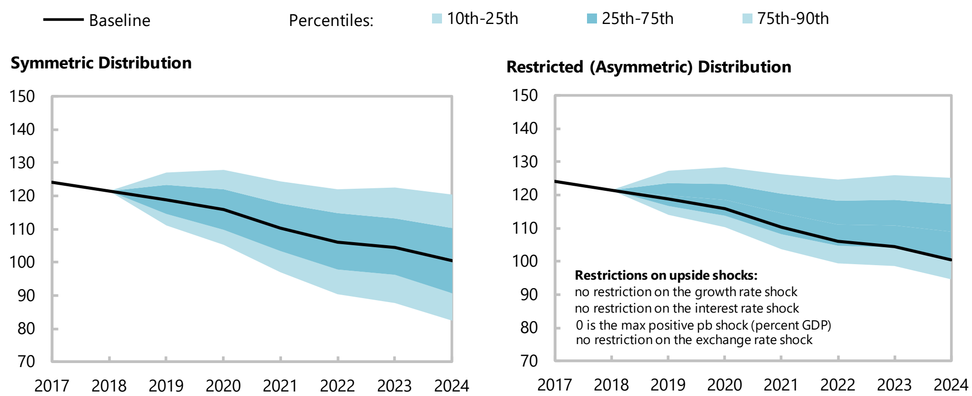
Figure 1. Portugal: Public DSA Risk Assessment, 2017–2024

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

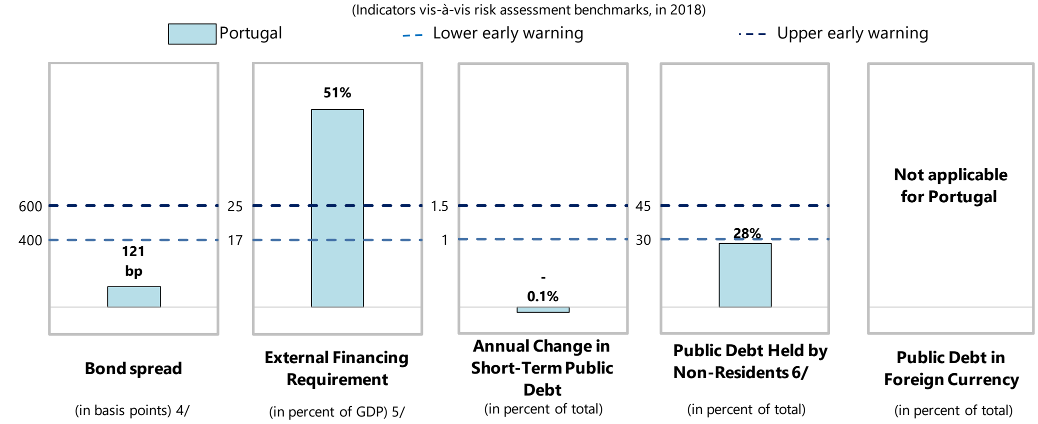
Evolution of Predictive Densities of Gross Nominal Public Debt

(Percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2018)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85 percent 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, and white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20 percent 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, and 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:

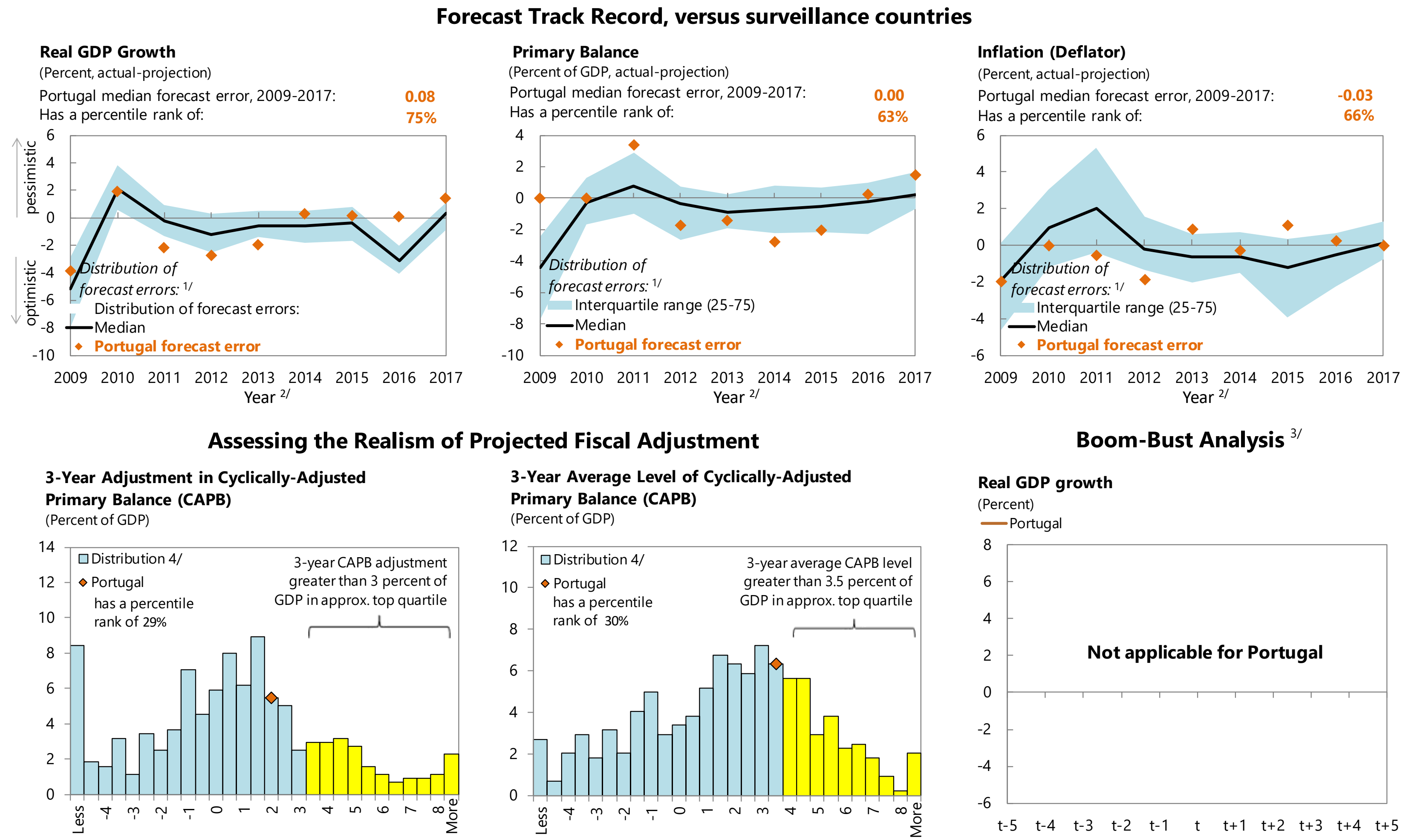
400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over German bonds, an average over the last 3 months, February 21, 2019 through May 22, 2019.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

6/ Excludes EFSF/ESM loans (23 percent of GDP at end-2018)

Figure 2. Portugal: Public DSA - Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.

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

3/ Not applicable for Portugal, as it meets neither the positive output gap criterion nor the private credit growth criterion.

4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 3. Portugal: Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario, 2008–2024

(Percent of GDP unless otherwise indicated)

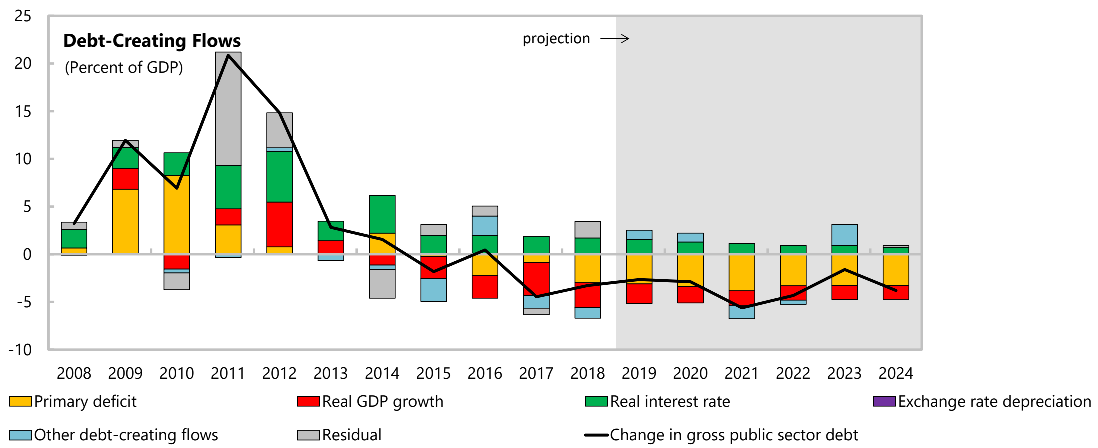
Debt, Economic and Market Indicators 1/

	Actual			Projections					
	2008-2016 2/	2017	2018	2019	2020	2021	2022	2023	2024
Nominal gross public debt	111.2	124.8	121.5	118.8	116.0	110.3	106.0	104.4	100.6
Public gross financing needs	23.7	17.2	12.2	13.9	12.5	14.7	13.0	11.4	16.1
Real GDP growth (in percent)	-0.4	2.8	2.1	1.7	1.5	1.4	1.4	1.4	1.4
Inflation (GDP deflator, in percent)	1.1	1.5	1.4	1.5	1.7	1.7	1.7	1.7	1.7
Nominal GDP growth (in percent)	0.7	4.4	3.6	3.3	3.2	3.1	3.1	3.1	3.1
Effective interest rate (in percent) 4/	4.0	3.1	2.9	2.9	2.9	2.7	2.6	2.6	2.5

As of May 22, 2019		
Sovereign Spreads		
EMBIG (bp) 3/		111
5Y CDS (bp)		63
Ratings	Foreign	Local
Moody's	Baa3	Baa3
S&Ps	BBB	BBB
Fitch	BBB	BBB

Contribution to Changes in Public Debt

	Actual			Projections							
	2008-2016	2017	2018	2019	2020	2021	2022	2023	2024	cumulative	debt-stabilizing primary balance 9/
Change in gross public sector debt	6.8	-4.5	-3.3	-2.6	-2.9	-5.6	-4.3	-1.6	-3.8	-20.9	
Identified debt-creating flows	5.1	-3.8	-5.0	-2.6	-2.9	-5.6	-4.3	-1.6	-4.0	-21.1	
Primary deficit	2.1	-0.9	-3.0	-3.1	-3.4	-3.8	-3.3	-3.3	-3.3	-20.2	-0.7
Primary (noninterest) revenue and grants	42.7	42.7	43.5	43.6	43.7	44.2	43.9	43.9	44.0	263.4	
Primary (noninterest) expenditure	44.9	41.8	40.5	40.5	40.4	40.4	40.6	40.6	40.7	243.1	
Automatic debt dynamics 5/	3.2	-1.6	-0.9	-0.5	-0.4	-0.4	-0.6	-0.5	-0.7	-3.2	
Interest rate/growth differential 6/	3.2	-1.6	-0.9	-0.5	-0.4	-0.4	-0.6	-0.5	-0.7	-3.2	
Of which: real interest rate	2.9	1.9	1.7	1.6	1.3	1.1	0.9	0.9	0.7	6.5	
Of which: real GDP growth	0.3	-3.5	-2.6	-2.1	-1.7	-1.6	-1.5	-1.4	-1.4	-9.7	
Exchange rate depreciation 7/	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.2	-1.3	-1.1	1.0	0.9	-1.4	-0.4	2.2	0.0	2.3	
Privatization revenue (negative)	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Increase in deposits and other	0.1	-1.3	-1.1	1.0	0.9	-1.4	-0.4	2.2	0.0	2.3	
Residual, including asset changes 8/	1.6	-0.7	1.7	0.0	0.0	0.0	0.0	0.0	0.2	0.2	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = 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 numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). In 2017, includes the recapitalization of CGD. For projections, includes exchange rate changes during the projection period.

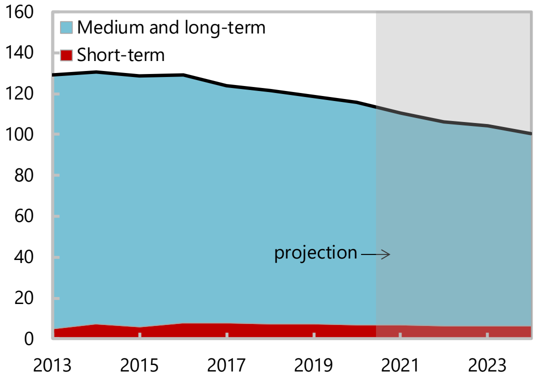
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 4. Portugal: Public DSA - Composition of Public Debt and Alternative Scenarios, 2013–2024

Composition of Public Debt

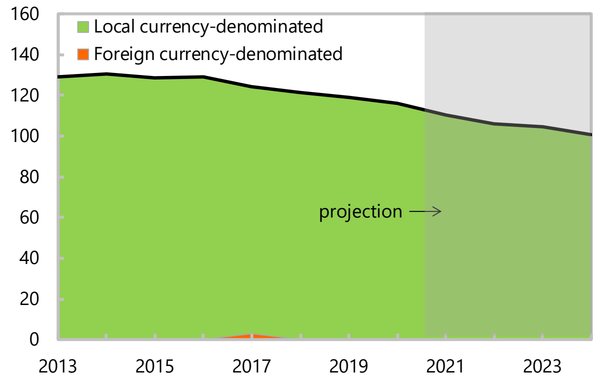
By Maturity

(Percent of GDP)



By Currency

(Percent of GDP)

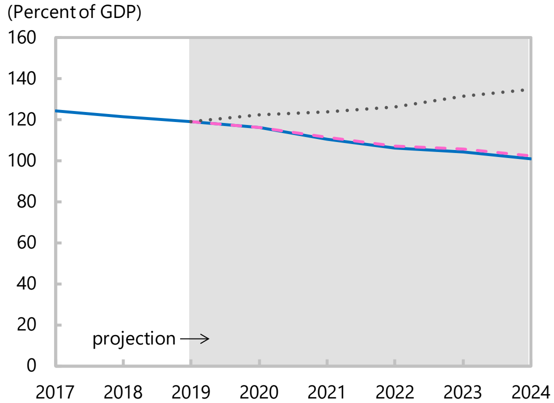


Alternative Scenarios

Baseline   Historical   Constant Primary Balance

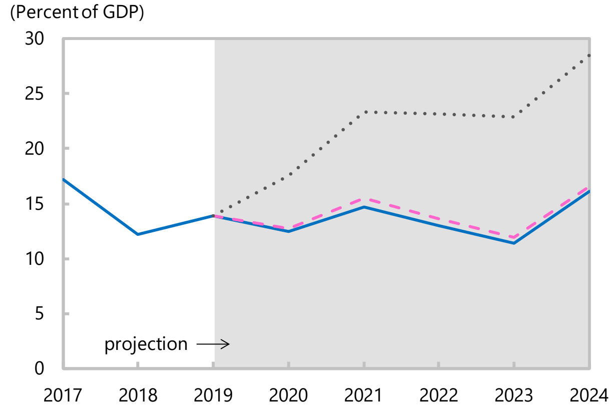
Gross Nominal Public Debt

(Percent of GDP)



Public Gross Financing Needs

(Percent of GDP)



Underlying Assumptions

(Percent)

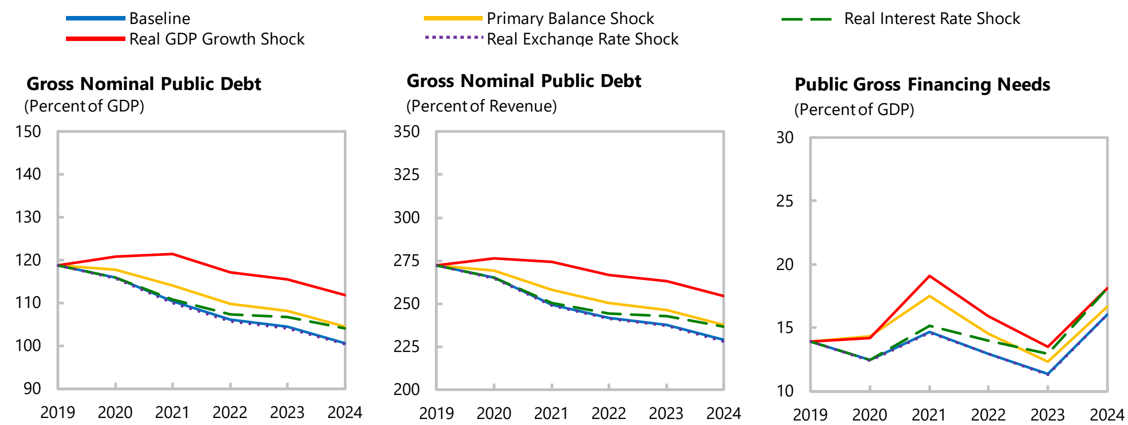
Baseline Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	1.7	1.5	1.4	1.4	1.4	1.4
Inflation	1.5	1.7	1.7	1.7	1.7	1.7
Primary Balance	3.1	3.4	3.8	3.3	3.3	3.3
Effective interest rate	2.9	2.9	2.7	2.6	2.6	2.5
Constant Primary Balance Scenario						
Real GDP growth	1.7	1.5	1.4	1.4	1.4	1.4
Inflation	1.5	1.7	1.7	1.7	1.7	1.7
Primary Balance	3.1	3.1	3.1	3.1	3.1	3.1
Effective interest rate	2.9	2.9	2.7	2.6	2.6	2.5

Historical Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	1.7	0.2	0.2	0.2	0.2	0.2
Inflation	1.5	1.7	1.7	1.7	1.7	1.7
Primary Balance	3.1	-1.5	-1.5	-1.5	-1.5	-1.5
Effective interest rate	2.9	2.9	2.9	2.9	3.1	3.1

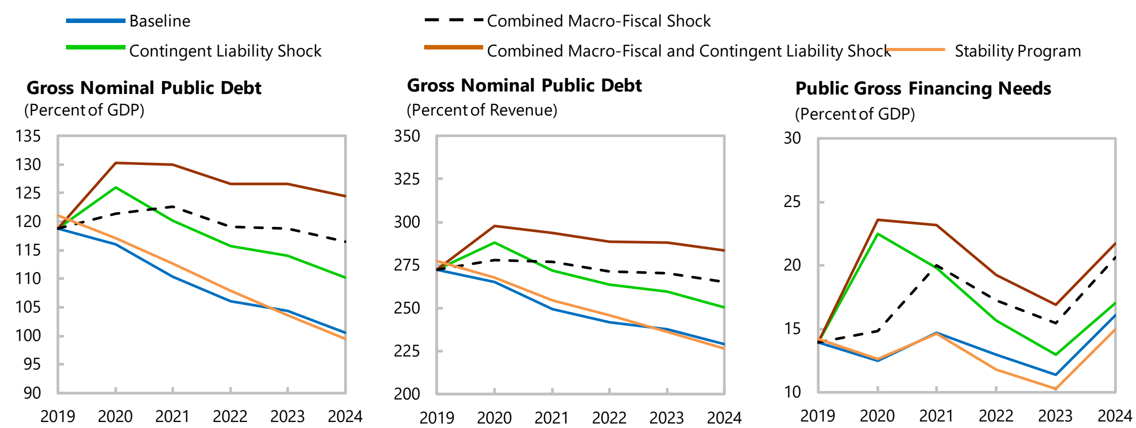
Source: IMF staff.

Figure 5. Portugal: Public DSA - Stress Tests, 2019–2024

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(Percent)

Primary Balance Shock	2019	2020	2021	2022	2023	2024
Real GDP growth	1.7	1.5	1.4	1.4	1.4	1.4
Inflation	1.5	1.7	1.7	1.7	1.7	1.7
Primary balance	3.1	1.5	2.0	3.3	3.3	3.3
Effective interest rate	2.9	2.9	2.8	2.7	2.6	2.5
Real Interest Rate Shock						
Real GDP growth	1.7	1.5	1.4	1.4	1.4	1.4
Inflation	1.5	1.7	1.7	1.7	1.7	1.7
Primary balance	3.1	3.4	3.8	3.3	3.3	3.3
Effective interest rate	2.9	2.9	3.2	3.3	3.6	3.7
Combined Shock						
Real GDP growth	1.7	-0.9	-1.0	1.4	1.4	1.4
Inflation	1.5	1.1	1.1	1.7	1.7	1.7
Primary balance	3.1	1.5	1.3	3.3	3.3	3.3
Effective interest rate	2.9	2.9	3.2	3.4	3.7	3.8
Contingent Liability Shock						
Real GDP growth	1.7	1.5	1.4	1.4	1.4	1.4
Inflation	1.5	1.7	1.7	1.7	1.7	1.7
Primary balance	3.1	-6.6	3.8	3.3	3.3	3.3
Effective interest rate	2.9	2.9	2.6	2.5	2.6	2.4

Real GDP Growth Shock	2019	2020	2021	2022	2023	2024
Real GDP growth	1.7	-0.9	-1.0	1.4	1.4	1.4
Inflation	1.5	1.1	1.1	1.7	1.7	1.7
Primary balance	3.1	2.1	1.3	3.3	3.3	3.3
Effective interest rate	2.9	2.9	2.8	2.7	2.6	2.5
Real Exchange Rate Shock						
Real GDP growth	1.7	1.5	1.4	1.4	1.4	1.4
Inflation	1.5	1.9	1.7	1.7	1.7	1.7
Primary balance	3.1	3.4	3.8	3.3	3.3	3.3
Effective interest rate	2.9	2.9	2.7	2.6	2.6	2.5
Combined Macro-Fiscal and Contingent Liability Shock						
Real GDP growth	1.7	-0.9	-1.0	1.4	1.4	1.4
Inflation	1.5	1.1	1.1	1.7	1.7	1.7
Primary balance	3.1	-7.2	3.2	3.3	3.3	3.3
Effective interest rate	2.9	2.9	3.4	3.5	3.8	4.0

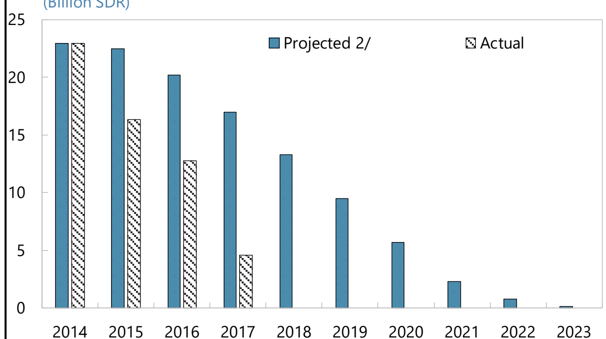
Source: IMF staff.

Annex II. Early Repayment to the IMF

On December 10, 2018, Portugal made a final repurchase, clearing the outstanding balance of its IMF credit, five years ahead of schedule. Portugal had been making early repayments since 2015, which accelerated in 2017. These repayments represented significant savings, especially on the debt subject to surcharges for large and prolonged use of IMF resources. The level of outstanding purchases remained above the surcharge threshold (187.5 percent of quota) until February 2018. Using as a comparator the yield on sovereign bonds with a similar maturity in secondary markets, Portugal was saving almost 400 basis points of interest (net) on the amounts repurchased by late 2017-early 2018, as well as the cost of hedging foreign exchange risk. After that time, Portugal was only paying the "basic rate" on the remainder of its IMF credit; still, this was more than 100 basis points higher than the sovereign yield for an equivalent maturity. In addition, the December 2018 repayments helped smooth the overall profile of maturities of Portugal's public debt. So, the repayment was a financially sound decision.

Portugal: Credit Outstanding to IMF 1/

(Billion SDR)



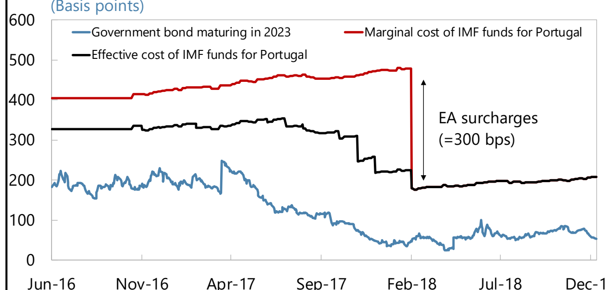
Source: IMF staff calculations.

1/ End-of-period values in calendar years.

2/ Projected in the First Post-Program Monitoring.

Portugal: Cost Advantage of Early Repurchases 1/

(Basis points)



Source: Bloomberg Finance L.P.

1/ The "marginal" cost of funding is the interest cost on the next SDR that stands to be repurchased at each moment. In February 2018, the outstanding balance fell to the threshold for exceptional access surcharges. Thus, before that date, the "marginal" cost of funds included Exceptional Access surcharges; but after February 2018, the marginal cost became equal to the IMF's basic rate. The "effective" cost is the average cost on all outstanding balances accruing at each point in time.

Annex III. Risk Assessment Matrix

Source of Risks	Relative Likelihood	Impact	Policy Response
Loss of investor confidence. Weaker structural and fiscal policy efforts, and reform reversals, or other negative surprises, potentially including difficulties in the banking system.	Low	**High** Increase in sovereign bond yields and reduction in foreign direct investment. Significant funding distress, higher public and private borrowing costs.	Strengthen policy buffers and avoid backtracking on reforms. Continue to implement policies that support growth, lasting fiscal adjustment, and a strong banking system, to foster investor confidence, and favorable financing conditions.
Rising protectionism and retreat from multilateralism. In the near term, escalating and sustained trade actions threaten the global trade system, regional integration, as well as global and regional collaboration. Additional barriers and the threat of new actions reduce growth both directly and through adverse confidence effects (increasing financial market volatility). In the medium term, geopolitical competition and fraying consensus about the benefits of globalization lead to economic fragmentation and undermine the global rules-based order, with adverse effects on growth and stability.	High	**High** Weaker economic environment and expectations would have broad negative effects on a small open economy like Portugal, both for the near-term and medium-term growth prospects.	Reform-oriented macro-financial and structural policies to support investment, sentiment, growth, and resilience of the economy.
Weaker-than-expected global growth. Euro Area: In the near term, weak foreign demand makes Euro Area businesses delay investment, while faltering confidence reduces private consumption. Adverse financial market reaction to debt sustainability concerns further dampens growth. A disorderly Brexit could cause market disruption with negative spillovers. In the medium term, disregard for the common fiscal rules and rising sovereign yields for high-debt countries test the Euro Area policy framework, with adverse impact on confidence and growth.	High	**High** With the Euro Area accounting for 60 percent of total exports, the current account balance and NIIP would be at risk. Lower growth and investment would imperil debt dynamics in all sectors.	Step up structural reforms to improve competitiveness and reduce indebtedness. Step up efforts to clean up corporate and bank balance sheets, to minimize drag on investment and growth.

Source of Risks	Relative Likelihood	Impact	Policy Response
Intensification of security risks in parts of Africa, Asia, Europe, Latin America, and/or the Middle East cause regional socio-economic and political disruptions, with potential global spillovers.	High	High Escalation of euro skepticism, leading to less cooperation and a reversal of integration.	Accelerate structural reforms to support investment and growth.
Sharp tightening of global financial conditions. This causes higher debt service and refinancing risks; stress on leveraged firms, households, and vulnerable sovereigns; capital account pressures; and a broad-based downturn. The tightening could be a result of sustained rise in risk premium in reaction to concerns about debt levels in some Euro Area countries and/or a disorderly Brexit.	Medium	High Less favorable financial conditions and potentially wider spreads as global conditions tighten would affect highly leveraged firms and households as short-term and variable-rate loans are repriced, and could weaken banks' balance sheets.	Step up efforts to implement policies that support growth, lasting fiscal adjustment, continued balance sheet clean-up, and a strong banking system, which would contribute to shoring up investor confidence, and ease financing conditions and restraints.

Annex IV. The New Financial Supervision Framework Bill

1. **The new financial supervision framework bill proposes to strengthen the coordination role of the National Council of Financial Supervisors (NCFS).** The bill grants the NCFS legal personality, and makes provisions for it to have its own human and financial resources to perform its duties autonomously and continuously. Its composition is enlarged by the even participation of the supervisory authorities—including Banco de Portugal, the Portuguese Securities and Exchange Commission, and the Portuguese Insurance and Pension Funds Supervisory Authority—and an appointed chief executive officer, with the executive board being chaired on a rotation basis by the heads of the supervisory authorities. The bill would also make the NCFS the macroprudential authority, enabling it to obtain an overview of the financial system, while the implementation of the NCFS decisions would be under the responsibility of the supervisory authorities.

1. **The bill also proposes the creation of the Resolution and Guarantees Authority (RGA). It recommends the reorganization of resolution and supervision by segregating and entrusting the resolution of financial firms to RGA.** Banking supervision would remain under the central bank while the prevention function (including resolution planning) associated with the resolution of the different financial institutions would remain under the different supervisory authorities, where applicable.

2. **The bill proposes the creation of the National System of Financial Supervision (NSFS). It would be composed of the supervisory authorities, the NCFS, and the RGA, requiring a harmonization of the statutory regimes of the supervisory authorities.** As part of this, the financial autonomy of the Portuguese Securities and Exchange Commission, and the Portuguese Insurance and Pension Funds Supervisory Authority would increase.

3. **The bill also proposes modifications in the length of term, possibility of removal, and procedures for designation of top officials of the three supervisory authorities, and provides for the performance of circumscribed inspections and audits by the IGF, an administrative body dependent from the Ministry of Finance.** In particular, extensive amendments would be made to the Organic Law of the Banco de Portugal to accommodate many of the proposed modifications. Some of these proposals, including the audits by IGF, the new rules for removal from office and replacement of the Governor of the Banco de Portugal, are among those considered by the ECB and the Banco de Portugal as incompatible with the European institutional framework.

Annex V. External Sector Assessment

		Overall Assessment
Foreign asset and liability position and trajectory	**Background.** The negative net international investment position (NIIP) declined from its peak in 2014 of 119 percent of GDP to about 101 percent of GDP in 2018. This improvement has been driven by positive current account balances following the large adjustment during the crisis, but offset by improving external debt valuations. Gross external debt remains high at 206 percent of GDP. Both are expected to continue to decline, but at a decelerating rate over the medium-term 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. Past debt management efforts to reduce sovereign external risk, including by smoothing the profile for redemptions and lengthening the average maturity have mitigated this risk, but Portugal remains exposed to a loss in confidence by external investors.	**Overall Assessment:** The external position in Portugal in 2018 was moderately weaker than that consistent with medium-term fundamentals and desirable policy settings. The large adjustment in the current account since the crisis has helped start reducing the large negative NIIP; a strong improvement to a more sustainable NIIP position would be supported by a current account in balance or moderate surplus over the medium term. **Potential policy responses:** Sustained fiscal consolidation and structural reforms to improve Portugal's saving rate, competitiveness, and potential growth are needed. Investment can be spurred by enhancing business conditions, streamlining regulations, and increasing the flexibility and responsiveness of institutions and markets. The stock of NPLs remains a concern and continued fast reduction, while keeping adequate capital buffers, is necessary.
Current account	**Background.** The Portuguese current account was in a surplus during 2013–17 after an extended period of deficits in the range of 10 percent of GDP, driven by a significant improvement in the balance of trade in goods and services, including on the heels of very strong growth in tourism. The current account registered a deficit of 0.6 percent of GDP in 2018, which is expected to slightly increase as import growth outstrips export growth. **Assessment.** EBA model-based estimates suggest a cyclically adjusted current account balance at -0.7 percent of GDP, compared to a norm of -0.6 percent of GDP, implying there is no current account gap. Nevertheless, staff assesses the small actual current account deficit of 0.7 percent to be insufficient in view of the still large negative NIIP. Assuming continued capital account surpluses, staff assesses a current account short-fall of about 1–3 percent of GDP to bring about a strong medium-term improvement in the NIIP. Key to strengthen the external position, including the high level of public debt, is sustained fiscal adjustment paired with structural reforms to support both saving and investment, and continued efforts to address remaining financial sector challenges.	
Real exchange rate	**Background.** Both the CPI-based real effective exchange rate (REER) and the unit labor cost (ULC)-based REER are still well below their pre-crisis peaks: CPI-based REER 2 percent below, and ULC-based REER 5 percent below. Both REER measures have been on an appreciating trend since the post crisis low points in early 2015, and although the appreciation since then is limited, the trade balance has started to deteriorate. Cost competitiveness will be challenged if the trend continues. **Assessment.** The EBA's *index* regression model suggest an overvaluation of 4.8 percent for 2018, while the level REER model suggest the REER is fairly valued with a marginal estimated 0.3 percent undervaluation. The index model metric is within the range of what is implied by the current account gap, given current policies, to put the NIIP on a faster downward trajectory, which suggest an overvaluation of the REER in the range of 2 to 6 percent applying the model elasticity. It should be noted that the adjustment could be less through price competitiveness and more through continued and sustained quality upgrades and innovation to improve non-price competitiveness.	
Capital and financial accounts: flows and policy measures	**Background.** Financing conditions have eased dramatically since the resumption of sovereign market access in 2014. Sovereign spreads have been below 100 basis points since May 2019, after being above 300 as recently as early 2017, and credit ratings have been upgraded. This reflects, among other things stronger GDP growth, an improved fiscal position, progress in addressing weaknesses in the banking sector, and support from ECB purchases. **Assessment.** A current account surplus and improved macro conditions have helped support external financing rollover needs for the near-term. Further policy action will be needed over the medium term to secure investor confidence and rule out negative equilibria.	
FX inter-vention 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 VI. Past Recommendations

Recommendations	Progress
Labor markets	
Labor market flexibility. Safeguard program-era policy changes to make: (i) hiring and collective bargaining more flexible; and (ii) permanent contracts more flexible rather than restricting temporary contracts.	**Partially implemented.** Measures under consideration emerged from a tripartite negotiation, preventing significant reversals. Agreed measures would mostly discourage temporary contracts, and constrain flexibility afforded by "banks of hours" however, allowances would be made for sectoral differences, and longer probation periods would improve permanent contracts.
Financial sector and Macro-financial Issues	
Enhancing profitability	**Implemented.** A thorough supervisory review of banks' business models has been conducted in the context of SREP, leading to recommendations to improve operational efficiency and streamline activities. Progress has been made on these two fronts. Nevertheless, further efforts are needed to continue to improve profitability.
Non-performing loans - Implement the NPL-resolution strategy and strengthening risk management and corporate governance to avoid further NPL build-up	**Implemented.** The execution of the NPL reduction plans submitted by banks to the supervisor has been strong, with outcomes exceeding targets in several cases. Progress has been made in strengthening risk management and corporate governance. Nevertheless, further efforst are required given the size of the challenges.
Preventing excessive risk taking.	**Implemented.** The Banco de Portugal deployed borrower-based macroprudential measures in 2018. There has been a gradual improvement in the borrowers' risk profile associated to mortgage and consumer loans since then.
Fiscal sector	
Structural primary adjustment. One percent of GDP tightening of the structural primary balance cumulatively over 2018–2019, including aiming for over-performing on their official overall balance target for 2018.	**Partially implemented.** According to staff estimates, the structural primary balance imporved by 0.2 percent of GDP between 2017 and 2018.
Civil service reform. A well-designed reform of the civil service, aimed at improving the level and composition of public employment, and guided by the demographic needs of the population.	**Partially implemented.** While there has been no wholesale review or reform of the civil service, the authorities have demonstrated restraint on wages and career unfreezing, and have focused new hiring in areas where the demographic demands are highest (in particular, nursing)
Pension reforms (1). Revisit recent pension reforms to reduce grandfathering.	**Not implemented.** No major reforms of the pension system have been implemented.
Pension reforms (2). Identify measures to offset the costs of reducing the penalties for the early retirement of long-career employees	**Not implemented.** No offsetting measures introduced.
Public sector payments discipline. Address the root causes of arrears, particularly from hospitals, such as under-budgeting, as well as weaknesses in monitoring and enforcement practices.	**Partially implemented.** In the context of the ongoing spending review, the initiatives in the healthcare sector to increase central control of budgetary execution, decrease arrears, strengthen the joint performance monitoring and control from the MoF and MoH have improved efficiency but have been insufficient to prevent hospitals from accumulating new arrears.

Annex VII. The Natural Rate of Interest in Portugal

The natural interest rate is an important macroeconomic variable for policymakers – it is used to assess the impact of monetary policy on economic activity, to pin down long-run debt dynamics and to help assess the impact of an aging population. Yet this variable is unobservable and estimates of it can vary significantly. This annex outlines several techniques for estimating the natural interest rate for Portugal and considers the implications for policymakers.[1]

Conceptual Issues

1. **The natural rate of interest (r*) is an equilibrium concept.** It is the rate of interest that that would equate (foreign and domestic) desired saving to desired investment with a closed output gap and stable inflation. Woodford (2003) introduced the modern formulation of r* as an unobserved variable that responds to *all* real shocks to hit an economy. As all real shocks are represented, r* can also be characterized as the interest rate that would prevail in the absence of nominal rigidities. Given that r* captures all real shocks – including from fiscal policy, financial intermediation, external demand, terms of trade etc. –it is subject to many sources of disturbance. As such, it can be pro-cyclical and highly volatile. Given the potential volatility of r*, it is also helpful to consider lower frequency trends. This view of r* is useful when thinking about the 'terminal interest rate' i.e. where interest rates might converge to once short-term shocks dissipate. Or when thinking about debt sustainability, where the cost of borrowing can have a significant cumulative effect. Over the longer term, r* is driven by many of same structural factors that determine potential output – technological progress, demographics and household preferences (Banco de Portugal, 2019).

2. **r* is typically defined in terms of the short-run, risk-free interest rate.** The methodologies applied here implicitly assumes that r* is a short-run interest rate – typically the overnight rate or 3- month maturity (the difference between the two being negligible in most cases). r* also typically corresponds to a 'risk-free' interest rate, often that of government debt, the policy rate used by central banks or the inter-bank overnight interest rate. For these reasons, r* is not equal to the average return on capital in an economy, which typically includes credit and duration risk. As noted by Brand et al (2018), while the return of capital has been stable or rising in the Euro Area, most measures of r* have been declining. They attribute this growing wedge to rising risk aversion and higher profit margins. This is one way to reconcile the concept of a negative r* with the idea that investments in the economy should yield a positive return in steady-state.

Laubach-Williams Model

3. **The seminal Laubach and Williams (2003) model (L-W model) is the benchmark framework used to estimate r*.** The set-up used here is based on a modified version of this model developed by Pescatori and Turunen (2015), which uses Bayesian techniques to calibrate the

[1] Further details will be presented in a forthcoming working paper.

coefficients. It combines a Phillips curve and IS curve to pin down the relationship between inflation and the output gap, and the output gap and the interest rate gap:

$$\pi_t = \sum_{j=1}^{8} \gamma_j \pi_{t-j} + \delta_1 \tilde{y}_{t-1} + \delta_2 \tilde{y}_{t-2} + \pi_{t-1}^{m} + \epsilon_t \quad (1)$$

$$\tilde{y}_t = \alpha_1 \tilde{y}_{t-1} + \alpha_2 \tilde{y}_{t-2} - \beta_1 (r_{t-1} - r_{t-1}^{*}) - \beta_2 (r_{t-2} - r_{t-2}^{*}) + \varepsilon_t \quad (2)$$

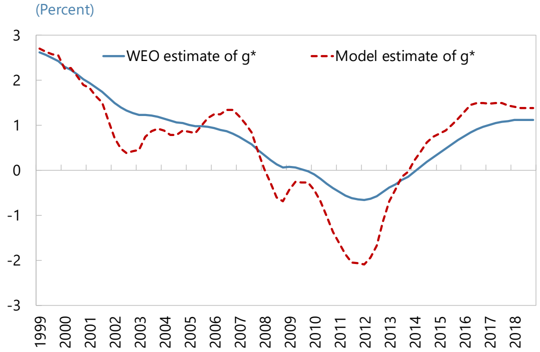
where $r_t = i_t - E_t(\pi_{t+1})$ and π_t^m is imported inflation. Trend growth (g_t^*) is assumed to follow a random walk with a persistent shock, and r* is a function of trend growth plus an exogenous process (z_t) capturing other drivers of r*:

$$r_t^* = c g_t^* + z_t \qquad (3)$$

where c is a constant, $c > 0$. In this model, z_t (which is assumed to follows an AR(2) process), r* and g_t^* are simultaneously estimated using a Kalman filter.

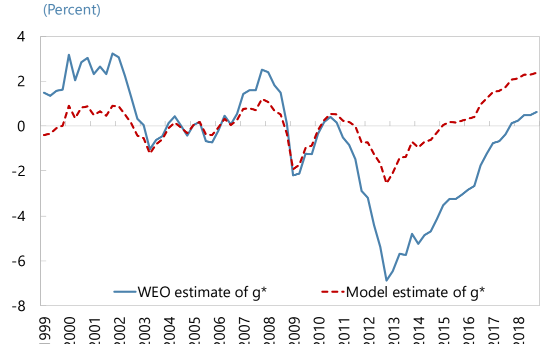
4. The L-W model estimates that r* declined significantly over the first two decades of the euro, but has bounced back in recent years. Figure 1 shows that the L-W model estimate of r* (orange line) predicts a fall from around 2.5 percent in 1999 to around -2 percent at the depth of the crisis, before rebounding back to around 1 percent by 2018. One shortcoming of this methodology, however, is that the estimate of g* leads to an implied output gap that appears too small, especially for the crisis period (Figure 2). In response, this model can be modified to incorporate the IMF WEO estimate of g* as an observable variable, leading to more plausible estimates of the output gap. With this modification, the estimate of r* (blue line, Figure 1) follows the same general trajectory, but the dip during the crisis is less deep (analogously, g* falls by less). The WEO output gap is used for all subsequent estimates of the L-W model.

Figure 1. r* Estimates using the L-W Model
(Percent)



Source: IMF staff calculations.

Figure 2. Output Gap Estimates
(Percent)

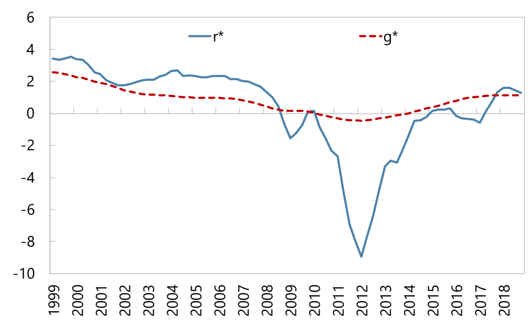


Source: IMF staff calculations.

5. Potential growth is not the only driver of r*. An extension of this model allows z_t (equation 3) to be a function of other variables rather than just following an AR(2) process. This modification to the model can be used to help explain movements in r* that are orthogonal to g_t^*. For example, these could include shocks to - the monetary policy transmission mechanism; external demand; fiscal policy; or any other real factors that might influence the output and interest rate gaps. For Portugal, the real effective exchange rate (REER), trading partner growth and the CDS spread were used as possible drivers of r*. The first two are designed to reflect the importance of external conditions on the Portuguese economy, while CDS spreads are used as a broad proxy for the deterioration in the monetary policy transmission during the Euro Area crisis.

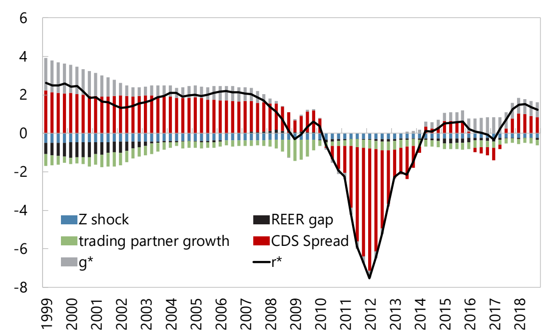
6. **CDS spreads are associated with large movements in estimated r*.** Figure 3 shows a much more volatile series for r*, reflecting the higher frequency nature of this estimate. In particular, while the decline in g* tracks the general downward trend of r*, the estimate of the latter falls to nearly -10 percent at the depths of the crisis. The CDS spread was 'responsible' for much of the volatility in r* (Figure 4). Prior to the crisis, near-zero credit spreads – a proxy for financing conditions in the economy - provided a positive boost to r*. But as the Euro Area crisis unfolded, and the 'credit crunch' ensued, this factor pushed down heavily on r* i.e. a much lower real interest rate was "needed" to achieve a closed output gap and stable inflation in the environment created by the sudden stop. In fact, this movement in r* can perhaps be best viewed as a summary indicator of the strong domestic policy actions on various fronts that were required to turn around the economy. External factors seem to have played a more ambiguous role. Trading partner growth seems to have provided a steady drag on r*, perhaps reflecting the general decline in growth in advanced economies (Portugal's main trading partners) that was experienced over the last two decades. And during the Global Financial Crisis (GFC), it is the main driver of the dip experienced in 2008/9. The model also suggests that the REER was overvalued when Portugal joined the euro, acting as a headwind to growth and pushing down on r*. The post-crisis recovery in r* was driven by a combination of higher potential growth and a normalization of credit spreads.

Figure 3. L-W Model, r* and g*
(Percent)



Source: IMF staff calculations.
Uses the WEO estimate of g.

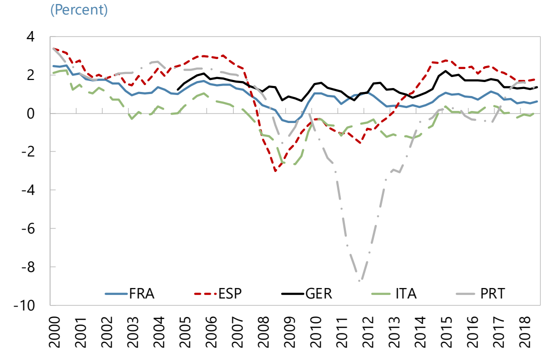
Figure 4. Decomposition of r*,
(Percent)



Source: IMF staff calculations.

7. **The decline in r* was much more severe in Portugal than other major Euro Area economies.** Figure 5 shows that for Germany, France, Spain and Italy, r* reached its lowest point during the GFC in 2008/9; with r* falling below that of Portugal in Spain and Italy. Yet these declines are dwarfed by the subsequent fall in r* in Portugal. This is important for the discussion of monetary policy, below, but also emphasizes the fact that at such frequencies, r* can

Figure 5. Euro Area Estimates of r*
(Percent)



Source: IMF staff calculations.

deviate significantly between countries, even those with close economic and financial ties. Finally, it is worth noting that while estimates of r* are currently relatively close for these countries, the estimate for Portugal is at the upper end of the range, and almost identical to that of Germany.

Techniques Using Financial Market Data

8. **Financial market data can also be used to provide valuable information about r* by modeling this unobservable variable as a deep trend in market rates.** These models implicitly assume that the real interest rate should fluctuate around r*, with the gap between them tending to close as real and nominal shocks dissipate through time. These models tend to be more agnostic about the economic drivers behind these estimates, but can be valuable nonetheless. Using a model developed by Del Negro et al (2018), it is possible to extract trends from inflation, real short-term interest rates and real long rates using a Kalman filter with Bayesian estimation techniques. The trend real short rate is used as a low-frequency measure of r*. As inputs, the method uses data on inflation, *nominal* short rates and *nominal* long rates, and assumes that these series are cointegrated as follows:

$$\pi_t = \pi_t^* + e_t \qquad (4)$$

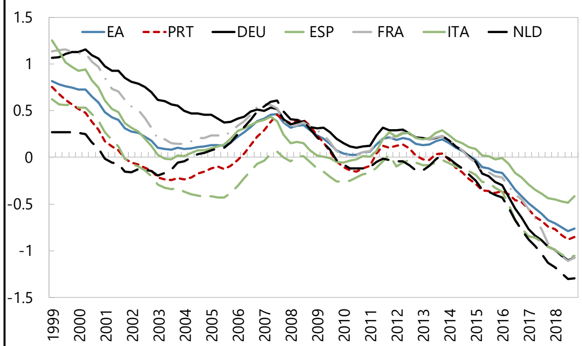
$$i_t^{3m} = \pi_t^* + r_t^* + u_t \qquad (5)$$

$$i_t^{10yr} = \pi_t^* + r_t^* + tp_t^* + v_t \qquad (6)$$

where π_t^* is trend inflation, i_t^{3m} is the three-month T-bill rate, i_t^{10yr} is the 10-year bond yield, tp_t^* is the trend term premia, and e_t, u_t and v_t are shocks (which could be persistent and correlated with each other). The trend components are assumed to follow a random walk and are subject to 'white-noise' shocks. Furthermore, recognizing that Portugal is a small open economy in a currency union, these trends are jointly estimated for the six largest Euro Area economies. Here, common factors on π_t^*, r_t^* and tp_t^* are estimated (the 'Euro Area factors'), as well country-specific trends. Figure 6 shows that r* seems to closely co-move between the countries and that there seems to have been some convergence since the early 2000s, perhaps reflecting greater economic and financial integration following the adoption of the euro. More recently, however, there seems to have been some divergence, which could reflect some fragmentation of financial markets, or perhaps as a result of economies being subject by more country-specific shocks.

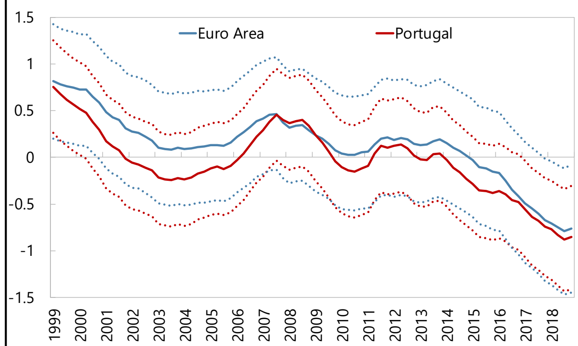
9. **Focusing on Portugal, this model suggests that r* has fallen significantly over recent years.** In 1999, r* was estimated to be around 0.8 percent, falling to around -0.8 percent in 2018 (Figure 7). Compared to the L-W models, this represents a smaller overall decline, but also no rebound in recent years. The gap between Portugal and the Euro Area common factor is also very small, with both median estimates within each each's 'credibility band'. In contrast perhaps to the results shown in Figure 5 (which showed the divergence in r* between Euro Area countries), this low-frequency measure of r* shows the importance of euro-area-wide factors in Portugal. This is perhaps not surprising given the close co-movement of business cycles between Portugal and the rest of the currency union.

Figure 6. r*, Common Factor Model
(Percent)



Source: IMF staff calculations.

Figure 7. Common Factor Model: Portugal and EA
(Percent)



Source: IMF staff calculations.

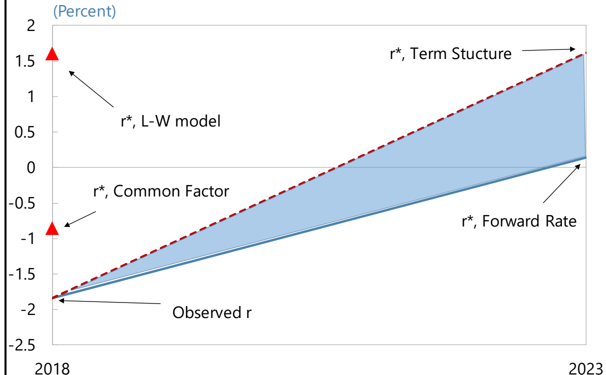
10. Financial markets can also provide information on where r* might be in the future. Given that the actual and natural rate of interest are expected to converge over the medium term (as nominal and real shocks dissipate), financial market data can be exploited to find useful information on the future position of r*. Here the implicit assumption is that as interest rate gaps should vanish over time, the expected future value of r should be close to the expected future value of r*. Two techniques are employed to make this projection:

a. ***Forward interest rates*** – the forward swap market on Portuguese government debt gives an indication of the future path of short rates. In this case, the 3-month treasury bill, 5-years ahead, is used as a proxy for the (nominal) natural rate of interest. Inflation expectations are used to convert nominal rates into real rates.

b. ***Term structure*** – A version of the Nelson-Siegal term structure model (Christensen et al, 2010) is used to fit the yield curve of Portuguese government debt through time. The implied path of future nominal short rates, consistent with this yield curve, can be derived and used as a proxy for the (nominal) natural rate, 5-years ahead. Again, inflation expectations are used to convert nominal rates into real rates.

11. r* is expected to remain broadly stable in coming years. These models suggest that r* is likely to be between 0.1 and 1.6 percent over the medium-term, around 2–3.5 percent higher than current (*observed*) real interest rates (Figure 8). But this is within the range of current estimates of r* for both the common factor model and the L-W models, perhaps reflecting the slow-moving nature of (low-frequency) estimates of r*. Finally, it is worth noting that these techniques are biased upwards if there is a substantial credit or liquidity premium in these markets.

Figure 8: Market Expectations of Real Rates
(Percent)



Source: IMF staff calculations.

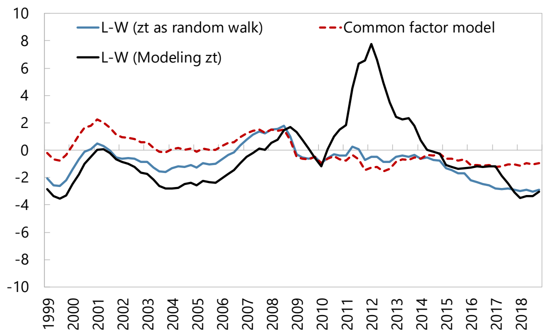
The Interest Rate Gap

12. The 'interest rate gap' – the difference between the actual real rate of interest and r* is an important indicator of monetary conditions. If the real interest rate is above (below) r*, the interest rate gap is positive (negative) and monetary conditions are deflationary (inflationary).[2] But given that r* is unobservable and time-varying, assessing these conditions can be challenging. Figure 9 shows the implied interest rate gap for Portugal based the three measures of r*: the L-W model with z_t assumed to follow a random walk; the common factor model; and the L-W model, with z_t explicitly modelled as function of other variables. The first two measures tell a broadly similar story – monetary policy conditions in Portugal were somewhat loose in the early years of the euro, but slowly tightened in the years immediately prior to the GFC. Once the crisis began and policy was loosened for the Euro Area as a whole, monetary conditions eased, especially when viewed using the L-W model. However, the third measure - which captures other economic variables that impact r* - is perhaps the more appropriate measure, as it accounts for many of the shocks that were driving the significant output gap in Portugal during the crisis. The implied interest gap using this measure implies highly restrictive monetary conditions in Portugal between 2011–2014 when Portugal was going through the worst of its risk-driven credit crunch, despite the monetary loosening taking place in the Euro Area.

13. Unconventional monetary policies (UMPs) have an important impact on the interest rate gap. The 'shadow' interest rate is a conceptual tool to help assess the monetary stimulus of policies such as asset purchases and forward guidance once interest rates have reached their effective lower bound (ELZ). Using the shadow rate estimates by Krippner (2015), the interest rate gap is recalculated (Figure 10). This shows that from 2014, monetary policy became highly accommodative for Portugal, with an interest rate gap of around -8 percent in 2016 for all three measures of r*. Nevertheless, according to the L-W model (modeling z_t), monetary conditions remained tight during the depths of the crisis. This reflects the fact that country-specific factors are key to assessing monetary conditions *within* a currency union.

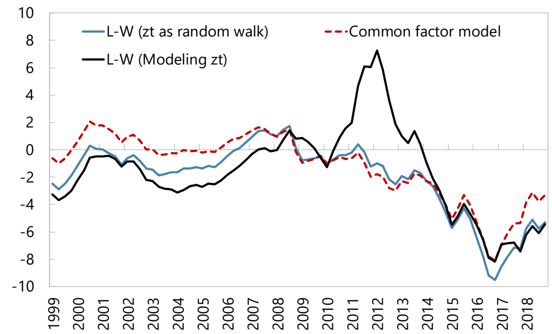
[2] In a country with its own currency and monetary policy, a more direct interpretation of r-r* would be the stance of monetary policy. However, we avoid this characterization given that monetary policy in the Euro Area is conducted on the basis of economic conditions in the Euro Area as a whole, which can be different from conditions in each individual member of the Euro Area.

Figure 9. Interest Rate Gap
(Percent)



Source: IMF staff calculations.

Figure 10. Interest Rate Gap (Shadow Rates)
(Percent)



Source: IMF staff calculations.

Public Debt Dynamics

14. The link between r* and debt dynamics is important but nuanced. Intuitively, a lower cost of borrowing for the public sector will support debt sustainability. This is clear by looking at the standard debt dynamics equation:

$$\Delta d_t = \frac{r_t^e - g_t}{1+g_t} d_{t-1} - pb_t \quad (7)$$

Changes in public debt (Δd_t) depend on the inherited debt level (d_{t-1}), the government's primary balance (pb_t), the real *effective* interest rate on public debt (r_t^e), and real growth (g_t). A lower r*, *ceteris paribus*, implies a lower r_t^e. Yet there are a number of reasons why this relationship is not so simple:

- **A low r* may imply a low g*** - many of the factors that drive r* also affect potential growth, in particular, demographics and productivity (even if the relationship is not one-for-one). Given that it is the differential between growth and the cost of borrowing that is important, these effects could mitigate each other.

- **The effective interest rate changes slowly.** A lower r* will need to be sustained to affect r_t^e because a large proportion of debt bears fixed rates.

- **The risk of hitting the ELB may increase –** the recent literature on a falling r* is closely linked to the secular stagnation hypothesis (Summers, 2014), which suggests that policy rates may increasingly hit the ELB. If the effectiveness of UMPs is limited or has costs, it may be harder to stabilize nominal GDP during a downturn, harming debt dynamics.

- **The credit risk premia is critical-** as witnessed during the crisis, interest rates on long-term debt can be dominated by movements in the risk premium, which is endogenous to both domestic factors (growth, debt, primary balance) and external market conditions. Boosting potential growth, raising the primary balance and reducing public debt are the best mitigants for this risk.

15. Both growth and the interest rate are projected to stay moderate in Portugal. The debt trajectory projected in the DSA (Annex I) assumes that the natural (and therefore effective) interest rate will stay low over the medium-term. This will be accompanied by relatively subdued growth, perhaps not surprising given that potential output is driven by the same factors as r*. This means that the differential between the two (equation 7) is projected to be close to zero, with the primary balance being the main driver of the debt reduction.

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INTERNATIONAL MONETARY FUND

PORTUGAL

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 18, 2019

Prepared By

European Department
(In Consultation with Other Departments)

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FUND RELATIONS

(As of April 20, 2019)

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	1,594.17	77.38
Reserve position in Fund	466.27	22.63

SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	806.48	100.00
Holdings	537.98	66.71

Outstanding Purchase and Loans: None

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				
	2019	**2020**	**2021**	**2022**	**2023**
Principal					
Charges/Interest	2.29	3.07	3.07	3.07	3.07
Total	**2.29**	**3.07**	**3.07**	**3.07**	**3.07**

[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.

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 May 16–29, 2018, and the staff report (Country Report No. 18/273) was discussed on September 7, 2018.

Post-Program Monitoring Discussions:
The Seventh Post-Program Monitoring Discussions were held in Lisbon during November 27– 30, 2018, and no staff report was considered as a result of Portugal's final repurchase on December 14 that cleared the outstanding balance of its IMF credit five years ahead of schedule.

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

Safeguards Assessment:
The first-time safeguards assessment of the Bank of Portugal (BdP), finalized in September 2011, found relatively strong safeguards in place. It recommended changes to the BdP Law to strengthen provision on BdP's autonomy and oversight, and to extend supervisory responsibilities of the Audit Board to other tasks such as oversight of internal control functions, financial reporting and audit. The BdP implemented all safeguards recommendations, including formally proposing amendments to the BdP law; however, these have not been enacted.

STATISTICAL ISSUES

As of May 31, 2019

I. Assessment of Data Adequacy for Surveillance
General. Data provision to the Fund is adequate for surveillance purposes.
Real sector. Since September 2014, the National Institute of Statistics (INE) publishes a full set of national accounts based on the *ESA 2010* methodology, including quarterly GDP estimates. The data are available beginning in the first quarter of 1995; the quarterly and annual data are consistent. INE publishes the Consumer Price Index, and the Harmonized Index of Consumer Prices (HICP) according to the methodology of EU Member States. Control and quality assessment are ensured through the supervision of Eurostat.
Fiscal sector. Government finance statistics (GFS) are compiled on an accrual basis according to the *ESA 2010* methodology and reported to Eurostat on a quarterly and annual basis. Data have undergone a number of revisions during the transition to the *ESA 2010*, sizably altering revenue and expenditure and hampering comparisons across years. Fiscal data in the *GFSM 2014* framework are reported through the Eurostat convergence project with the IMF. The IMF GFS datasets cover data on the general government operations and financial balance sheet.
External sector. The Bank of Portugal (BP) compiles and disseminates balance of payments and international investment position (IIP) statistics on quarterly basis following the IMF's sixth edition of the *Balance of Payments and International Investment Position Manual*. The BP participates in the IMF's surveys on direct and portfolio investments, and reports data template on international reserves and foreign currency liquidity regularly. The portfolio investment data collection system encompasses transactions of resident banks, domestic securities transactions undertaken by nonresidents (through the resident custodians), external securities transactions undertaken by residents (through the resident investor or custodian), as well as residents' issuance of securities in foreign markets.
Monetary and financial 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. Portugal also provides monthly monetary statistics to the IMF for the central bank and other depository corporations through the ECB. Data for other financial corporations is not reported. Portugal reports data on some key series and indicators of the Financial Access Survey (FAS) including the two indicators adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs).

Financial sector surveillance: Portugal reports eleven core FSIs (excluding the net open position in foreign exchange capital), twelve encouraged FSIs for the deposit takers as well as ten encouraged FSIs for the other sectors on a quarterly basis.	
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 adheres 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 May 31, 2019)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	06/30/18	06/30/18	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1/]	5/18	6/18	M	M	M
Reserve/Base Money	4/19	5/19	M	M	M
Broad Money	4/19	5/19	M	M	M
Central Bank Balance Sheet	4/19	5/19	M	M	M
Consolidated Balance Sheet of the Banking System	4/19	5/19	M	M	M
Interest Rates[2/]	3/19	5/19	M	M	M
Consumer Price Index	4/19	5/19	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3/] – General Government[4/]	4/18	6/18	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3/]– Central Government	2018:Q4	4/19	Q	Q	Q
Stocks of Central Government and Central Government-Guaranteed Debt[5/]	4/18	6/18	M	M	M
External Current Account Balance	2018:Q4	3/19	Q	Q	Q
Exports and Imports of Goods and Services	2018:Q4	3/19	Q	Q	Q
GDP/GNP	2018:Q4	6/19	Q	Q	Q
Gross External Debt	2018:Q1	5/18	Q	Q	Q
International Investment Position	2018:Q4	3/19	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 and domestic banks 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).

July 1, 2019

Statement by Mr. Fanizza and Ms. Lopes on Portugal
Executive Board Meeting
July 8, 2019

Overview

The Portuguese authorities would like to thank the IMF staff for the fruitful Article IV Consultation discussions. They take good note of the staff's policy advice and reiterate their commitment to economic, fiscal and financial policies that promote competitiveness, economic growth, social cohesion, and sound public finances.

We welcome the acknowledgement of improvements in the Portuguese economy fundamentals, and its fiscal position. These improvements stem from substantial progress in (a) fiscal consolidation; (b) deleveraging of both households and non-financial corporates; and (c) strengthening the banking system.

Economic Activity

After decelerating in the second half of 2018 GDP grew at 0.5 percent q-o-q, and 1.8 percent y-o-y in the first quarter of this year – broadly in line with the annual growth forecasts. Domestic demand played an important role in driving growth in the quarter, with a significant increase in gross fixed capital formation (GFCF, 11.6 percent in 2019Q1 y-o-y). Current leading indicators suggest that GDP growth has stabilized in second quarter of 2019.

With regards to trade, imports have been growing above exports mostly on the back of strong GFCF growth. Net exports are projected to slightly deteriorate because of weaker international demand; nevertheless, the weight of exports in GDP has now reached a historically high level of 48 percent, almost doubling its weight since 2000.

Consumer price inflation remained subdued and below the Euro Area average until May 2019. The Harmonized Index of Consumer Prices (HICP) annual average stood at 1.1 percent, compared to 1.2 percent in 2018 and 1.8 percent in the Euro Area.

The labor market has continued to improve. In the first quarter of 2019, employment grew at 1.5 percent y-o-y as a result of higher permanent job creation, while temporary employment decreased for the first time in the post-crisis period. The unemployment rate decreased to 6.8 percent, down from 7.9 percent the year before. Both youth and long-term unemployment contributed to this reduction.

Fiscal Policy

The general government headline deficit decreased to 0.5 percent of GDP in 2018, a new record-low in Portugal's modern democratic history! The Portuguese Government expects this deficit to shrink to 0.2 percent of GDP in 2019 – in line with the staff's projections – and to become a surplus 0.3 percent of GDP in 2020.

In the first quarter of 2019, Portugal achieved a general government headline surplus of 0.4 percent of GDP. This reflects, in part, strong labor market and economic activity. Tax revenue grew 5.1 percent, despite reductions in a wide range of tax rates. Social Security contributions increased 6.5 percent, which reflects the growth in employment and wages. Strict control of budgetary execution kept expenditure growth moderate (2.6 percent y-o-y), despite an increase in public investment of 12 percent y-o-y.

The public debt-to-GDP ratio remained on a downward trend in 2018, supported by a strong primary surplus and decreasing interest costs. The Portuguese authorities expect this ratio to reach 118.6 percent of GDP in 2019, down from 121.5 percent in 2018. The Portuguese Government is strongly committed to using any revenue windfalls to reduce its public debt.

Active and dynamic debt management strategies have been adopted to smooth the amortization profile and optimize financing costs. This has contributed to improve investors' perception of Portugal's credit risk. In the context of this strategy, the Portuguese authorities decided to repay the remaining € 5.51bn of the total € 26bn of the IMF loan in December 2018. Indeed, the IMF loan was the instrument that could generate greatest interest savings.

Structural Reforms

The Portuguese Government's structural reform agenda continues to be framed by the National Reform Programme with the objective to increase productivity, improve domestic savings, and enhance the business climate. Within this framework, strides have been made in several areas, and it is worth highlighting some of the most important recent developments.

On the **labor market**, a comprehensive set of policy measures have been taken aimed at (i) tackling the demographic challenge by fostering longer working lives, increased fertility rates, and positive net migration flows, (ii) reducing segmentation, and (iii) promoting Active Labor Market Policies.

With regards to **education and skills**, policy efforts are concentrated in reducing school failure and dropout rates as well as to reduce skills mismatches. There are ongoing efforts to make the vocational education and training system more aligned with labor market needs. Furthermore, the Portuguese authorities are, of course, aware that digital skills are highly demanded by the market, therefore, a strategy has been designed to improve population's average digital skills. Its main goal is to equip not only students, but also adults and workers, with digital skills.

Moving on to the **judicial system**, there have been important recent developments around insolvency proceedings. The Insolvency and Companies' Recovery Code was revised, which included changes to special revitalization proceedings, with the aim of making them more agile and efficient. Moreover, a new regime for out-of-court restructuring of companies has been created, which aims to facilitate agreement between debtors and creditors, with support from experts on company recoveries. In parallel, an Early Warning Mechanism was developed to inform companies on their global financial situation, and to provide relevant recommendations on their sustainability. The authorities expect these initiatives to contribute to reducing court workload and to improving the chances of viable companies to keep their activity going. New credit lines were also set up to stimulate SMEs and start-ups.

Finally, concerning the **energy** sector, the tariff debt continues in a downward trend and is expected to decline by further 12 percent in 2019 (or cumulatively by 37 percent from a € 5.1bn peak in 2015). Under the current baseline scenario, the energy debt is expected to be fully repaid by the end of 2022, which would reduce the overall burden on the energy price for consumers. Additionally, policy efforts focus on the promotion of investment in renewable capacity and the development of the electricity transport network.

Financial Sector Policies

The Portuguese economy proceeded with the long-lasting adjustment process which has contributed to strengthen its financial system. The debt ratios continued to decline for both non-financial corporations (NFC) and households. Non-financial corporations also increased capitalization and liquidity, fostering an overall reduction in the credit risk of the sector. However, for both NFC and households, the reduction in indebtedness levels in 2018 was mainly driven by the denominator effect. The adjustment of the non-financial private sector has occurred in a context of particularly favorable economic and financial conditions. It is of paramount importance that the adjustment continues even in the event of an economic slowdown.

Despite some recent signs of cooling off, prices in residential real estate markets have been growing steadily in recent years, supported by robust demand from non-residents and tourism; house supply factors might have also played a role. Signs of mild overvaluation surfaced from mid-2017. The Macroprudential Recommendation issued by Banco de

Portugal on new consumer and housing loans[1], should contribute to mitigate the risk of interaction between the domestic credit and prices in the real estate market. Banco de Portugal's progress report on the implementation of this measure shows that institutions are converging towards the limits set in the Recommendation, with the exceptions scrutinized by Banco de Portugal. Additionally, developments in new housing loans seem to show that the Recommendation helped reduce the share of credit granted to borrowers with a higher risk profile. In regards NFC, the annual rate of change of credit granted by resident banks to NFC turned positive in 2018 and evidence shows that banks continued to differentiate NFC, both in terms of spreads and in terms of volumes, according to their risk profile.

Favorable developments in several domains were also observed in the Portuguese banking system in 2018, most notably the significant recovery of profitability and the continuing significant reduction of non-performing loans. Profitability improved because of both lower flows of impairments and operating costs. Banks continued to manage their NPL stock actively, which as result fell both in gross and in net terms: by the end 2018, NPL ratio was already below 10 percent and the net NPL ratio below 5 percent. This constitutes a decrease of NPL of around 50 percent since the July 2016 peak, mainly driven by NPL reduction associated to NFC. Banks' liquidity position stood at comfortable levels, while the own funds ratio stabilized. Recently, Portuguese banks made some issuances of debt eligible as own funds.

Portuguese banks will continue to face challenges related to the low interest rate environment, which compresses interest-related net revenues. Together with continuing the implementation of the NPL reduction plans, banks will need to build on their achievements and progress with the increase of operational efficiency. This is especially relevant in the context of competition coming from new players equipped with innovative technologies that provide financial services digitally, such as Bigtech companies. Additional adjustment of the banking sector has a bearing to safeguarding access to international financial markets under favorable conditions; this is particularly important given the increasing regulatory demands, most notably those associated to the Minimum Requirement for own funds and Eligible Liabilities (MREL).

The New Financial Supervision Framework Bill

The bill proposes the creation of the National System of Financial Supervision (NSFS) with the purpose of improving the functioning of the financial supervision system, promoting the cooperation between the Portuguese authorities and fostering the financial stability. The NSFS comprises Banco de Portugal, the Portuguese Securities Market Commission, the Insurance and Pension Funds Supervisory Authority and also two new legal entities, the

[1] With limits to Loan-to-Value ratios on mortgage loans, to Debt-Service-to-Income ratios and to maturity of loans, while setting amortization requirements.

National Council of Financial Supervisors (NCFS) and the Resolution and Guarantees Authority (RGA). Furthermore, with the creation of a resolution authority separated from the banking supervisor, the Portuguese Government also aimed with the bill to limit the risk of conflicts of interest among supervision and resolution functions.

The Government believes that the proposal respects and strengthens the independence of the supervisors, is consistent with the European framework, is cost-efficient and fosters timely and well-informed supervisory decisions, with the relevant participation and contribution of all supervisors.

In the opinion of the Portuguese financial supervisory authorities, the bill may introduce complexity, uncertainty and generate costs for the supervisors and for the Portuguese financial market. Additionally, Banco de Portugal conveyed specific concerns regarding its central bank and SSM member's independence and autonomy. More recently, on 21 May 2019, the ECB issued an opinion (CON/2019/19) also raising several concerns regarding central bank independence, the macroprudential mandate and the resolution function.

The proposal is under discussion in the Parliament.

Conclusion

In line with its Stability Programme 2019-2023, the Portuguese Government is committed to sound public finances and to continue the ongoing positive trajectory of fiscal consolidation, in parallel with the implementation of the structural reform agenda to foster social cohesion and sustainable economic growth, as foreseen in the National Reform Programme.

The Portuguese authorities look forward to the next Article IV Consultation in 2020, which will constitute a good opportunity to continue closely working with the IMF, deepening the dialogue and promoting an even closer mutual understanding.