INTERNATIONAL MONETARY FUND

IMF Country Report No. 18/52

PORTUGAL

February 2018

SIXTH POST-PROGRAM MONITORING DISCUSSIONS—PRESS RELEASE; STAFF REPORT

In the context of the Sixth Post-Program Monitoring Discussions, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse of time basis, following discussions that ended on December 6, 2017, 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 February 5, 2018.

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND
COMMUNICATIONS DEPARTMENT

Press Release No. 18/65
FOR IMMEDIATE RELEASE
February 23, 2018

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

IMF Executive Board Concludes 2018 Article IV Consultation with Portugal

On February 21, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Sixth Post-Program Monitoring[1] of Portugal and considered and endorsed the staff appraisal on a lapse-of-time basis.[2]

Portugal's repayment capacity is expected to be adequate under the baseline. With improved market access and sovereign outlook and ratings, as well as additional early repayments to the Fund in 2017, risks to repayment capacity have moderated significantly since the last PPM.

The Portuguese economy has strengthened. Supported by a benign external environment, job-rich growth has gathered momentum since late 2016. The headline fiscal balance continued to benefit from stronger growth, controlled budget execution, and falling interest costs, with the 2017 deficit target of 1.4 percent of GDP likely to have been met with some margin. Financial stability has also improved with various bank capital augmentations and the sale of Novo Banco in 2017 while banks have also reduced their NPLs and returned to modest profitability. Growth is projected at 2.2 percent in 2018. Downside risks in the near term are mostly external in nature and appear moderate.

Executive Board Assessment[3]

The Portuguese economy has continued to strengthen. Supported by a benign external environment, job-rich and broad-based growth has gathered momentum since late 2016, contributing to better than anticipated fiscal outcomes in 2017, including the exiting from the European Commission's excessive deficit procedure. Financial stability also improved in the last

[1] Member countries with IMF credit outstanding exceeding the smaller of SDR1.5 billion or 200 percent of quota are subject to post-program monitoring. Post program monitoring takes place between successive Article IV consultations. Post-program monitoring gives especial attention to matters related to capacity to repay the Fund, vulnerabilities, and risks.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening a formal meeting.

year. Downside risks in the near term are mostly external in nature and appear moderate.

Portugal has further improved its access to financial markets. Portugal maintains prudent liquidity buffers, and its sovereign debt has become eligible for inclusion in several international bond indexes, which should help support it even as the ECB's asset purchase program is eventually wound down. Portugal's capacity to repay the Fund is adequate in the baseline and robust to the risk scenarios in the DSA. In fact, owing to substantial early repurchases to date, no repurchases are due until 2021.

Despite the recent positive economic developments, important crisis legacies remain. The nonfinancial private sector's debt is large (including by European standards) and remains a source of vulnerability. The still large stock of bad loans on banks' books constrains their ability to provide new credit for investment. Public debt, at 126 percent of GDP, is the euro area's third largest. While the public debt ratio is expected to decline to 108 percent of GDP by 2023, this ratio would still leave Portugal vulnerable to unexpected rises in interest rates, the wind-down in the monetary stimulus of the last few years, and cyclical downturns in Portugal and its trading partners.

Favorable borrowing conditions and the economic upswing provide an auspicious opportunity for an even faster reduction of public debt. Structural consolidation in the primary fiscal balance remains essential to keep public debt on a firmly downward trajectory over the medium-term. An adjustment focused on durable expenditure reform is likely to prove more sustainable and supportive of growth. The authorities should be cautious about permanent increases in spending that might reduce the flexibility of public expenditure when cyclical conditions change. Such caution is especially important in relation to decisions that may affect the trajectory of the government wage bill in coming years.

Banks will need to continue strengthening their business models and cleaning their NPLs. Although financial stability has improved over the past year, the high level of NPLs limits banks' internal capacity to generate stronger returns and increase their capital. Also, some upcoming regulatory changes in the euro area, although aiming to boost resilience, could affect some banks' funding structure and costs. Banks' improved financial results in 2017 are encouraging, as is the ongoing implementation of ECB guidance to banks on NPLs. Continued efforts in these areas, including by improving business models and cost efficiency, so banks can generate new capital from their own profits, are necessary to ensure that they remain resilient and better support the economy. New initiatives to further improve the legal framework to support the debt restructuring of viable but distressed debtors and the recovery of collateral, including through out-of-court mechanisms, need to be implemented and closely monitored. In addition, there is a need to monitor carefully developments in the housing markets. Macroprudential authorities should also stand ready to take additional macroprudential measures if needed to prevent the build-up of imbalances and to strengthen the resilience of banks and borrowers.

Raising the economy's growth potential and resilience to shocks will also require further structural reforms and higher investment and productivity. For the economy to absorb negative shocks and adapt to new opportunities, a flexible labor market is key. Flexibility needs to be preserved even as an environment with more stable jobs is sought. Investment needs to increase substantially to raise the economy's medium-term growth potential. Preserving external balance while raising investment requires strengthening national saving rates as well. Along with ongoing initiatives to develop human capital, structural reforms should include efforts to continue improving the business environment.

Portugal: Selected Economic Indicators

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

		Projections		
	2016	2017	2018	2019
Real GDP	1.5	2.6	2.2	1.8
Private consumption	2.1	2.2	2.0	1.6
Public consumption	0.6	1.1	0.2	-0.1
Gross fixed capital formation	1.6	8.7	8.1	5.1
Exports	4.1	7.0	6.6	4.5
Imports	4.1	7.5	7.0	4.5
Contribution to growth (Percentage points)				
Total domestic demand	1.6	3.0	2.7	1.9
Foreign balance	-0.1	-0.4	-0.4	-0.1
Resource utilization				
Employment	1.5	3.1	1.3	1.1
Unemployment rate (Percent)	11.1	9.0	7.8	7.2
Prices				
GDP deflator	1.4	1.6	1.5	1.5
Consumer prices (Harmonized index)	0.6	1.5	1.5	1.6
Money and credit (End of period, percent change)				
Private sector credit	-3.7	-1.5	0.1	0.8
Broad money	-0.4	3.7	3.2	2.8
Fiscal indicators (Percent of GDP)				
General government balance	-2.0	-1.2	-1.1	-0.9
Primary government balance	2.2	2.7	2.6	2.6
Structural primary balance (Percent of potential GDP)	2.9	2.7	2.4	2.0
General government debt	130.1	125.7	121.7	118.4
Current account balance (Percent of GDP)	0.7	0.4	0.2	-0.1
Nominal GDP (Billions of euros)	185.2	193.0	200.2	206.8

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

INTERNATIONAL MONETARY FUND

PORTUGAL

SIXTH POST-PROGRAM MONITORING DISCUSSIONS

February 5, 2018

EXECUTIVE SUMMARY

The Portuguese economy has strengthened. Supported by a benign external environment, job-rich growth has gathered momentum since late 2016. The headline fiscal balance continued to benefit from stronger growth and falling interest costs, with the 2017 deficit target of 1.4 percent of GDP likely to have been met with some margin. Financial stability has also improved with various bank capital augmentations and the sale of Novo Banco in 2017, while banks have also reduced their NPLs and returned to modest profitability. Growth is projected at 2.2 percent in 2018. Downside risks in the near term are mostly external in nature and appear moderate.

Portugal has also continued to enjoy access to market financing on favorable terms. With the recovery in market confidence, the authorities have diversified their investor base, including by increasing their bond issuance to retail investors. Consequently, the importance of net asset purchases under the ECB's Asset Purchase Program in supporting financing conditions for Portugal declined in 2017. Portugal has made a total of SDR 19.1 billion in advanced repurchases to the Fund since the end of the program, leaving Portugal's debt outstanding to the Fund at SDR 3.9 billion (187.5 percent of quota). Portugal's capacity to repay the Fund is adequate in the baseline and robust to the risk scenarios in the DSA.

Despite the recent positive economic developments, important crisis legacies remain. Flow variables such as GDP and the fiscal balance have improved significantly. However, the still large stocks of public and private debt remain sources of vulnerability, including to changes in sentiment or in financial conditions globally, while the large stock of bad loans on banks' books constrains their ability to provide new credit for investment. Structural fiscal consolidation based on durable expenditure reform remains essential to keep public debt on a firmly downward trajectory over the medium-term. Continued efforts to improve banks' profitability and reduce their NPLs, so they can generate new capital from their own profits, are necessary to ensure that banks remain resilient and better support the economy. Finally, raising the economy's growth potential and resilience to shocks while maintaining competitiveness will also require further structural reforms, higher investment and productivity.

Approved By
Mahmood Pradhan and Seán Nolan

Discussions took place in Lisbon during November 28 - December 6, 2017. The staff team comprised A. Cuevas (head), M. Gaertner, K. Kirabaeva, A. Santos (all EUR); E. Lundback (SPR); V. Crispolti (FAD); and M. Koulet-Vickot (MCM). Y. Cai and V. Bezerra de Menezes (both EUR) supported the mission from headquarters.

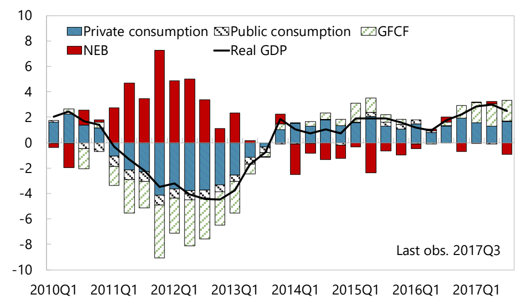
CONTENTS

RECENT DEVELOPMENTS AND OUTLOOK

The near-term outlook has strengthened. The cyclical upturn continued during 2017, with a pick-up in exports and investment. The 2017 headline fiscal deficit target is expected to have been met with a margin, and debt dynamics have improved. Stability and confidence in the banking system have also improved following successful efforts to raise capital.

1. **Real growth gained strength and breadth in 2017.** Real GDP growth was 2.5 percent year-on-year (0.5 percent q/q) in 2017Q3, up from 1.5 percent in 2016, and is expected to have reached 2.6 percent in 2017. Output growth has been supported by a pickup in private investment, which bounced back to above 9 percent year-on-year in 2017Q3 from 1.6 percent in 2016. Construction, driven by tourism-related projects and rising house prices, contributed to the pickup in private investment. Household consumption has remained a key driver of growth supported by strong job creation, which has brought the unemployment rate down to 8.1 percent in 2017 Q4. Employment growth has been broad-based, including both permanent and temporary jobs.

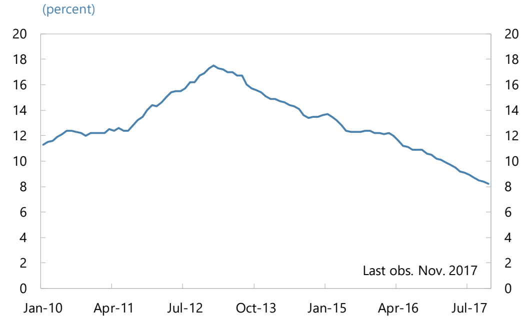
Contribution to Real GDP Growth
(percentage points, year-on-year)



Sources: Haver Analytics.

2. **Consumer price increases have moderated since their peak in April 2017, but price competitiveness has declined further.** Headline inflation fell to 1.6 percent in December 2017 (core inflation also moderated to 1.2 percent) after its peak of 2.4 percent year-on-year in April 2017. Unit labor costs (ULCs) have also risen at a slower pace in the last several quarters than they did during the first half of 2016, with the 2017 ULC increase arising from jobs growing faster than GDP. Nevertheless, price competitiveness has continued to decline as the ULC-based REER appreciated by 1.9 percent from end-2016 through November 2017. Compared to last year, the goods and services trade balance deteriorated by about ½ percent of GDP.

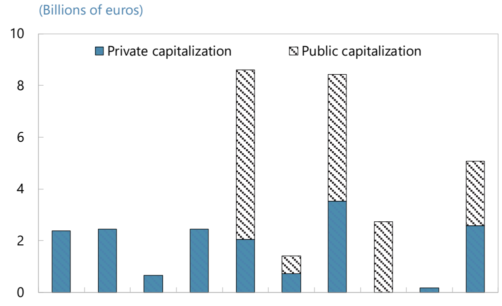
Portugal: Unemployment Rate
(percent)



Sources: Haver Analytics.

3. **Banks have made additional progress in repairing their balance sheets**. In 2017, the main Portuguese banks finalized their capital augmentations. These, together with a reduction in risk-weighted assets, resulted in higher capital adequacy ratios, with the CET1 ratio increasing by 2.1 percentage points since end-2016 to 13.5 percent in September 2017. Although still high, nonperforming loans (NPLs) fell 2.6 percentage points to 14.6 percent of total loans through September 2017, driven by write-offs and sales, while the provision coverage ratio improved marginally to 47 percent. Banks reduced their reliance on wholesale and ECB funding as liquidity improved, and returned to modest profitability after posting losses in 2016.

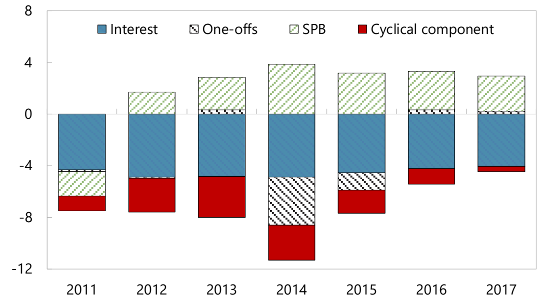
Private and Public Capitalizations
(Billions of euros)



Sources: Banco de Portugal and Staff calculations.

4. The headline fiscal balance continues to benefit from stronger growth, controlled budget execution, and falling interest costs, with the 2017 deficit target of 1.4 percent of GDP likely to have been met with a margin.[1] This follows Portugal's exit from the EU's Excessive Deficit Procedure in June 2017, after closing 2016 with an overall deficit of 2 percent of GDP. In primary structural terms, however, a modest loosening of the fiscal stance is estimated in 2017, as in the previous two years.

Fiscal Balance
(percent GDP)



Sources: IMF staff calculations.

5. The 2018 budget targets a further reduction in the headline fiscal deficit to 1.1 percent of GDP, largely reflecting savings on interest payments. Interest costs are projected to fall to 3.7 percent of GDP in 2018, a decline of 1 percentage point since 2015, as treasury bill yields remain negative and yields on new bonds are well below those on maturing debt (including advanced repurchases to the Fund).

6. Prospects for growth in the baseline scenario are positive, and risks appear broadly balanced in the near term. Real GDP growth is projected to slightly decelerate to 2.2 percent in 2018, and then to moderate over the medium term. Employment growth is expected to remain strong, with unemployment declining further in 2018. For 2018 staff projects consumer inflation of 1.5 percent and of about 2 percent over the medium term. The potential downside risks to the baseline include a repricing of risks in global markets, weaker than expected growth in the Eurozone, and prolonged uncertainty in Spain. Upside risks include stronger cyclical momentum in the Euro area. Medium term risks include a rise in volatility in European bond markets as monetary accommodation is gradually reduced in the Eurozone and insufficient progress on (or yield from) reforms.

Authorities' Views

7. The authorities see growth likely to be more robust than in staff's baseline scenario over the medium term. The authorities emphasized that supply-side structural reforms in recent years have laid the foundation for stronger export-oriented growth. They further stressed that potential output estimates should try to capture the structural change in the Portuguese economy stemming from ongoing and past structural reforms.

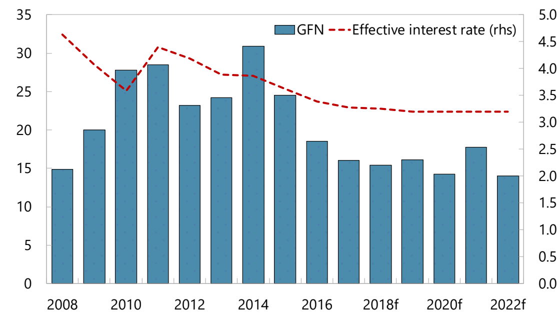
[1] Eurostat is still to determine whether the recapitalization of the *Caixa Geral de Depositos* should be booked "above the line." In that event, the 2017 deficit could be as high as 3.5 percent of GDP.

CAPACITY TO REPAY THE FUND

Portugal's repayment capacity is expected to be adequate under the baseline. With improved market access and sovereign outlook and ratings, as well as additional early repayments to the Fund in 2017, risks to repayment capacity have moderated significantly since the last PPM.

8. **Portugal has continued to enjoy access to market financing on relatively favorable terms, allowing further improvement in its debt profile.** Annual public gross financing needs have declined significantly in recent years, and are projected now at around 15 percent of GDP, as a combination of longer-term issuance, debt buybacks and exchanges have helped to smooth the redemption profile of public debt. The authorities have increased their issuance in the domestic retail market to further diversify their investor base. The ratings upgrades to investment grade by S&P (September 2017) and Fitch (December 2017) will allow Portuguese bonds to reach a new set of institutional investors, including because of their eligibility for inclusion in several international bond indexes. The average maturity of non-IMF/EU debt was 6.4 years at end-December 2017, while the implicit interest rate on the new debt has declined to 2.6 percent (10-year yields fell to about 2 percent by early 2018, down from the most recent peak of almost 4.3 percent). The authorities are prudently targeting a cash buffer of at least 40 percent of 2018 financing needs (excluding short-term debt rollover requirements).

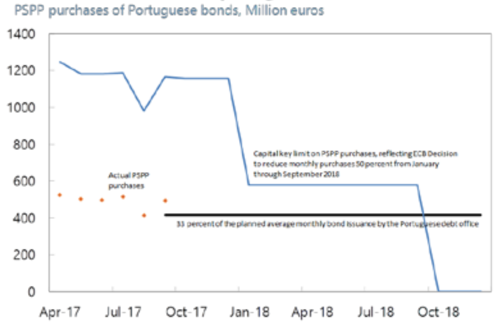
Gross Financing Needs and Effective Interest Rate
(percent GDP and percent)



Sources: IMF staff calculations.

9. **The importance of the ECB's Asset Purchase Program (APP) in supporting financing conditions for Portugal has declined since last year as market confidence has recovered.** The ECB's October 2017 decision to lower by half the net asset purchases from January 2018 to September 2018 will not automatically affect its monthly purchase of Portuguese sovereign bonds. Even with the reduced APP, the ECB will be able to maintain its purchases of Portuguese bonds close to the level of recent months, as the 33 percent limit has become nearly binding. Despite a reduction of roughly one-half in average monthly purchases under the Public Sector Purchase Program (PSPP, the main component of APP) in 2017, Portuguese spreads vis-à-vis Germany narrowed by about 200 basis points throughout the year to around 150 basis points at end-2017. Still, Portuguese yields could be sensitive to changes in market sentiment owing to generally tighter financial conditions, including as APP is phased out or risk is repriced in global markets, or to renewed domestic policy uncertainty. Increased access to foreign investors, a positive development in itself, may nevertheless increase the sensitivity of Portuguese debt to these potential shocks.

Staff Scenario of ECB Tapering
PSPP purchases of Portuguese bonds, Million euros



Sources: ECB, IGCP, Staff calculations

10. Fund credit to Portugal has continued to fall and maturities have been pushed back further owing to early repurchases. Portugal made SDR 8.2 billion and SDR 0.7 billion in advanced repurchases to the Fund in 2017 and January 2018, respectively, for a total of SDR 19.1 billion since the end of the program. This leaves debt outstanding to the Fund as of January 2018 at SDR 3.9 billion, corresponding to 187.5 percent of quota (the threshold for surcharges on the use of Fund resources), still above the SDR 1.5 billion threshold for the IMF's Post-Program Monitoring (PPM) framework. The next scheduled repurchase will not be due until 2021. In consequence, repayment risks are pushed to the medium term. As the macro-fiscal stress tests in the DSA show (Annex 1), Portugal's capacity to repay the Fund appears resilient also outside the baseline scenario.

Authorities' Views

11. The authorities noted that the Portuguese economy has enjoyed improving financing conditions. The authorities expected that global monetary conditions would remain broadly accommodative and that any turbulence due to tightening would be manageable. They stressed that Portugal's record of fiscal adjustment and reform implementation had strengthened its credibility with investors, and that Portugal's investment grade rating would help expand the investor base for Portuguese sovereign debt. While agreeing that some vulnerabilities remain in Portugal, they indicated that the Portuguese economy is now more resilient to global or regional financial shocks and will not be singled out by markets as in the past. In this context, they underscored that the maturity structure of public debt and the large cash buffer would help the government withstand fluctuations in market conditions. Finally, they noted that the advanced Fund repurchases had reduced the average debt cost while maintaining the average maturity profile.

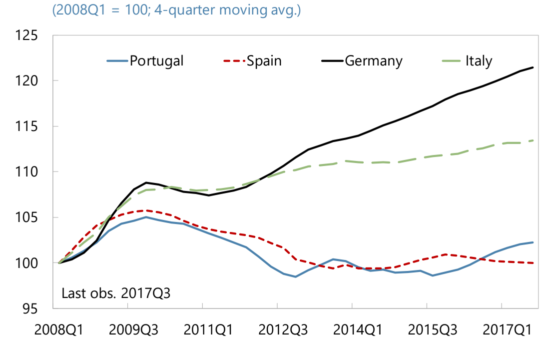
RISKS AND POLICY DISCUSSIONS

While the near-term outlook has improved, corporate, household, and government debt remain high. Economic growth is expected to moderate over the medium term without a significant reduction in stock imbalances, improvements in financial sector intermediation, and amelioration of structural rigidities. Moreover, high debt stocks keep the economy vulnerable to domestic and external shocks.

A. Risks to the Growth Outlook

12. The evolution of labor costs could influence the outlook for both investment and exports. Their decline in past years helped firms generate surpluses to start deleveraging, and/or to finance new investment from internal resources. If these costs were to rise faster going forward, dampening corporate savings without an offsetting rise in savings elsewhere in the economy, investment could not keep increasing without giving rise to an external imbalance. Moreover, even if enough savings were generated elsewhere in the economy (e.g., in the public sector), a still-recovering

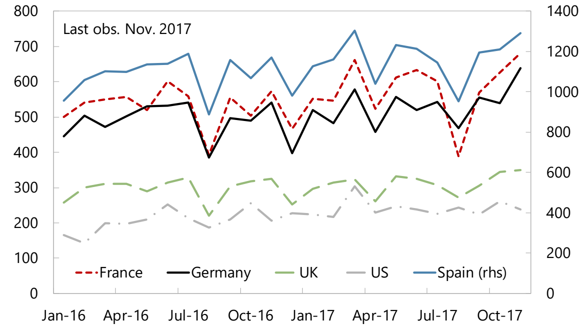
Unit Labor Costs
(2008Q1 = 100; 4-quarter moving avg.)



Sources: Haver Analytics; and IMF staff calculations.

banking system may not be able to intermediate them effectively. From a different perspective, in the last several quarters ULCs have risen faster than in key partners, particularly Spain whose ULCs have recently fallen. Should this pattern continue, it could affect external competitiveness. The increase in the minimum wage in 2018 to EUR 580 (from EUR 557) may contribute to increasing labor costs in the coming year as the minimum wage covers about a fifth of full-time employees.

Portuguese Exports by Destination
(millions of euros)



Sources: Haver Analytics.

13. Changes in the external environment could also hamper growth prospects. The reliance on the tourism sector leaves Portugal vulnerable to external shocks. The tourism sector has benefited from geopolitical developments that have increased the attractiveness of Portugal relative to competing destinations. More generally, a slowdown in trading partner growth (especially in Spain) could affect Portugal. Tighter global financial conditions, including the scaling down of the ECB's APP and Fed normalization, could also affect growth through their effects on domestic and external demand. Domestic effects would be magnified by the significant degree of leverage throughout the economy.

14. In this context, structural reforms are critical to support growth and financial stability, and policy reversals would be costly. Structural policy priority areas include labor market flexibility, judicial efficiency, and corporate debt restructuring, as argued in the 2017 Article IV Staff Report and Selected Issues Paper.[2] Program-era reforms to make hiring and collective bargaining more flexible should be safeguarded, with the gap between temporary and permanent contracts addressed by making permanent contracts more flexible rather than simply restricting temporary contracts. Flexibility in labor markets is key for the economy's capacity to absorb negative shocks and adapt to new opportunities that arise with structural change. Moreover, wages that reflect productivity would help Portugal take fuller advantage of higher-skilled entrants to the labor force while safeguarding competitiveness.

Authorities' Views

15. The authorities acknowledged the potential downside risk from a weakening of the external environment, while stressing that Portugal was competing successfully in international markets. They pointed to the ongoing structural transformation in the Portuguese economy, in which diverse sectors and firms had been gaining market share supported by improvements in non-cost competitiveness, including higher quality products and services. Past and ongoing reforms in several areas, including education, should continue to boost growth in coming years. The authorities, however, expressed skepticism regarding potential risks from rising labor costs.

---

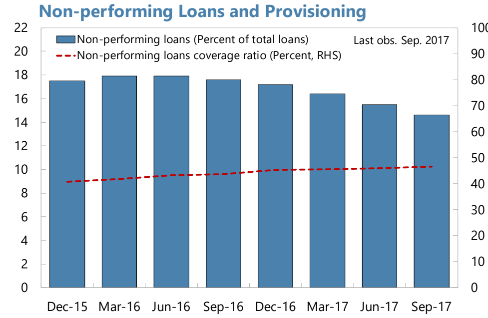
[2] See "Portugal – Staff Report for the 2017 Article IV Consultation", CR17/278, and "Portugal—Selected Issues," CR17/279.

16. The authorities stated that program-era reforms are not at stake, while indicating their intention to continue reducing labor market segmentation. Active labor market policies are focused on supporting permanent contracts for low-skilled workers and the long-term unemployed, while financial incentives seek to discourage temporary contracts. A broad range of training programs have been introduced to upgrade the skills of the labor force.

B. Risks to Balance Sheets

17. Portuguese banks continue to face significant challenges from the large stock of NPLs, and a comprehensive NPL reduction strategy is under execution. High NPLs continue to constrain banks' profits, capital generation, and lending capacity. However, in line with the ECB guidance to banks on NPLs, banks have developed time-bound NPL reduction plans. These include specific operational targets by asset class and time horizon, and are subject to monitoring by supervisors.[3] In addition, three banks with high NPLs and common exposures to non-financial corporates have launched a platform to expedite coordinated credit and corporate restructurings. Finally, the ongoing *Capitalizar* program seek to facilitate corporate restructuring and funding.

Non-performing Loans and Provisioning



Source: Banco de Portugal.

18. A forceful implementation of the NPL resolution strategy would have a beneficial effect on financial stability and economic growth. In this regard, supervisors should continue to ensure that banks' plans are credible, and stand ready to activate supervisory measures in case of deviations. Given the size of the legacy NPLs and the available capital buffers, additional capital augmentations might be needed for further write-offs. Finally, strengthening banks' corporate governance, including the role of the risk management and audit committees, would also reduce the uncertainty associated with the valuation and treatment of NPLs and the criteria for future lending.

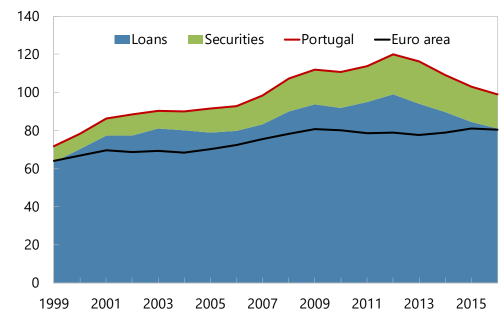
19. While banks returned to profitability in 2017, ensuring strong and sustained profitability will be challenging going forward. Already, net interest income, the main source of Portuguese banks' profits, is stabilizing as households are refinancing their mortgages as variable rates' spreads have been declining in the last two years, deposit rates are moving close to zero, and commercial margins on new loans are narrowing owing to heightened bank competition. The introduction of IFRS 9 accounting standards in 2018 and the issuance of MREL instruments will pose additional challenges to bank profitability, as will emerging competition from new firms specialized in digital financial services (Fintech) with the entry into force in 2018 of the EU Directive on payment systems.[4]

[3] For instance, Caixa Geral de Depositos, the largest Portuguese bank, targets a reduction of nonperforming exposures from 16 percent in 2016 to 8 percent by 2020 in its "Plano Estrategico 2020". This ratio already stood at 10.1 percent in September 2017, helped by the recapitalization concluded in March 2017.

[4] One of the purposes of this Directive is to increase competition from non-banks, which are not subject to the same prudential and regulatory requirements as banks.

20. Progress on reducing corporate sector debt has been significant, but far from sufficient. Although the non-financial corporate debt stock (including trade credits and advances) has fallen from its 2012 peak of 127.9 percent of GDP, it remains high at 102.4 percent of GDP as of September 2017. Moreover, the deleveraging process appears to be moderating, particularly in the construction and utility sectors and among non-financial holdings. This slowdown has, however, been accompanied by a shift at the margin in the debt composition by creditors, with a small decline in bank lending coinciding with an increase in loans granted by non-residents. It has also been associated with a gradual shift in non-financial corporate funding from debt towards equity, particularly for SMEs. Further corporate governance reforms are needed to encourage firm owners to retain more earnings and inject new equity into their companies (see 2017 Art. IV Staff Report).

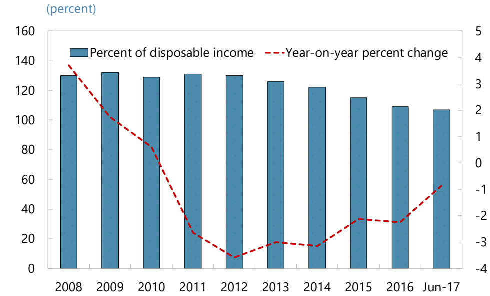
Non-financial Corporations Debt
(Percent of GDP)



Source: Eurostat.

21. Balance sheet repair in the household sector has continued, but it may be slowing. After falling by over 20 percentage points between 2011 and 2016, the household debt-to-disposable income ratio declined another 3 percentage points to 107 percent through September 2017, remaining above the EU average. The pace of decline has been moderating owing to an increase in new loans for consumption and house purchases.[5] Residential real estate prices have risen by about 20 percent in real terms since 2013 compared with 7 percent in the euro area, reaching the 2009 level.[6] While the increase can be partially linked to purchases of existing dwellings by non-residents, a growing share of housing transactions is financed by bank loans (45 percent in 2017Q2). In view of these developments and the broader macro-financial context, the Banco de Portugal recently announced the introduction of macroprudential measures on a recommendation basis.[7]

Household Debt
(percent)



Source: Banco de Portugal.

22. There are both cyclical and structural reasons (including the low interest rate environment and the upcoming regulatory changes) to deepen ongoing efforts to transform banks' business models to ensure sustainable profitability. Portuguese banks should take advantage of the recent capital increases and improved macroeconomic conditions to step up efforts to adapt their business models to the post-crisis environment. Specifically, they should

[5] Although the outstanding stock of mortgage loans declined 1.6 percent in 2017, the flow of new loans for house purchases has been growing, while the outstanding stock of loans to individuals for consumption and other purposes increased 6.4 percent.

[6] Data on price-to-income and price-to-rent ratios up to 2016 from OECD indicate that house price increases have not drifted away from fundamentals.

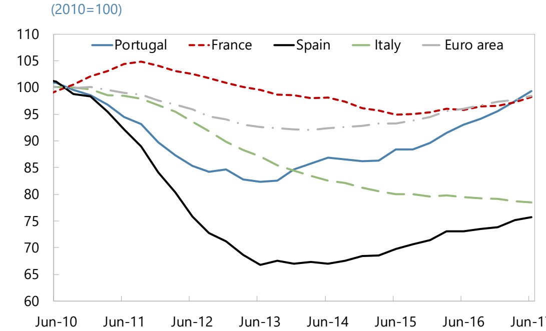
[7] On February 1, 2018, the Banco de Portugal announced new limits on maturities, loan-to-value ratios, and debt service-to-income ratios for new mortgage and consumer loans to households granted starting on July 1, 2018. These measures were adopted as a recommendation, that is, on a "comply or explain" basis.

continue to develop digital banking platforms that will help rationalize the extensive branch network and reduce costs, and redirect their lending activities towards the dynamic tradable sector.

23. Policy reform to facilitate restructurings is essential to accelerate deleveraging in the non-financial corporate sector. The measures to strengthen the debt enforcement and insolvency framework taken by the authorities under the *Capitalizar* initiative should further help distressed but viable businesses to seek a debt restructuring early. Data from the court system indicate that the pending cases and disposition times for civil, debt enforcement, and insolvency cases have continued to decline, and that the clearance rate for these cases has consistently exceeded 100 percent of new cases.[8] Moreover, several changes to the insolvency and debt enforcement framework are under consideration to further expedite processes, strengthen creditor rights, and support debt restructurings. These include enabling debt-equity swaps and the transfer of whole NPL portfolios, and establishing business recovery mediators to assist debtors and an additional legal framework in out-of-court debt restructurings. To better target the reform agenda, the government should commission an in-depth survey of stakeholders on the efficiency of the judicial system in the areas of insolvency and debt enforcement (see 2017 Art. IV Staff Report).

24. There is a need for closely monitoring rising housing market risks. While recent housing price growth has not been driven by the credit cycle, macroprudential authorities should remain vigilant and stand ready to take additional macroprudential measures if needed to prevent the build-up of imbalances and to strengthen the resilience of banks and borrowers. In this regard, efforts to broaden the coverage and enhance the quality of real estate data, and strengthen the analytical tools need to be stepped up. Continued attention also needs to be paid to credit standards.

Real House Prices
(2010=100)



Source: OECD.

Authorities' Views

25. While acknowledging current challenges in the financial system, the Portuguese authorities pointed to ongoing efforts by all stakeholders to address them. They highlighted that banks' NPL reduction plans were the result of an iterative process involving supervisors, and had shown a good performance through September 2017. They stressed that the implementation of the strategy to reduce NPLs was progressing, that asset disposal strategies needed to consider the EU regulatory framework (BRRD, State aid rules) and any potential impact on the public accounts, and that a rush to dispose of assets could result in an undue erosion of bank capital and other unwarranted impacts on the economy. They underscored that several factors would mitigate the impact on bank profitability of the introduction of IFRS 9 and the implementation of MREL, including the envisaged phasing-in periods for those regulations, the increase in impairment recognition in

[8] During 2012Q2-2017Q2, the number of pending civil enforcement actions declined by 39.7 percent while disposition time fell 31 percent to 1,072 days.

recent years following asset quality review exercises, the improvement in market perceptions of Portuguese banks, and the favorable macroeconomic outlook. While noting that there was no clear indication of overvaluation in the real estate market at this stage, they acknowledged that recent developments deserved enhanced monitoring. They indicated that they had stepped up efforts to close data gaps and improve assessment tools, and stood ready to deploy macroprudential tools, including those focused on strengthening credit-risk assessments by banks, in order to reinforce the resilience of the financial sector.

C. Risks to Public Debt Sustainability

26. The Public Sector DSA for Market-Access Countries (Annex I) suggests that the trajectory of Portugal's public debt remains subject to significant risks. Market conditions have improved in 2017, supported by the stronger near-term growth outlook and successful efforts to meet headline fiscal targets and raise bank capital, which were reflected in the upgrades to investment grade ratings by S&P and Fitch. Nevertheless, debt dynamics remain vulnerable to macro-fiscal and contingent liabilities shocks, including the possible need for further fiscal support for the financial sector (RAM, Appendix II). Staff's baseline projections reflect the authorities' current fiscal policies (¶1 in DSA); durable structural fiscal consolidation—based on the measures discussed in the 2017 Article IV—remains critical to anchor debt safely on a downward-sloping path, boosting policy credibility and strengthening the country's resilience to reversals in market sentiment.[9]

27. The high level of public debt remains a significant medium-term risk. Public debt is projected to remain high throughout the forecast period, despite declining from 130.1 percent of GDP at end-2016 to around 126 percent at end-2017, and further to around 108 percent of GDP by 2023. This leaves Portugal vulnerable to fluctuations in market conditions in a financing environment that is likely to be less benign over the medium-term. High debt and substantial financing needs, furthermore, limit the available fiscal space to address lingering vulnerabilities in the banking sector aggressively. While the headline fiscal deficit has diminished in recent years, there has been a modest loosening in the structural primary balance since 2015. In this context, the current cyclical conditions provide a favorable opportunity for more ambitious structural consolidation to ensure that the debt ratio is placed on a firmly declining path and falls even faster than currently projected in the baseline (see 2017 Article IV for a detailed discussion of fiscal policy options). This consolidation should, moreover, aim to generate net savings while ringfencing growth-enhancing expenditures.

28. Durable progress in improving the efficiency of public spending and strengthening tax collection is needed to support structural consolidation. The authorities should be cautious about permanent increases in spending that might reduce the flexibility of public expenditure when cyclical conditions change. Such caution is especially important in relation to decisions that may affect the trajectory of the government wage bill in coming years. Going forward, containing the public wage bill requires a comprehensive public-sector reform geared at adjusting the level and composition of public employment across sectors and at revisiting the compensation structure to

[9] See Annex I for more discussion of the impact of rising interest rates and the assumptions under the baseline.

streamline allowances and improve equity among civil servants. Also, advancing public financial management reforms—including by implementing the new budget framework law and enforcing full compliance with the commitment control legislation—will contribute to keeping non-wage expenditures contained, while preventing the accumulation of new payment arrears (especially in the health sector). In this connection, a design and implementation of the current spending review more in line with best practices would help identify a menu of high quality saving options.[10] Finally, tax collection could be further strengthened by simplifying procedures to comply with tax obligations and limiting the recourse to reduced VAT rates.[11]

Authorities' views

29. The authorities reiterated their commitment to medium-term fiscal consolidation to bring down public debt while preserving growth. They noted that the success in meeting headline fiscal deficit targets in 2016 and 2017 reflected both the pickup in growth and efforts to improve control over spending execution, and that fiscal management will be further supported by the ongoing expenditure review. The authorities considered that the recent ratings upgrades and the decline in borrowing costs were a recognition of their efforts and had reduced financing risks even in the event of more difficult market conditions. They indicated that they intend to continue reducing the public debt ratio, while noting that fiscal policy should be mindful of the need to preserve economic growth.

30. The authorities stressed the importance of their fiscal structural agenda. They indicated that the spending review should generate savings of about 0.1 percent of GDP in 2018, helping offset the budgetary cost associated with a gradual unfreezing of career progressions and an increase in retirement benefits. On the revenue front, the authorities indicated that reform efforts have focused on enhancing the progressivity of the personal and corporate income taxes by reducing the tax burden on low- and middle-income households and increasing taxes on companies with profits above €35 million. The government is also considering additional tax measures for 2018 to incentivize investment by SMEs with a view to supporting growth and employment creation.

STAFF APPRAISAL

31. The Portuguese economy has continued to strengthen. Supported by a benign external environment, job-rich and broad-based growth has gathered momentum since late 2016, contributing to better than anticipated fiscal outcomes in 2017, including the exiting from the European Commission's excessive deficit procedure. Financial stability also improved in the last year. Downside risks in the near term are mostly external in nature and appear moderate.

32. Portugal has further improved its access to financial markets. Portugal maintains prudent liquidity buffers, and its sovereign debt has become eligible for inclusion in several

[10] http://blog-pfm.imf.org/pfmblog/2016/12/spending-reviews-in-the-european-union.html.

[11] Recent progress in enhancing tax compliance and making the tax administration more efficient include the recruitment of new tax auditors, a gradual reorganization of the structure of local tax offices, the expansion of the taxpayer services department's coverage from large companies to wealthier households, and greater tax incentives for reporting.

international bond indexes, which should help support it even as the ECB's asset purchase program is eventually wound down. Portugal's capacity to repay the Fund is adequate in the baseline and robust to the risk scenarios in the DSA. In fact, owing to substantial early repurchases to date, no repurchases are due until 2021.

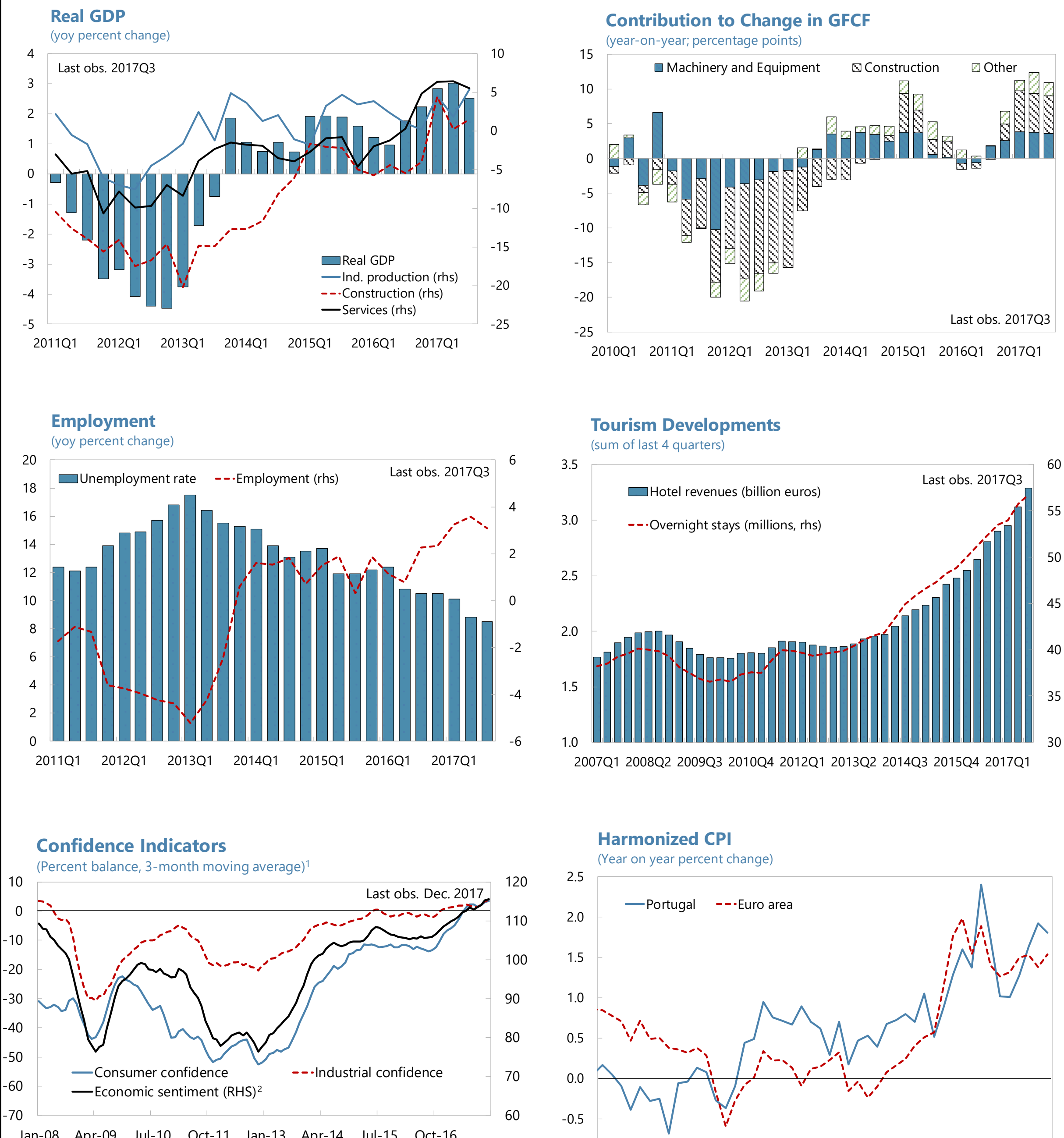
33. Despite the recent positive economic developments, important crisis legacies remain. The nonfinancial private sector's debt is large (including by European standards) and remains a source of vulnerability. The still large stock of bad loans on banks' books constrains their ability to provide new credit for investment. Public debt, at 126 percent of GDP, is the euro area's third largest. While the public debt ratio is expected to decline to 108 percent of GDP by 2023, this ratio would still leave Portugal vulnerable to unexpected rises in interest rates, the wind-down in the monetary stimulus of the last few years, and cyclical downturns in Portugal and its trading partners.

34. Favorable borrowing conditions and the economic upswing provide an auspicious opportunity for an even faster reduction of public debt. Structural consolidation in the primary fiscal balance remains essential to keep public debt on a firmly downward trajectory over the medium-term. An adjustment focused on durable expenditure reform is likely to prove more sustainable and supportive of growth. The authorities should be cautious about permanent increases in spending that might reduce the flexibility of public expenditure when cyclical conditions change. Such caution is especially important in relation to decisions that may affect the trajectory of the government wage bill in coming years.

35. Banks will need to continue strengthening their business models and cleaning their NPLs. Although financial stability has improved over the past year, the high level of NPLs limits banks' internal capacity to generate stronger returns and increase their capital. Also, some upcoming regulatory changes in the euro area, although aiming to boost resilience, could affect some banks' funding structure and costs. Banks' improved financial results in 2017 are encouraging, as is the ongoing implementation of ECB guidance to banks on NPLs. Continued efforts in these areas, including by improving business models and cost efficiency, so banks can generate new capital from their own profits, are necessary to ensure that they remain resilient and better support the economy. New initiatives to further improve the legal framework to support the debt restructuring of viable but distressed debtors and the recovery of collateral, including through out-of-court mechanisms, need to be implemented and closely monitored. In addition, there is a need to monitor carefully developments in the housing markets. Macroprudential authorities should also stand ready to take additional macroprudential measures if needed to prevent the build-up of imbalances and to strengthen the resilience of banks and borrowers.

36. Raising the economy's growth potential and resilience to shocks will also require further structural reforms and higher investment and productivity. For the economy to absorb negative shocks and adapt to new opportunities, a flexible labor market is key. Flexibility needs to be preserved even as an environment with more stable jobs is sought. Investment needs to increase substantially to raise the economy's medium-term growth potential. Preserving external balance while raising investment requires strengthening national saving rates as well. Along with ongoing initiatives to develop human capital, structural reforms should include efforts to continue improving the business environment.

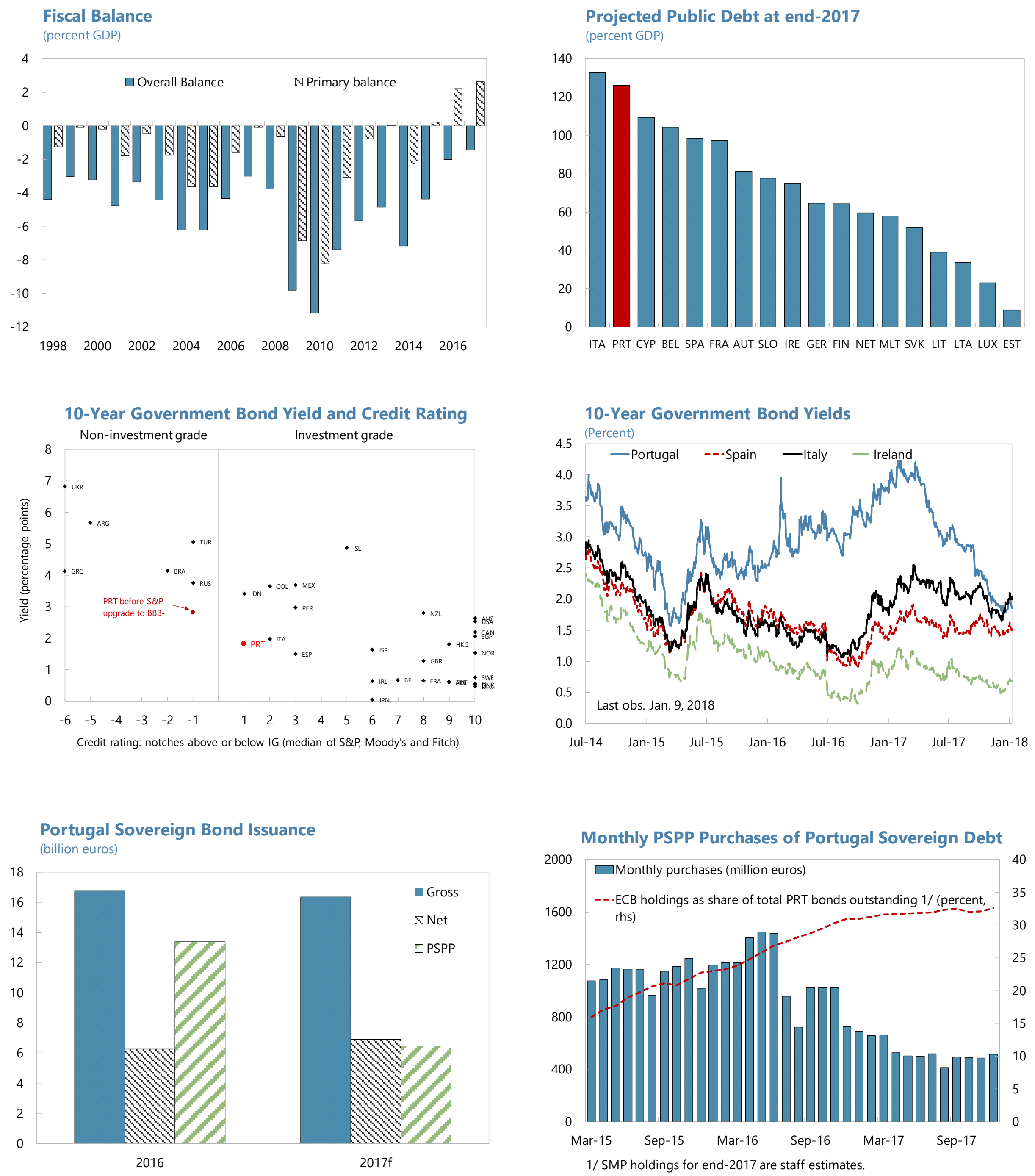
Figure 1. Portugal: Real Sector Indicators



[1] Percent balance equals percent of respondents reporting an increase minus the percent of respondents reporting a decrease.
[2] Long-term average = 100.

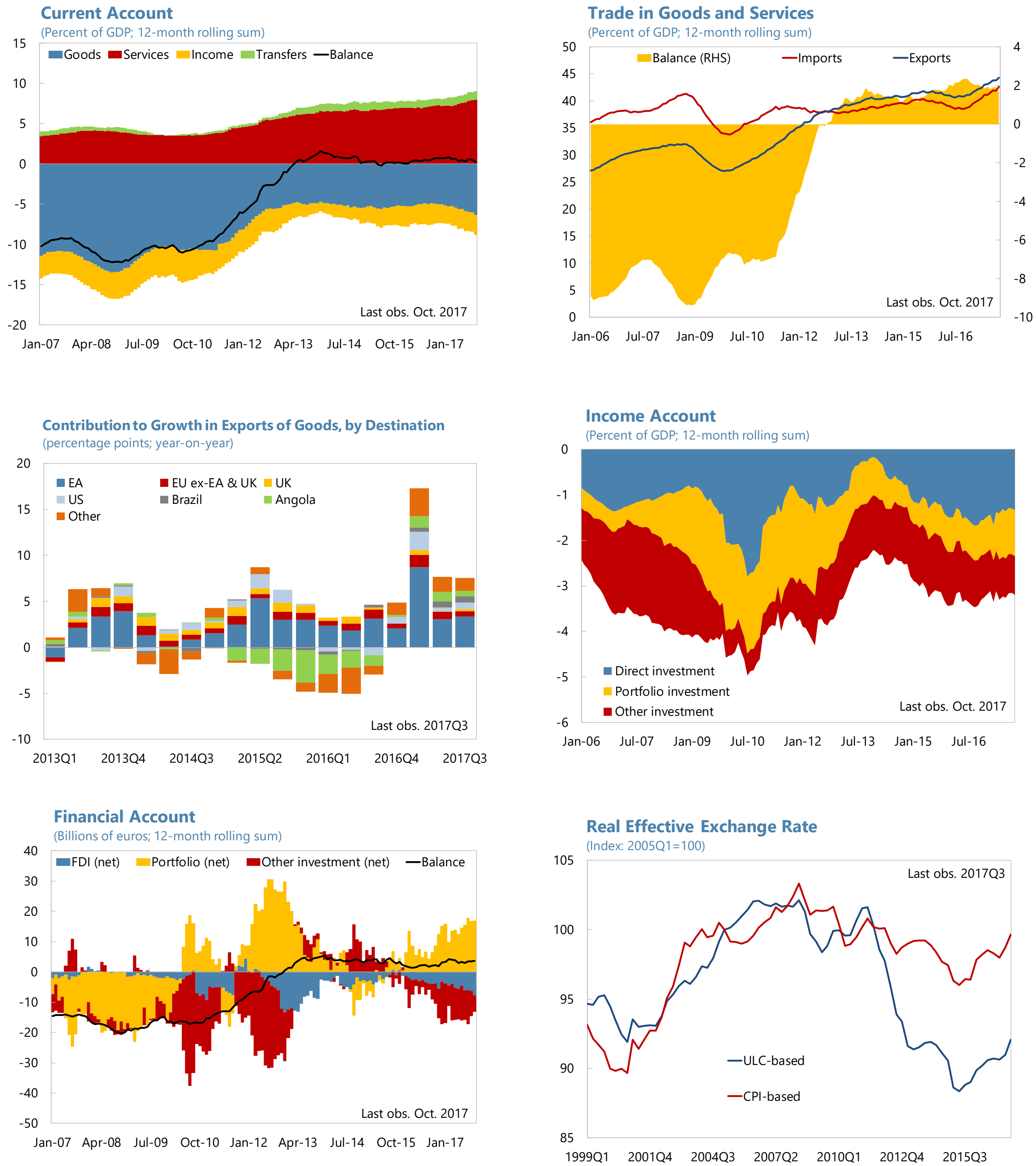
Sources: INE; Haver Analytics; and IMF staff calculations

Figure 2. Portugal: Fiscal Sector Indicators



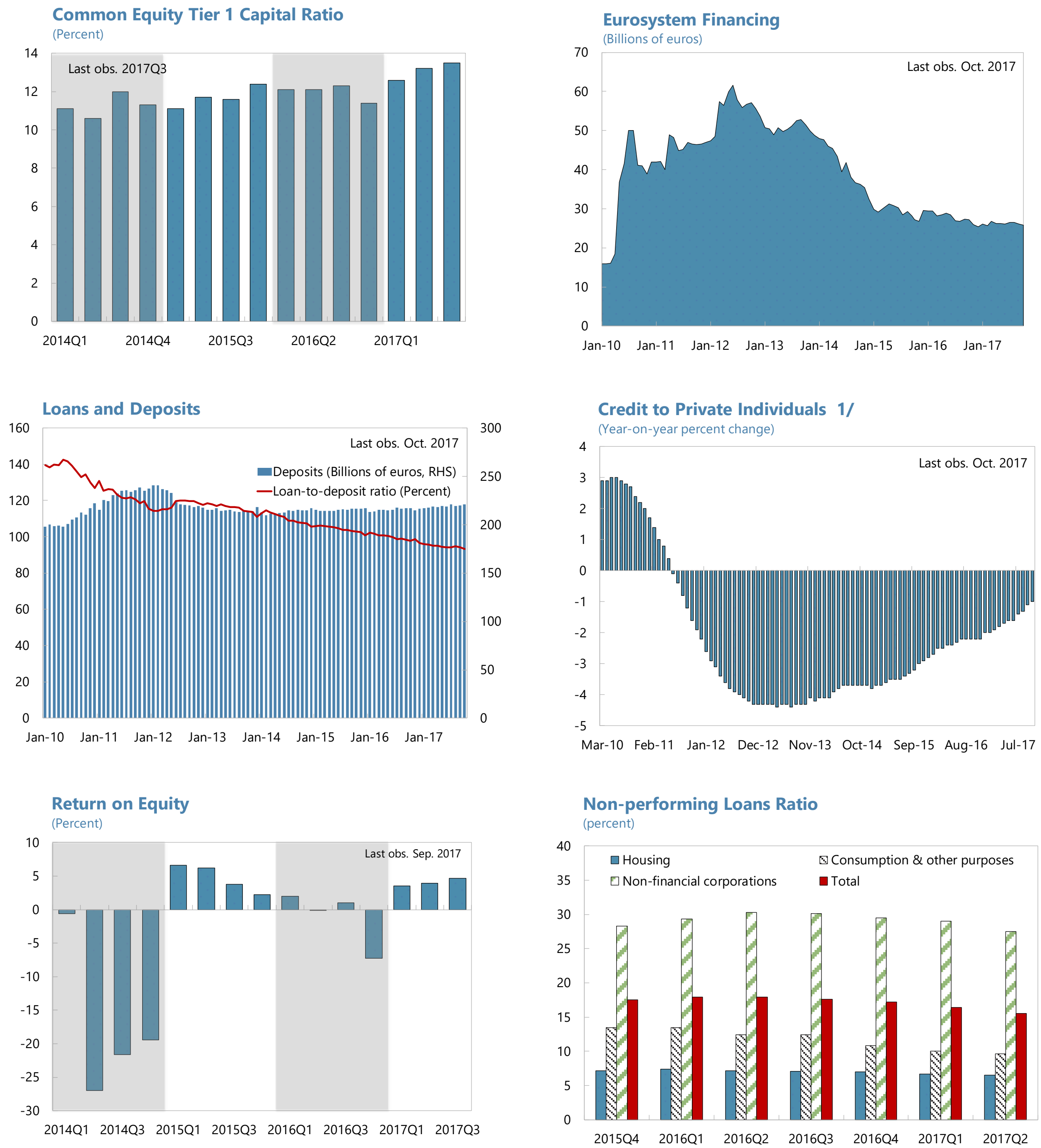
Sources: Haver Analytics; IGCP; ECB; and IMF staff calculations.

Figure 3. Portugal: External Sector Indicators



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

Figure 4. Portugal: Financial Sector Indicators



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

Table 1. Portugal: Selected Economic Indicators

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

				Projections						
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Real GDP	0.9	1.8	1.5	2.6	2.2	1.8	1.5	1.2	1.2	1.2
Total domestic demand	2.2	2.7	1.6	3.0	2.7	1.9	1.6	1.3	1.2	1.2
Private consumption	2.3	2.3	2.1	2.2	2.0	1.6	1.4	1.1	0.8	0.8
Public consumption	-0.5	1.3	0.6	1.1	0.2	-0.1	-0.4	-0.3	-0.1	-0.2
Gross fixed investment	2.3	5.8	1.6	8.7	8.1	5.1	4.4	3.5	3.8	3.7
Private	4.1	4.3	7.4	8.3	6.2	5.5	4.5	3.7	4.1	4.1
Government	-7.9	15.9	-32.5	12.5	25.9	1.7	3.8	1.2	1.2	1.2
Exports	4.3	6.1	4.1	7.0	6.6	4.5	4.2	4.1	4.1	4.1
Imports	7.8	8.5	4.1	7.5	7.0	4.5	4.3	4.1	3.9	3.9
Contribution to Growth										
Total domestic demand	2.2	2.8	1.6	3.0	2.7	1.9	1.7	1.3	1.2	1.2
Private consumption	1.5	1.5	1.4	1.4	1.3	1.0	0.9	0.7	0.5	0.5
Public consumption	-0.1	0.3	0.1	0.2	0.0	0.0	-0.1	-0.1	0.0	0.0
Gross fixed investment	0.4	0.9	0.3	1.4	1.4	0.9	0.8	0.7	0.7	0.8
Foreign balance	-1.4	-1.1	-0.1	-0.4	-0.4	-0.1	-0.2	-0.1	0.0	0.0
Savings-investment balance (Percent of GDP)										
Gross national savings	15.4	15.9	16.2	17.5	18.3	18.8	18.9	18.8	19.0	19.3
Private	17.4	16.9	16.7	17.0	17.4	17.7	17.6	17.5	17.6	17.7
Public	-2.0	-0.9	-0.5	0.4	0.9	1.1	1.3	1.4	1.4	1.6
Gross domestic investment	15.3	15.8	15.5	17.0	18.1	18.8	19.4	19.8	20.2	20.7
Private	13.2	13.4	14.0	15.4	16.1	16.8	17.2	17.7	18.1	18.6
Public	2.1	2.4	1.5	1.6	2.1	2.1	2.1	2.1	2.1	2.1
Resource utilization										
Potential GDP	0.7	1.0	0.2	0.4	0.7	0.9	1.1	1.1	1.2	1.2
Output Gap (Percent of potential)	-4.5	-3.8	-2.5	-0.4	1.1	2.0	2.4	2.5	2.5	2.5
Employment	1.5	1.2	1.5	3.1	1.3	1.1	0.5	0.5	0.5	0.5
Unemployment rate (Percent)	13.9	12.4	11.1	9.0	7.8	7.2	6.7	6.2	5.7	5.2
Prices										
GDP deflator	0.8	2.0	1.4	1.6	1.5	1.5	1.7	1.7	1.7	1.7
Consumer prices (Harmonized index)	-0.2	0.5	0.6	1.5	1.5	1.6	1.9	1.9	2.1	2.1
Compensation per worker (Whole economy)	-1.8	0.6	2.3	1.7	2.4	2.4	2.7	2.7	2.7	2.7
Money and credit (End of period, percent change)										
Private sector credit	-8.0	-4.1	-3.7	-1.5	0.1	0.8	1.6	1.6	1.6	1.6
Broad money	-0.4	4.1	-0.4	3.7	3.2	2.8	2.7	2.4	2.4	2.4
Interest rates (Percent)										
Short-term deposit rate	1.6	0.8	0.4	…	…	…	…	…	…	…
Government bond rate, 10-year	3.8	2.4	3.2	4.0	…	…	…	…	…	…
Fiscal indicators (Percent of GDP)										
General government balance	-7.2	-4.4	-2.0	-1.2	-1.1	-0.9	-0.8	-0.7	-0.7	-0.5
Revenues	44.6	43.8	43.0	43.2	43.2	43.0	42.9	42.8	42.7	42.6
Expenditures	51.8	48.2	45.0	44.3	44.2	43.9	43.7	43.5	43.4	43.1
Primary government balance	-2.3	0.2	2.2	2.7	2.6	2.6	2.6	2.6	2.6	2.6
General government debt	130.6	128.8	130.1	125.7	121.7	118.4	115.4	112.7	110.4	108.0
External sector (Percent of GDP)										
Trade balance (Goods)	-5.5	-5.2	-5.0	-6.2	-7.1	-7.4	-7.8	-8.3	-8.8	-9.5
Trade balance (Goods and Services)	1.1	1.8	2.2	1.8	1.5	1.4	1.2	0.9	0.7	0.4
Current account balance	0.1	0.1	0.7	0.4	0.2	-0.1	-0.5	-0.9	-1.2	-1.4
Net international investment position	-117.5	-112.0	-104.7	-99.0	-94.0	-89.7	-86.2	-83.5	-81.2	-79.2
REER based on ULC (2010=100)	91.4	88.8	90.4	91.9	92.7	93.7	94.6	95.4	96.0	97.4
(Rate of growth)	-0.3	-2.9	1.9	1.6	0.9	1.1	1.0	0.8	0.7	1.4
REER based on CPI (2010=100)	98.7	96.2	98.1	97.9	97.6	97.6	97.7	97.7	97.8	97.9
(Rate of growth)	-1.1	-2.5	2.0	-0.3	-0.2	0.0	0.1	0.0	0.1	0.1
Nominal GDP (Billions of euros)	173.1	179.8	185.2	193.0	200.2	206.8	213.4	219.6	226.1	232.6

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

Table 2a. Portugal: General Government Accounts 1/

(Billions of euros)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Projections						
Revenue	77.2	78.8	79.7	83.3	86.4	88.9	91.5	94.1	96.6	99.1
Taxes	43.6	45.6	46.4	48.5	50.0	51.4	52.9	54.4	55.8	57.2
Taxes on production and imports	24.6	26.1	27.3	28.7	30.2	31.1	32.0	32.9	33.7	34.5
Current taxes on income, wealth, etc. and capital taxes	19.0	19.5	19.1	19.8	19.8	20.4	21.0	21.5	22.1	22.7
Social contributions	20.5	20.8	21.6	22.6	23.3	24.0	24.7	25.4	26.1	26.7
Grants and other revenue	13.2	12.4	11.7	12.1	13.0	13.5	13.9	14.3	14.7	15.2
Property income	1.7	1.3	1.2	1.4	1.4	1.4	1.5	1.5	1.6	1.6
Sales of goods and services	6.3	6.4	6.6	6.7	7.2	7.5	7.7	7.9	8.2	8.4
Other current revenue	3.4	3.3	3.0	3.2	3.4	3.6	3.7	3.8	3.9	4.0
Capital transfers and investment grants	1.7	1.4	0.8	0.9	1.0	1.0	1.0	1.1	1.1	1.1
Expenditure	89.6	86.7	83.4	85.6	88.5	90.8	93.2	95.6	98.2	100.4
Expense	91.2	87.7	85.8	88.1	90.3	92.7	95.1	97.5	100.1	102.4
Compensation of employees	20.5	20.3	20.9	21.5	21.7	22.2	22.7	23.3	23.9	24.5
Use of goods and services	9.8	10.0	10.4	10.5	11.0	11.4	11.7	12.1	12.4	12.8
Consumption of fixed capital	5.1	5.2	5.3	5.7	5.9	6.1	6.3	6.5	6.6	6.8
Interest	8.5	8.2	7.8	7.5	7.3	7.3	7.3	7.3	7.4	7.2
Subsidies	1.2	1.1	1.0	0.9	1.0	1.1	1.1	1.1	1.2	1.2
Social benefits	34.1	34.7	35.1	36.0	37.2	38.2	39.3	40.3	41.4	42.5
Grants and other expense	11.9	8.1	5.4	6.0	6.2	6.5	6.7	7.0	7.2	7.4
Other current expense	4.7	4.6	4.7	4.9	5.3	5.5	5.6	5.9	6.1	6.2
Capital transfers	7.2	3.4	0.8	1.0	1.0	1.0	1.0	1.1	1.1	1.1
Net acquisition of nonfinancial assets	-1.6	-1.0	-2.5	-2.5	-1.8	-1.9	-1.8	-1.9	-2.0	-2.0
Gross fixed capital formation	3.4	4.0	2.8	3.1	4.1	4.2	4.4	4.6	4.7	4.8
(-) Consumption of fixed capital	-5.1	-5.2	-5.3	-5.7	-5.9	-6.1	-6.3	-6.5	-6.6	-6.8
Acquisitions less disposals of other nonfinancial assets	0.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-8.9	-3.7	-0.9	0.9	1.9	2.3	2.7	3.0	3.2	3.6
Net lending (+)/borrowing (–)	-12.4	-7.9	-3.7	-2.3	-2.1	-1.9	-1.7	-1.5	-1.5	-1.3
Net acquisition of financial assets	-6.5	-4.0	5.6	...	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	0.0	...	...	...	...	...	...	...
Currency and deposits	0.0	-3.1	4.5	...	...	...	...	...	...	...
Debt securities	-4.7	-1.0	0.0	...	...	...	...	...	...	...
Loans	-0.1	0.1	0.0	...	...	...	...	...	...	...
Equity and investment fund shares	-2.1	-0.1	-0.1	...	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...	...
Financial derivatives and employee stock options	0.1	-0.3	-0.5	...	...	...	...	...	...	...
Other accounts receivable	0.3	0.3	1.8	...	...	...	...	...	...	...
Net incurrence of liabilities	5.9	3.9	9.3	...	...	...	...	...	...	...
SDRs	0.0	0.0	0.0	...	...	...	...	...	...	...
Currency and deposits	4.9	4.0	4.0	...	...	...	...	...	...	...
Debt securities	-1.9	11.2	11.3	...	...	...	...	...	...	...
Loans	3.6	-9.4	-6.0	...	...	...	...	...	...	...
Equity and investment fund shares	0.0	-0.1	0.0	...	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	0.0	...	...	...	...	...	...	...
Other accounts payable	-0.8	-1.7	0.1	...	...	...	...	...	...	...
Memorandum items:										
Primary balance	-3.9	0.3	4.1	5.3	5.2	5.4	5.6	5.8	5.8	5.9
Debt at face value (EDP notification)	226.0	231.5	241.0	242.6	243.6	244.9	246.3	247.5	249.5	251.3
Nominal GDP	173.1	179.8	185.2	193.0	200.2	206.8	213.4	219.6	226.1	232.6

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)

				Projections						
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Revenue	44.6	43.8	43.0	43.2	43.2	43.0	42.9	42.8	42.7	42.6
Taxes	25.2	25.4	25.1	25.1	25.0	24.9	24.8	24.8	24.7	24.6
Taxes on production and imports	14.2	14.5	14.8	14.9	15.1	15.0	15.0	15.0	14.9	14.8
Current taxes on income, wealth, etc. and capital taxes	11.0	10.9	10.3	10.3	9.9	9.9	9.8	9.8	9.8	9.8
Social contributions	11.8	11.6	11.7	11.7	11.7	11.6	11.6	11.6	11.5	11.5
Grants and other revenue	7.6	6.9	6.3	6.3	6.5	6.5	6.5	6.5	6.5	6.5
Property income	1.0	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Sales of goods and services	3.6	3.5	3.6	3.5	3.6	3.6	3.6	3.6	3.6	3.6
Other current revenue	2.0	1.8	1.6	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Capital transfers and investment grants	1.0	0.8	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Expenditure	51.8	48.2	45.0	44.3	44.2	43.9	43.7	43.5	43.4	43.1
Expense	52.7	48.8	46.4	45.7	45.1	44.8	44.6	44.4	44.3	44.0
Compensation of employees	11.9	11.3	11.3	11.1	10.8	10.8	10.6	10.6	10.6	10.5
Use of goods and services	5.7	5.6	5.6	5.4	5.5	5.5	5.5	5.5	5.5	5.5
Consumption of fixed capital	2.9	2.9	2.8	2.9	2.9	2.9	2.9	2.9	2.9	2.9
Interest	4.9	4.6	4.2	3.9	3.7	3.5	3.4	3.3	3.3	3.1
Subsidies	0.7	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Social benefits	19.7	19.3	19.0	18.7	18.6	18.5	18.4	18.4	18.3	18.3
Grants and other expense	6.9	4.5	2.9	3.1	3.1	3.1	3.1	3.2	3.2	3.2
Other current expense	2.7	2.6	2.5	2.6	2.6	2.6	2.6	2.7	2.7	2.7
Capital transfers	4.2	1.9	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Net acquisition of nonfinancial assets	-0.9	-0.6	-1.3	-1.3	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9
Gross fixed capital formation	2.0	2.3	1.5	1.6	2.0	2.0	2.1	2.1	2.1	2.1
(-) Consumption of fixed capital	-2.9	-2.9	-2.8	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9
Acquisitions less disposals of other nonfinancial assets	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-5.1	-2.1	-0.5	0.4	1.0	1.1	1.3	1.4	1.4	1.5
Net lending (+)/borrowing (–)	-7.2	-4.4	-2.0	-1.2	-1.1	-0.9	-0.8	-0.7	-0.7	-0.5
Net acquisition of financial assets	-3.8	-2.2	3.0	...	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	0.0	...	...	...	...	...	...	...
Currency and deposits	0.0	-1.7	2.4	...	...	...	...	...	...	...
Debt securities	-2.7	-0.5	0.0	...	...	...	...	...	...	...
Loans	-0.1	0.1	0.0	...	...	...	...	...	...	...
Equity and investment fund shares	-1.2	-0.1	-0.1	...	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...	...
Financial derivatives and employee stock options	0.1	-0.2	-0.3	...	...	...	...	...	...	...
Other accounts receivable	0.2	0.2	1.0	...	...	...	...	...	...	...
Net incurrence of liabilities	3.4	2.2	5.0	...	...	...	...	...	...	...
SDRs	0.0	0.0	0.0	...	...	...	...	...	...	...
Currency and deposits	2.8	2.2	2.1	...	...	...	...	...	...	...
Debt securities	-1.1	6.2	6.1	...	...	...	...	...	...	...
Loans	2.1	-5.2	-3.2	...	...	...	...	...	...	...
Equity and investment fund shares	0.0	-0.1	0.0	...	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	0.0	...	...	...	...	...	...	...
Other accounts payable	-0.5	-1.0	0.0	...	...	...	...	...	...	...
Memorandum items:										
Primary balance	-2.3	0.2	2.2	2.7	2.6	2.6	2.6	2.6	2.6	2.6
Structural balance (Percent of potential GDP)	-1.1	-1.4	-1.1	-1.2	-1.3	-1.6	-1.7	-1.6	-1.6	-1.4
Structural primary balance (Percent of potential GDP)	3.6	3.0	2.9	2.7	2.4	2.0	1.8	1.8	1.7	1.7
Debt at face value (EDP notification)	130.6	128.8	130.1	125.7	121.7	118.4	115.4	112.7	110.4	108.0
Nominal GDP (Billions of euros)	173.1	179.8	185.2	193.0	200.2	206.8	213.4	219.6	226.1	232.6

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

[1] GFSM 2001 presentation.

Table 3. Portugal: Monetary Survey, 2014–2023
(Millions of euros, unless otherwise indicated; end of period)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Projections						
	Aggregated Balance Sheet of Monetary Financial Institutions (MFIs)[1]									
Assets	405,636	389,637	370,614	374,539	376,668	380,964	386,995	391,590	397,477	400,819
Claims on Bank of Portugal	5,093	9,353	7,235	7,018	7,228	7,445	7,669	7,899	8,136	8,380
Claims on non-residents	71,467	63,875	55,396	55,950	56,509	57,075	57,645	58,222	58,804	59,392
Claims on non-monetary resident sector	307,488	296,203	285,502	290,147	291,559	295,046	300,283	304,081	309,143	311,654
General government	41,504	39,948	40,488	45,209	47,311	48,716	50,656	51,253	52,813	51,883
Central government	34,990	33,634	34,085	38,806	40,666	42,040	43,981	44,413	45,973	45,043
Loans	3,092	2,547	2,569	5,228	7,502	11,955	15,103	18,377	20,658	20,877
Securities	30,072	29,087	29,336	31,398	30,983	27,905	26,697	23,857	23,135	21,987
General government, excluding central government	6,514	6,314	6,403	6,402	6,646	6,676	6,676	6,840	6,840	6,840
Private sector	224,396	215,174	207,317	204,207	204,411	206,047	209,343	212,693	216,096	219,554
Non-financial corporations	100,711	96,630	91,608	93,856	96,200	97,819	99,324	100,577	102,018	103,515
Private individuals[2]	123,685	118,544	115,709	110,351	108,212	108,228	110,019	112,116	114,078	116,039
Non-monetary financial institutions	43,414	41,081	37,697	40,731	39,836	40,283	40,283	40,134	40,234	40,217
Other assets	21,587	20,206	22,481	21,425	21,371	21,398	21,398	21,389	21,395	21,394
Liabilities	405,636	389,637	370,614	374,539	376,668	380,964	386,995	391,590	397,477	400,819
Liabilities to Bank of Portugal	32,503	29,616	25,450	24,687	23,946	23,228	22,531	21,855	21,199	20,563
Liabilities to non-residents	68,369	59,750	57,061	55,920	54,801	53,705	52,631	51,579	50,547	49,536
Liabilities to non-monetary resident sector	216,942	216,963	216,328	220,747	222,867	226,906	231,243	235,777	241,702	247,913
General government	12,741	11,545	9,563	6,913	5,313	4,113	3,313	2,513	2,513	2,513
Central government	9,120	6,667	4,239	3,064	2,355	1,823	1,469	1,114	1,114	1,114
General government, excluding central government	3,621	4,878	5,324	3,849	2,958	2,290	1,844	1,399	1,399	1,399
Private sector[2]	163,138	168,061	172,097	176,376	180,919	185,747	190,883	196,354	202,188	208,415
Non-monetary financial institutions	41,062	37,358	34,668	37,458	36,635	37,047	37,047	36,910	37,001	36,986
Securities other than capital	28,638	24,092	15,985	15,026	15,477	15,941	16,419	16,912	17,419	17,942
Capital and reserves	59,184	59,216	55,791	58,160	59,576	61,184	64,171	65,468	66,610	64,865
	Money and Credit									
Broad money (M3)	147,174	153,193	152,601	158,298	163,380	168,000	172,502	176,673	180,944	185,316
Intermediate money (M2)	144,449	150,413	149,912	155,509	160,501	165,039	169,462	173,560	177,756	182,051
Narrow money (M1)	54,988	66,400	66,639	69,127	71,346	73,363	75,329	77,151	79,016	80,925
Private sector credit	224,396	215,174	207,317	204,207	204,411	206,047	209,343	212,693	216,096	219,554
Public sector credit	41,504	39,948	40,488	45,209	47,311	48,716	50,656	51,253	52,813	51,883
	(Percent of GDP)									
Broad money	85.0	85.2	82.4	82.0	81.6	81.2	80.8	80.4	80.0	79.7
Private sector credit	129.6	119.7	112.0	105.8	102.1	99.6	98.1	96.8	95.6	94.4
Public sector credit	24.0	22.2	21.9	23.4	23.6	23.6	23.7	23.3	23.4	22.3
	(Percentage change)									
Broad money	-0.4	4.1	-0.4	3.7	3.2	2.8	2.7	2.4	2.4	2.4
Private sector credit	-8.0	-4.1	-3.7	-1.5	0.1	0.8	1.6	1.6	1.6	1.6
Public sector credit	7.3	-3.7	1.4	11.7	4.7	3.0	4.0	1.2	3.0	-1.8
Memorandum items:										
ECB access (Percent of assets)	8.0	7.6	6.9	6.6	6.4	6.1	5.8	5.6	5.3	5.1
Credit to deposits (Percent)	122.6	117.6	114.6	113.0	112.9	112.3	112.4	111.9	111.3	109.5
Loan to deposits (Percent)	105.4	100.6	96.7	94.5	94.8	95.7	96.7	97.7	97.6	96.7
Wholesale market funding (Percent of assets)[3]	19.6	16.5	17.4	15.1	15.5	15.7	16.0	16.3	16.5	16.8

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, 2014–2023

(Billions of euros)

				Projections						
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Current and Capital account	2.7	2.3	3.2	2.8	3.0	2.6	1.5	0.6	-0.1	-0.8
Current account	0.2	0.2	1.3	0.8	0.3	-0.1	-1.0	-2.1	-2.7	-3.4
Balance of goods and services	1.9	3.2	4.0	3.5	2.9	2.8	2.5	1.9	1.5	1.0
Trade balance	-9.5	-9.4	-9.3	-12.0	-14.2	-15.3	-16.6	-18.1	-20.0	-22.0
Exports fob	47.3	49.1	49.4	54.8	58.7	62.4	65.8	69.3	72.8	77.2
Imports fob	56.8	58.5	58.7	66.8	72.9	77.7	82.5	87.4	92.7	99.2
Services, net	11.4	12.6	13.3	15.4	17.1	18.1	19.1	20.1	21.5	23.0
Exports	23.4	25.3	26.4	30.0	33.3	35.1	37.1	39.2	42.0	45.1
Imports	12.0	12.8	13.1	14.6	16.1	17.0	18.0	19.1	20.5	22.1
Of which:										
Tourism	7.1	7.8	8.8	10.7	11.9	12.9	13.8	14.9	15.9	17.1
Exports	10.4	11.5	12.7	15.1	16.7	18.0	19.4	20.9	22.4	24.1
Imports	3.3	3.6	3.8	4.4	4.8	5.2	5.6	6.0	6.5	7.0
Primary income, net	-3.3	-4.5	-4.3	-4.4	-4.3	-4.7	-5.2	-5.7	-5.9	-6.2
Secondary income, net	1.6	1.5	1.6	1.8	1.8	1.7	1.7	1.7	1.7	1.8
Capital account	2.5	2.1	1.9	1.9	2.7	2.8	2.5	2.6	2.6	2.6
Financial account	8.3	2.3	3.2	2.8	3.0	2.6	1.5	0.6	-0.1	-0.8
Direct investment	-2.6	-1.2	-3.3	-4.9	-3.8	-3.8	-3.7	-3.5	-3.3	-3.1
Direct investment assets	7.2	1.0	5.0	3.7	5.0	5.2	5.4	5.6	5.8	6.0
Direct investment liabilities	9.8	2.2	8.4	8.6	8.8	8.9	9.1	9.1	9.1	9.1
Portfolio investment, net	-1.1	0.5	15.1	-5.8	1.1	2.7	2.7	0.5	-4.4	-3.3
Financial derivatives	1.9	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Other investment, net	8.3	1.1	-13.9	12.2	4.1	2.1	0.9	1.9	5.7	3.6
Reserve assets	1.7	1.5	4.7	0.8	1.0	1.1	1.1	1.1	1.4	1.5
Errors and omissions	0.4	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:					(Percent GDP)					
Current account	0.1	0.1	0.7	0.4	0.2	-0.1	-0.5	-0.9	-1.2	-1.4
Current account (Including capital transfers)	1.6	1.3	1.7	1.4	1.5	1.3	0.7	0.3	0.0	-0.3
Of which: Balance of goods and services	1.1	1.8	2.2	1.8	1.5	1.4	1.2	0.9	0.7	0.4
Net international investment position[1]	-117.5	-112.0	-104.7	-99.0	-94.0	-89.7	-86.2	-83.5	-81.2	-79.2
Direct investment, net	-31.2	-30.9	-31.3	-32.6	-33.3	-34.0	-34.7	-35.4	-35.8	-36.1
Portfolio investment, net	-10.5	-9.4	1.0	-2.1	-1.4	-0.1	1.2	1.3	-0.6	-2.0
Financial derivatives	-1.0	0.1	-0.1	0.2	0.4	0.7	0.9	1.1	1.3	1.5
Other investment, net	-84.2	-81.6	-87.2	-77.3	-72.5	-69.1	-66.6	-63.8	-59.5	-56.3
Reserve assets	9.3	9.9	12.9	12.8	12.8	12.9	13.1	13.2	13.4	13.7

Sources: Bank of Portugal; and IMF staff projections.

1/ End-of-period data.

Table 5. Portugal: Selected Financial Indicators of the Banking System, 2013Q1–2017Q3 1/

(Percent)

	2013				2014				2015				2016				2017		
	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.
Capital adequacy																			
Regulatory capital to risk-weighted assets	13.0	13.1	13.4	13.3	12.3	12.0	13.0	12.3	12.0	12.6	12.6	13.3	13.0	13.1	13.2	12.3	13.9	14.4	14.7
Common Equity Tier 1 capital to risk-weighted assets					11.1	10.6	12.0	11.3	11.1	11.7	11.6	12.4	12.1	12.1	12.3	11.4	12.6	13.2	13.5
Regulatory tier 1 capital to risk-weighted assets	11.7	11.7	12.0	11.9	11.1	10.7	12.2	11.4	11.2	11.8	11.7	12.6	12.3	12.4	12.6	11.7	13.2	13.7	14.0
Capital to assets 2/	6.9	6.8	7.1	6.8	6.4	6.2	6.9	6.4	6.5	6.8	6.9	7.2	7.0	7.0	7.1	6.5	7.1	7.3	7.4
Asset composition and quality																			
Non-performing loans to total gross loans												17.5	17.9	17.9	17.6	17.2	16.4	15.5	14.6
Credit at risk 3/	10.4	10.5	11.1	10.6	10.8	11.2	11.9	11.9	12.3	12.7	12.9	12.0	12.3	12.7	12.6	11.8			
Sectoral distribution of loans																			
Residents	83.2	83.9	86.7	86.8	86.1	85.8	84.8	85.5	85.5	85.8	87.5	87.8	88.3	88.3	88.6	89.1	88.3	89.3	89.8
Nonresidents	16.8	16.1	13.3	13.2	13.9	14.2	15.2	14.5	14.5	14.2	12.5	12.2	11.7	11.7	11.4	10.9	11.7	10.7	10.2
Earnings and profitability																			
Return on assets	-0.3	-0.6	-0.5	-0.8	-0.1	-1.8	-1.5	-1.4	0.5	0.4	0.3	0.2	0.2	0.0	0.1	-0.6	0.3	0.3	0.4
Return on equity	-4.2	-9.3	-8.5	-12.5	-0.8	-27.4	-21.9	-19.7	6.3	5.9	3.6	2.1	1.9	-0.1	1.0	-7.4	3.5	3.9	4.7
Interest margin to gross income	42.2	44.4	46.9	48.8	46.8	48.7	49.7	50.6	45.2	46.8	50.0	46.1	56.2	51.6	52.9	50.3	54.3	50.4	50.5
Noninterest expenses to gross income	66.3	68.2	69.7	71.9	60.0	68.0	67.8	68.0	53.7	55.6	60.1	63.0	68.1	65.6	65.0	62.2	70.4	64.5	64.4
Liquidity																			
Liquid assets to total assets 4/	8.1	7.8	9.3	9.8	8.4	8.0	9.0	14.4	11.8	11.4	11.1	10.9	10.7	10.5	10.2	10.7	11.5	12.8	12.9
Liquid assets to short-term liabilities 4/	13.4	12.9	14.8	15.4	13.1	12.4	13.5	20.3	16.8	16.4	15.7	15.7	15.4	15.4	14.9	15.5	17.2	19.0	19.0
Loans to deposits 5/	119.0	117.7	115.8	111.8	112.3	109.0	106.8	102.1	101.7	101.0	98.8	96.1	95.2	95.4	94.2	95.3	94.4	93.6	94.0
Foreign-currency-denominated liabilities to total liabilities 6	4.5	4.4	4.4	4.3	4.3	4.7	4.8	4.5	4.6	4.5	4.4	4.1	4.1	4.0	3.9	3.8	3.7	3.6	3.3

Source: Bank of Portugal.

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

2/ Corresponds to the ratio between Tier 1 Capital, computed at consolidated level, and total assets.

3/ National concept of asset quality.

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

5/ Data reflects the information from Instruction No 23/2004 of Banco de Portugal (until 2015Q3). From 2015Q4, data is based on the ITS reporting framework.

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

Table 6. Portugal: External Debt Sustainability Framework, 2015-2023

(Percent of GDP, unless indicated)

			Projections							
	2015	2016	2017	2018	2019	2020	2021	2022	2023	Debt-stabilizing non-interest current account[6]
Baseline: External debt	222.3	215.8	202.4	195.4	189.2	183.5	178.7	176.3	173.4	1.6
Change in external debt	-13.7	-6.5	-13.4	-6.9	-6.2	-5.7	-4.8	-2.5	-2.8	
Identified external debt-creating flows (4+8+9)	-11.5	-6.6	-4.3	-3.6	-2.6	-1.6	-0.6	-0.4	-0.3	
Current account deficit, excluding interest payments	-5.1	-5.2	-4.2	-3.8	-3.0	-3.4	-0.7	-1.8	-1.6	
Deficit in balance of goods and services	-1.8	-2.2	-1.8	-1.5	-1.4	-1.2	-0.9	-0.7	-0.4	
Exports	41.4	40.9	44.0	45.9	47.1	48.3	49.4	50.8	52.6	
Imports	39.6	38.8	42.2	44.5	45.8	47.1	48.5	50.1	52.1	
Net non-debt creating capital inflows (negative)	-2.6	0.5	1.5	0.8	0.8	0.7	0.6	0.5	0.4	
Automatic debt dynamics[1]	-3.8	-2.0	-1.6	-0.7	-0.3	1.1	-0.5	0.9	1.0	
Contribution from nominal interest rate	5.0	4.4	3.7	3.6	3.1	3.8	1.6	3.0	3.0	
Contribution from real GDP growth	-4.1	-3.3	-5.4	-4.3	-3.4	-2.8	-2.1	-2.1	-2.1	
Contribution from price and exchange rate changes[2]	-4.7	-3.1	...	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3)[3]	-2.2	0.1	-3.7	-0.4	-0.8	-1.0	-1.1	0.9	-0.5	
External debt-to-exports ratio (Percent)	537.1	527.1	460.3	425.3	401.4	380.4	362.1	347.2	329.9	
Gross external financing need (Billions of Euros)[4]	162.3	170.0	173.4	170.0	166.0	169.8	177.1	175.4	163.3	
Percent of GDP	90.3	91.8	89.9	84.9	80.3	79.6	80.6	77.6	70.2	
Scenario with key variables at their historical averages[5]			212.1	213.8	215.2	216.2	217.1	220.4	223.0	2.0
Key Macroeconomic Assumptions Underlying Baseline										
Real GDP growth (Percent)	1.8	1.5	2.6	2.2	1.8	1.5	1.2	1.2	1.2	
GDP deflator in Euros (Percent)	2.0	1.4	1.6	1.5	1.5	1.7	1.7	1.7	1.7	
Nominal external interest rate (Percent)	2.2	2.1	1.8	1.9	1.6	2.1	0.9	1.7	1.8	
Growth of exports (Euros, percent)	5.2	1.9	12.0	8.4	6.0	5.6	5.3	5.8	6.6	
Growth of imports (Euros, percent)	3.5	0.8	13.4	9.4	6.4	6.1	6.0	6.4	7.1	
Current account balance, excluding interest payments	5.1	5.2	4.2	3.8	3.0	3.4	0.7	1.8	1.6	
Net non-debt creating capital inflows	2.6	-0.5	-1.5	-0.8	-0.8	-0.7	-0.6	-0.5	-0.4	

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, 2012–2023 1/

(Millions of SDR, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Disbursements	6,899	2,977	1,563	...	...	...	...	...	...	...	...	...
(Percent of quota)	670	289	152	...	...	...	...	...	...	...	...	...
(Projected debt service to the Fund, based on existing and prospective drawings)												
Total	373	527	716	7,263	4,065	8,608	795	71	71	1,616	1,570	661
Interest and charges	373	527	716	684	505	376	87	71	71	69	34	12
Repayments	0	0	0	6,579	3,560	8,232	708	0	0	1,548	1,536	649
Total debt service, in percent of												
Exports of goods and services	0.7	0.9	1.2	12.4	6.7	12.5	1.0	0.1	0.1	1.8	1.6	0.6
GDP	0.3	0.4	0.5	5.1	2.8	5.5	0.5	0.0	0.0	0.9	0.8	0.3
(Projected level of credit outstanding based on existing and prospective drawings)												
Outstanding stock	18,402	21,379	22,942	16,363	12,803	4,571	3,863	3,863	3,863	2,315	779	130
Percent of quota[2]	1,787.1	2,076.2	2,228.0	1,589.1	621.5	221.9	187.5	187.5	187.5	112.4	37.8	6.3
Percent of GDP	12.8	14.1	15.7	11.6	8.8	2.8	2.3	2.2	2.2	1.3	0.4	0.1
Memorandum Items (Billions of SDR)												
Exports of goods and services	54	60	62	59	60	69	77	82	86	91	96	103
GDP	141	149	151	142	147	157	167	173	179	184	192	199

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.

Table 8. Portugal: General Government Financing Requirements and Sources 1/

(Billions of euros)

	2017	2018	2019	2020	2021	2022	2023
Gross borrowing need	38.1	28.7	29.8	29.1	38.3	34.1	32.1
Overall balance	2.3	2.1	1.9	1.7	1.5	1.5	1.6
Amortization	33.0	26.1	27.3	26.9	36.1	31.9	30.1
Medium- and long-term	7.9	8.2	12.4	11.9	19.3	15.1	14.3
Residents	3.2	2.4	5.4	4.2	10.2	12.4	8.4
Non-residents	4.7	5.8	7.0	7.8	9.2	2.7	5.9
Short-term[2]	15.0	17.0	15.0	15.0	15.0	15.0	15.0
Residents	10.2	11.6	9.6	9.6	9.6	9.6	9.6
Non-residents	4.8	5.4	5.4	5.4	5.4	5.4	5.4
EU and IMF[3]	10.1	0.8	0.0	0.0	1.8	1.8	0.8
Other (Net)[4]	2.8	0.6	0.5	0.5	0.7	0.7	0.5
Gross financing sources	37.5	28.7	29.8	29.1	38.2	33.9	31.8
Privatization receipts	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Market access	34.6	27.1	28.6	28.3	37.4	33.9	31.8
Medium- and long-term	19.7	12.1	13.6	13.3	22.4	19.0	16.9
Residents	8.0	5.6	7.4	6.4	11.8	10.0	7.4
Non-residents	11.7	6.5	6.2	6.9	10.6	9.0	9.5
Short-term[2]	15.0	15.0	15.0	15.0	15.0	15.0	15.0
Residents	9.6	9.6	9.6	9.6	9.6	9.6	9.6
Non-residents	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Use of deposits[5]	2.9	1.6	1.2	0.8	0.8	0.0	0.0
Net placement (Market access-amortization)	1.6	1.0	1.2	1.4	1.2	2.0	1.8
Residents	-0.9	0.8	2.1	2.2	1.2	-2.9	-1.2
Medium- and long-term	-0.3	2.8	2.1	2.2	1.2	-2.9	-1.2
Short-term (Net increase)	-0.6	-2.0	0.0	0.0	0.0	0.0	0.0
Non-residents	2.5	0.3	-0.8	-0.8	0.1	4.9	2.9
Medium- and long-term	1.9	0.3	-0.8	-0.8	0.1	4.9	2.9
Short-term (Net increase)	0.6	0.0	0.0	0.0	0.0	0.0	0.0

Source: Portuguese authorities and IMF staff estimates.

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

2/ For projection years, all t-bills issuance is assumed to be short term (i.e. at maturities of 12 months or below).

3/ For EFSF loans, outstanding loans are assumed to be rolled over for an additional 7 years, as agreed with the EU.

4/ Includes net financing from retail government securities programs, as well as adjustments for cash-accrual differences and consistency between annual projections and preliminary quarterly accounts.

5/ Changes in government deposits.

Table 9. Portugal: External Financing Requirements and Sources

(Billions of euros, unless otherwise indicated)

			Projections				
	2017	2018	2019	2020	2021	2022	2023
Gross financing requirements	172.5	163.9	165.7	169.6	177.1	175.6	163.6
Current account deficit	-0.8	-0.3	0.1	1.0	2.1	2.7	3.4
Medium- and long-term debt amortization	24.7	30.9	33.4	36.6	41.2	38.9	26.9
Public sector	4.7	5.8	7.0	7.8	9.2	2.7	5.9
Banks	15.6	19.7	19.9	20.2	20.5	20.8	21.0
Other private	4.4	5.4	6.5	8.7	11.6	15.4	0.0
Short-term debt amortization	138.5	132.4	132.1	132.0	132.0	132.2	132.5
Public sector	85.9	81.7	81.0	80.3	79.6	78.9	78.2
Central Bank	81.1	76.3	75.6	74.9	74.2	73.5	72.8
General government and SOEs	4.8	5.4	5.4	5.4	5.4	5.4	5.4
Banks	36.9	36.5	38.4	40.2	42.1	44.0	45.9
Other private	15.8	14.2	12.8	11.5	10.4	9.3	8.4
EU and IMF[1]	10.1	0.8	0.0	0.0	1.8	1.8	0.8
Sources of financing	172.5	163.9	165.7	169.6	177.1	175.6	163.6
Capital account (Net)	1.9	2.7	2.8	2.5	2.6	2.6	2.6
Foreign direct investment (Net)	-4.9	-3.8	-3.8	-3.7	-3.5	-3.3	-3.1
Inward	8.6	8.8	8.9	9.1	9.1	9.1	9.1
New borrowing and debt rollover	164.5	164.8	165.7	168.9	176.0	178.8	167.0
Medium and long-term borrowing	32.0	32.7	33.7	36.9	43.8	46.3	41.7
General government	11.7	6.5	6.2	6.9	10.6	9.0	9.5
Banks	15.5	20.8	21.0	21.3	21.6	21.9	32.3
Other private	4.8	5.4	6.5	8.7	11.6	15.4	0.0
Short-term borrowing	132.4	132.1	132.0	132.0	132.2	132.5	125.3
Public sector	81.7	81.0	80.3	79.6	78.9	78.2	78.2
Central bank	76.3	75.6	74.9	74.2	73.5	72.8	72.8
Of which: ECB access	21.2	20.4	19.7	19.0	18.3	17.7	17.1
General government	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Banks	36.5	38.4	40.2	42.1	44.0	45.9	39.5
Other private	14.2	12.8	11.5	10.4	9.3	8.4	7.5
Other (Includes asset operations)	11.0	0.2	1.0	1.9	2.0	-2.5	-3.0
Of which: Net errors and omissions	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Rollover rates							
General government	179.5	106.0	93.4	93.6	109.9	177.5	131.6
Private	97.7	102.0	102.2	102.3	102.3	102.3	105.3
Banks	99.0	105.2	105.1	104.9	104.8	104.7	107.2
Other private	94.4	92.8	93.4	94.3	95.3	96.2	90.0

Sources: Bank of Portugal and IMF staff estimates.

1/ For EFSF loans, outstanding loans are assumed to be rolled over for an additional 7 years, as agreed with the EU.

Annex I. Public Debt Sustainability Analysis (DSA)[1]

Staff's analysis, applying the Public DSA framework for Market-Access Countries, suggests that Portugal's gross debt trajectory remains subject to significant risks, in the context of the very high level of public debt. Market conditions have improved in 2017, supported by the improved near-term growth outlook and successful efforts to meet headline fiscal targets and raise bank capital, which were reflected in the upgrade to an investment grade rating by S&P and Fitch. In the baseline, public debt falls from 126 percent in 2017 to 108 percent of GDP in 2023. Nevertheless, debt dynamics remain vulnerable to adverse yet plausible macro-fiscal and contingent liabilities shocks, including the possible need for further fiscal support for the financial sector. Staff's baseline projections reflect the authorities' current fiscal policies; durable structural fiscal consolidation remains critical to anchor debt safely on a downward-sloping path, boosting policy credibility and strengthening the country's resilience to reversals in market sentiment.

A. Baseline Scenario

1. **The public debt ratio remains sizable, but is expected to have declined by about 4 percent of GDP in 2017, reflecting the stronger primary surplus and improved growth dynamics.** Public debt is projected to decline to 126 percent of GDP at end-2017, the lowest level since 2011. The primary surplus is projected to have risen to 2.7 percent of GDP in 2017, accompanied by an acceleration in real GDP growth to 2.6 percent and a decline in the effective nominal interest rate on public debt from 3.4 to 3.1 percent. Although yields on new issuance are expected to rise over the medium-term (see paragraph 5), projected interest costs are lower than in the 2017 Article IV DSA, reflecting the fall in Portuguese bond yields in the second half of 2017 and additional Fund repurchases. Under the baseline, borrowing costs on new issuance are projected to gradually increase in line with German bund yields; the impact during the projection period is relatively muted, however, as debt maturing over the next several years was originally issued at much higher yields. The impact of rising yields on the effective interest rate would only be felt after 2022 as lower-cost debt begins to be rolled over. The public sector contribution to the recapitalization of CGD in the first half of 2017 amounted to 2 percent of GDP, but will be accomodated through a decline in deposits that were accumulated in 2016. The further drawdown of cash deposits from 2018–23 is projected to be modest, reflecting the authorities' intention to maintain cover for over 40 percent of the next 12 month's financing needs.

B. Risk Assessment

2. **Portugal's sizable debt burden continues to pose significant risks to debt sustainability and leaves debt dynamics very sensitive to macro shocks**. As shown in Figure 1, Portugal's debt ratio already exceeds the debt burden benchmark for advanced economies of 85 percent of GDP under the baseline scenario. However, Portugal's public gross financing needs fall below the relevant benchmark of 20 percent of GDP, as the combination of longer-term issuance and shorter-term

[1] Based on available debt data as of end-January 2018.

debt buybacks (including advanced repurchases to the Fund) has helped to moderate near-term refinancing needs and smooth the redemption profile of public debt. The debt profile remains subject to medium to low risks in terms of market perception, projected change in short-term debt, and the share of public debt held by nonresidents.[2]

C. Realism of Baseline Assumptions and Alternative Scenarios

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

4. Given Portugal's sizable debt burden, the primary balance is expected to exceed its debt-stabilizing threshold over the projection period. Under staff's baseline scenario,[3] the fiscal primary balance is expected to stabilize at around 2½ percent of GDP over the medium term. Nevertheless, Portugal's debt profile remains highly vulnerable to a primary balance shock (Figures 4 and 5), as also highlighted by the asymmetric fan chart analysis in Figure 1, which shows the risks to the debt outlook if only negative shocks to the primary balance were to materialize. The authorities' medium-term fiscal strategy under the Stability Program for 2017–21 envisages a reduction in public debt to 109.4 percent of GDP by 2021. However, this projection is based on an ambitious timetable for fiscal adjustment with largely unspecified cost savings and more optimistic assumptions on medium-term growth than staff's. The Stability Program assumes annual real GDP growth of 2.0 percent in 2017–21, as opposed to staff's baseline projection of average annual growth of 1.7 percent over the same period.

D. Stress Test

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

- Under a *growth shock* that lowers output by nearly 4.5 percentage points in 2019–20 (and in turn inflation by a cumulative 1 percentage point), debt would peak at about 127 percent of GDP in 2020, 11 percentage points higher than under the baseline.

[2] The total (public and private) external financing requirements exceed significantly the relevant benchmark under the baseline. However, in the case of Portugal, the figure includes, among others, non-residents bank deposits, accounting for about 25 percent of GDP.

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

- The *interest rate shock* is particularly relevant for Portugal, as a less supportive financing environment as monetary accommodation is reduced increases the risk of sudden fluctuations in market conditions. A sustained interest rate shock of 340 basis points throughout the projection period is not expected to have a large immediate effect, reflecting the relatively long-term maturity of public debt, but it would slow down the rate of debt decline in the medium term, so that by 2023 the debt-to-GDP ratio is about 3 points higher compared with the baseline.

- Further materialization of contingent liabilities would also have implications for Portugal's debt dynamics. The recent sale of Novo Banco included a commitment by the Resolution Fund related to the performance of a specific portfolio over the next eight years contingent on the banks' capital adequacy ratio breaching certain thresholds. Such commitments might have potential fiscal effects; the commitment can be called starting in 2018, and is subject to a cumulative ceiling of €3.89 billion, which may in part or in full be reflected in government debt statistics.[4] This is expected to have at most only a modest impact on debt dynamics, increasing the debt-to-GDP ratio about 2 percent of GDP above the baseline by 2023 if the cumulative ceiling is reached (see contingent liability shock (a)). Contingent liability shock (b) shows the impact of a larger financial sector shock, in which public sector costs amount to 10 percent of GDP, as in the DSA for the 2017 Article IV consultation. A contingent liabilities shock of this magnitude would push the 2019 debt ratio to 130 percent of GDP.

- A severe combined shock that incorporates the macro-fiscal and contingent liabilities adverse scenarios mentioned above would significantly affect the country's debt dynamics, with debt rising to 136 percent of GDP in 2020 and then remaining close to this level over the medium term.

[4] While the sale of Novo Banco to Lone Star has avoided its resolution, a contingent liability remains which could ultimately impact the public finances. After the completion of the sale, the Portuguese Resolution Fund retained control of 25 percent of Novo Banco's shares. Under the terms of sale, the Resolution Fund might be called upon to make additional (contingent) payments to Novo Banco of up to €3.89 billion (2 percent of 2017 GDP) depending on the performance of some of the bank's assets and the evolution of its capital adequacy ratio. The government recently agreed on an arrangement giving the Resolution Fund access to funding from the Portuguese Treasury if additional funding for such payments were to be needed and if the Resolution Fund does not have sufficient resources of its own. The payments themselves would be classified as government spending, given the sectorization of the Resolution Fund.

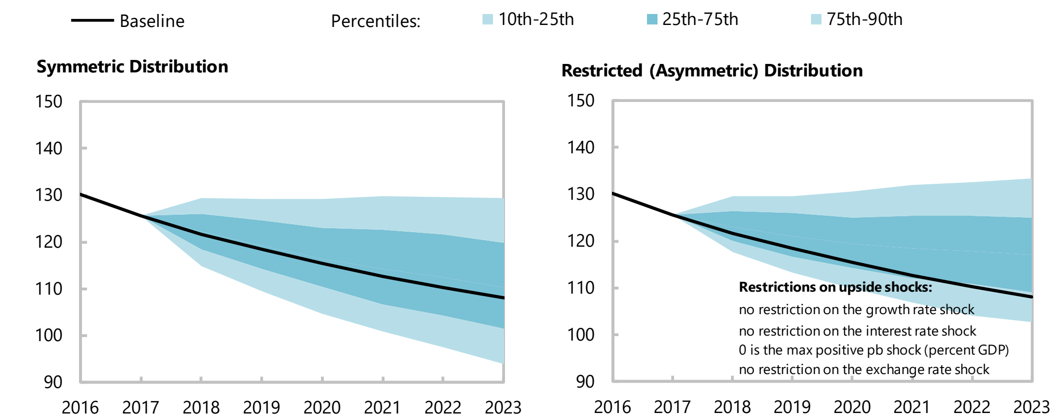
Figure 1. Portugal: Public DSA Risk Assessment, 2016–2023

Heat Map

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

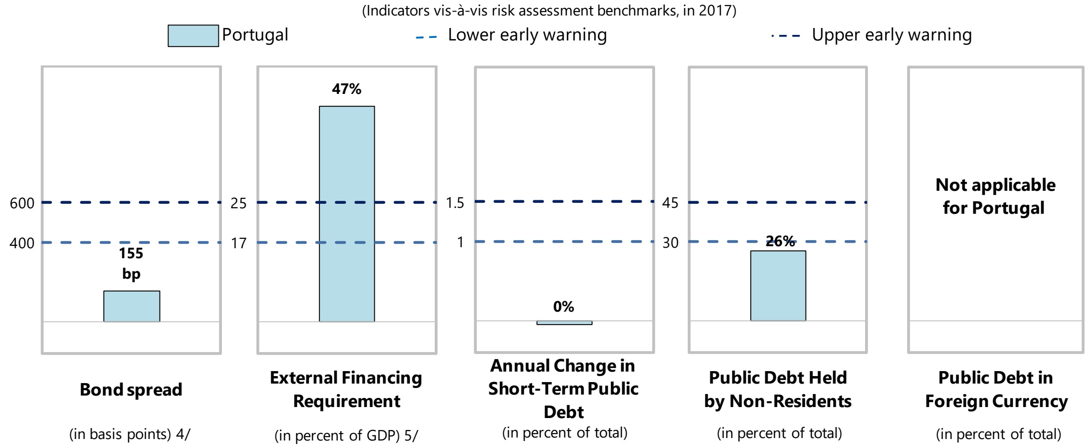
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2017)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

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

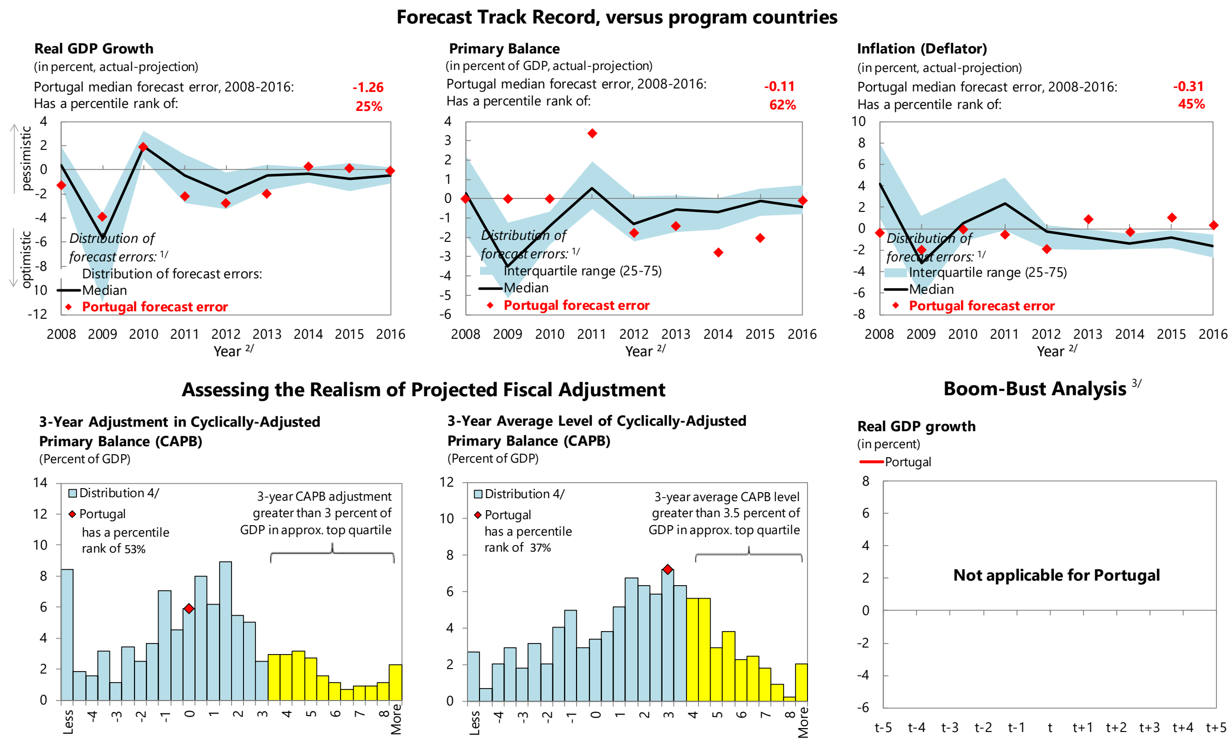
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant,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

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

4/ Long-term bond spread over German bonds, an average over the last 3 months, 20-Oct-17 through 18-Jan-18.

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.

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



Source : IMF Staff.

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

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

3/ 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, 2007–2023

(Percent of GDP, unless otherwise indicated)

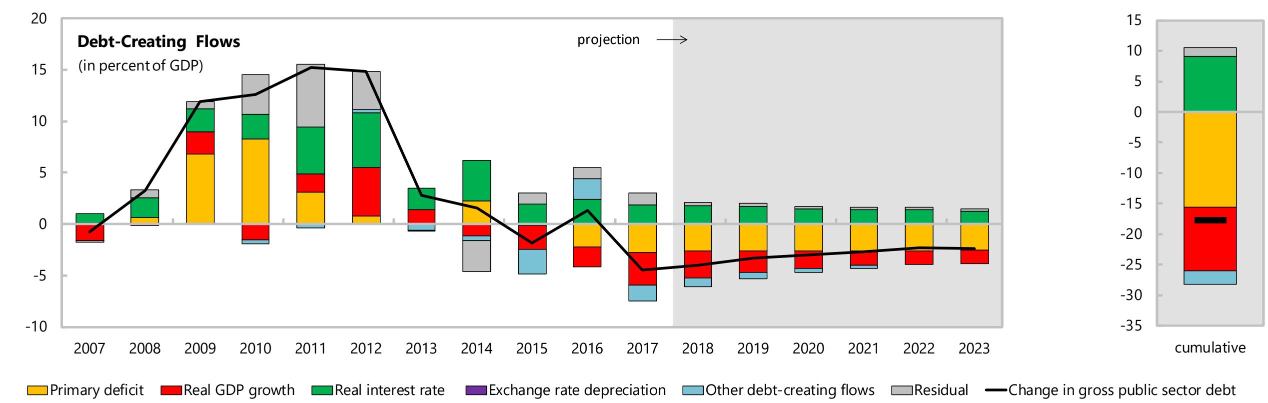
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2007-2015 [2/]	2016	2017	2018	2019	2020	2021	2022	2023
Nominal gross public debt	105.1	130.1	125.7	121.7	118.4	115.4	112.7	110.4	108.0
Public gross financing needs	24.2	18.5	18.3	14.1	14.1	13.4	17.1	14.8	13.5
Real GDP growth (in percent)	-0.3	1.5	2.6	2.2	1.8	1.5	1.2	1.2	1.2
Inflation (GDP deflator, in percent)	1.2	1.4	1.6	1.5	1.5	1.7	1.7	1.7	1.7
Nominal GDP growth (in percent)	0.9	3.0	4.2	3.7	3.3	3.2	2.9	2.9	2.9
Effective interest rate (in percent) [4/]	4.1	3.4	3.1	3.0	3.0	3.0	3.0	3.0	2.9

As of January 18, 2018		
Sovereign Spreads		
EMBIG (bp) 3/		145
5Y CDS (bp)		72
Ratings	Foreign	Local
Moody's	Ba1	Ba1
S&Ps	BBB-	BBB-
Fitch	BBB	BBB

Contribution to Changes in Public Debt

	Actual			Projections							
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	6.6	1.4	-4.4	-4.0	-3.3	-3.0	-2.7	-2.3	-2.4	-17.7	
Identified debt-creating flows	5.2	0.3	-5.6	-4.2	-3.6	-3.2	-2.9	-2.5	-2.6	-19.1	
Primary deficit	2.4	-2.2	-2.7	-2.6	-2.6	-2.6	-2.6	-2.6	-2.6	-15.6	0.0
Primary (noninterest) revenue and grants	42.6	43.0	43.2	43.2	43.0	42.9	42.8	42.7	42.6	257.2	
Primary (noninterest) expenditure	45.0	40.8	40.4	40.6	40.4	40.3	40.2	40.2	40.0	241.6	
Automatic debt dynamics [5/]	3.2	0.5	-1.4	-0.8	-0.4	-0.2	0.0	0.1	0.0	-1.4	
Interest rate/growth differential [6/]	3.2	0.5	-1.4	-0.8	-0.4	-0.2	0.0	0.1	0.0	-1.4	
Of which: real interest rate	2.8	2.4	1.9	1.8	1.7	1.5	1.4	1.4	1.3	9.1	
Of which: real GDP growth	0.4	-1.9	-3.2	-2.7	-2.1	-1.7	-1.3	-1.3	-1.3	-10.5	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.4	2.1	-1.5	-0.8	-0.6	-0.4	-0.4	0.0	0.0	-2.1	
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 (- means drawn down of deposits)	-0.1	2.1	-1.5	-0.8	-0.6	-0.4	-0.4	0.0	0.0	-2.1	
Residual, including asset changes [8/]	1.5	1.1	1.2	0.2	0.2	0.2	0.2	0.2	0.2	1.4	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Bond Spread over German Bonds.

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

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

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

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

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

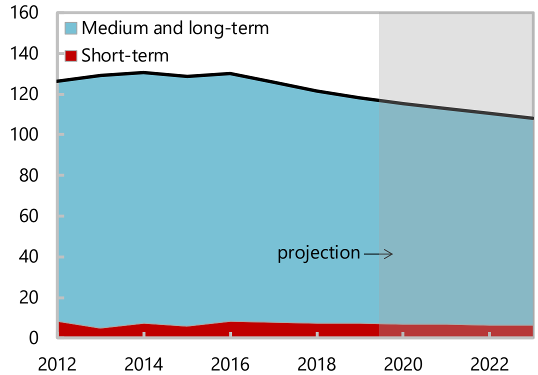
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 4. Portugal: Public DSA - Composition of Public Debt and Alternative Scenarios, 2012–2023

Composition of Public Debt

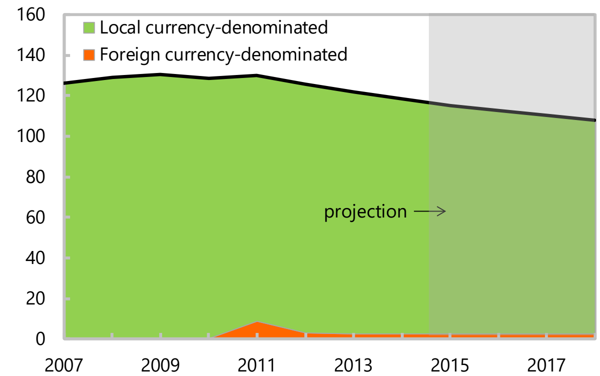
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

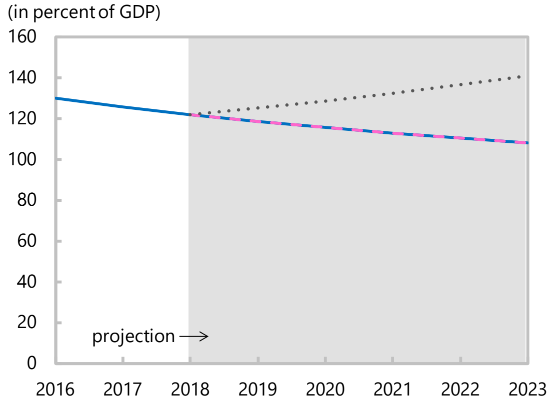


Alternative Scenarios

Baseline   Historical   Constant Primary Balance

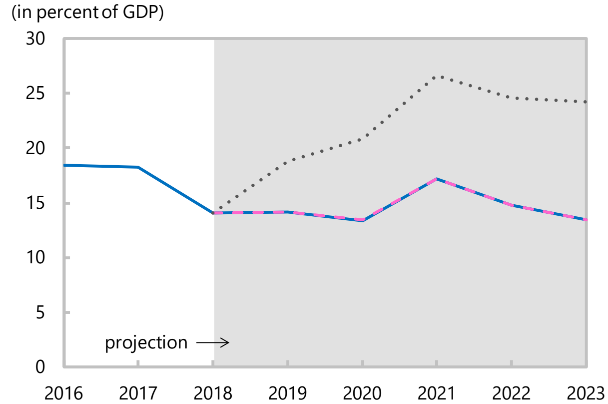
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

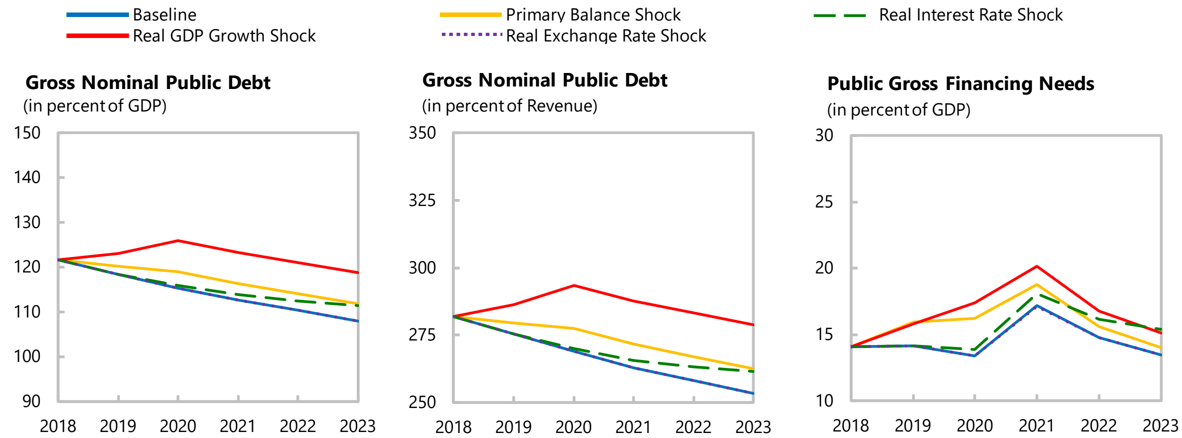
Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	2.2	1.8	1.5	1.2	1.2	1.2
Inflation	1.5	1.5	1.7	1.7	1.7	1.7
Primary Balance	2.6	2.6	2.6	2.6	2.6	2.6
Effective interest rate	3.0	3.0	3.0	3.0	3.0	2.9
Constant Primary Balance Scenario						
Real GDP growth	2.2	1.8	1.5	1.2	1.2	1.2
Inflation	1.5	1.5	1.7	1.7	1.7	1.7
Primary Balance	2.6	2.6	2.6	2.6	2.6	2.6
Effective interest rate	3.0	3.0	3.0	3.0	3.0	2.9

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	2.2	-0.1	-0.1	-0.1	-0.1	-0.1
Inflation	1.5	1.5	1.7	1.7	1.7	1.7
Primary Balance	2.6	-1.7	-1.7	-1.7	-1.7	-1.7
Effective interest rate	3.0	3.0	3.1	3.2	3.5	3.6

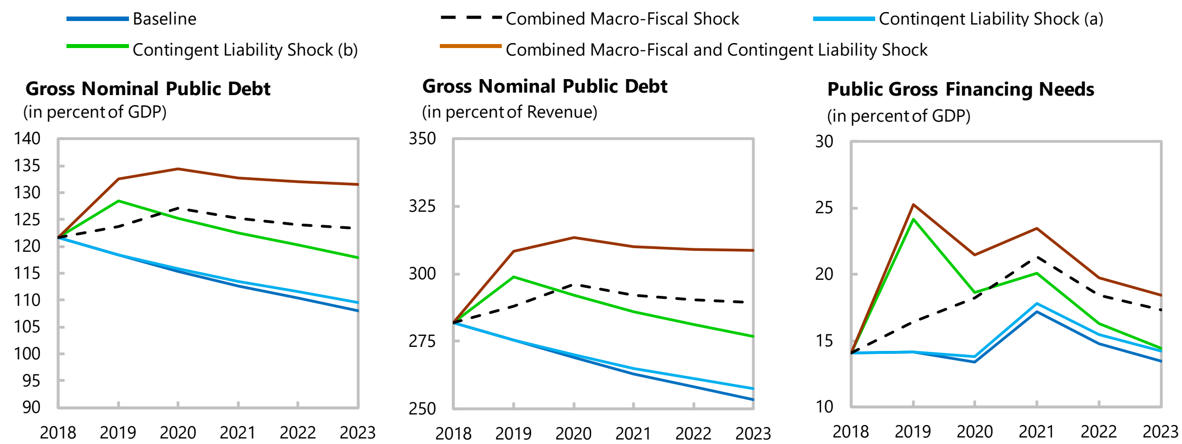
Source: IMF staff estimates.

Figure 5. Portugal: Public DSA - Stress Tests, 2018–2023

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2018	2019	2020	2021	2022	2023
Real GDP growth	2.2	1.8	1.5	1.2	1.2	1.2
Inflation	1.5	1.5	1.7	1.7	1.7	1.7
Primary balance	2.6	0.8	0.8	2.6	2.6	2.6
Effective interest rate	3.0	3.0	3.0	3.0	3.0	3.0
Real Interest Rate Shock						
Real GDP growth	2.2	1.8	1.5	1.2	1.2	1.2
Inflation	1.5	1.5	1.7	1.7	1.7	1.7
Primary balance	2.6	2.6	2.6	2.6	2.6	2.6
Effective interest rate	3.0	3.0	3.4	3.5	3.9	4.0
Combined Shock						
Real GDP growth	2.2	-0.5	-0.8	1.2	1.2	1.2
Inflation	1.5	0.9	1.1	1.7	1.7	1.7
Primary balance	2.6	0.8	0.3	2.6	2.6	2.6
Effective interest rate	3.0	3.0	3.4	3.6	4.0	4.2
Contingent Liability Shock (b)						
Real GDP growth	2.2	1.8	1.5	1.2	1.2	1.2
Inflation	1.5	1.5	1.7	1.7	1.7	1.7
Primary balance	2.6	-7.4	2.6	2.6	2.6	2.6
Effective interest rate	3.0	3.0	2.9	2.9	3.0	2.9

Real GDP Growth Shock	2018	2019	2020	2021	2022	2023
Real GDP growth	2.2	-0.5	-0.8	1.2	1.2	1.2
Inflation	1.5	0.9	1.1	1.7	1.7	1.7
Primary balance	2.6	1.5	0.3	2.6	2.6	2.6
Effective interest rate	3.0	3.0	3.0	3.0	3.0	3.0
Real Exchange Rate Shock						
Real GDP growth	2.2	1.8	1.5	1.2	1.2	1.2
Inflation	1.5	1.6	1.7	1.7	1.7	1.7
Primary balance	2.6	2.6	2.6	2.6	2.6	2.6
Effective interest rate	3.0	3.0	3.0	3.0	3.0	2.9
Contingent Liability Shock (a)						
Real GDP growth	2.2	1.8	1.5	1.2	1.2	1.2
Inflation	1.5	1.5	1.7	1.7	1.7	1.7
Primary balance	2.6	2.6	2.2	2.2	2.2	2.2
Effective interest rate	3.0	3.0	3.0	3.0	3.0	2.9
Combined Macro-Fiscal and Contingent Liability Shock						
Real GDP growth	2.2	-0.5	-0.8	1.2	1.2	1.2
Inflation	1.5	0.9	1.1	1.7	1.7	1.7
Primary balance	2.6	-8.0	2.1	2.6	2.6	2.6
Effective interest rate	3.0	3.0	3.5	3.8	4.1	4.3

Source: IMF staff estimates.

Annex II. Risk Assessment Matrix

Source of Risks	Relative Likelihood	Impact	Policy response
Loss of investor confidence due to reform reversals or other negative surprises potentially including difficulties in the banking system. • Increase in sovereign bonds yields and reduction in foreign direct investment.	Low	High Significant funding distress higher public and private borrowing costs.	Strengthen policy buffers and avoid backtracking on reforms to prevent negative domestic shocks. Step up efforts to implement policies that supports growth, lasting fiscal adjustment, and a strong banking system, which would contribute to shoring up investor confidence, and ease financing conditions and restraints.
Financial distress in one or more banks, requiring intervention.	Low	High Loss of confidence in the banking system, resulting in potentially high fiscal costs.	Proactive bank supervision to ensure balance sheet clean-up, a build-up of capital buffers in banks and of fiscal buffers. Strengthen oversight of banks' risk management practices. Shore up the banks using the existing toolkit, while ensuring public debt dynamics are not compromised.
Policy and geopolitical uncertainties: • **Policy uncertainty.** Two-sided risks to U.S. growth with difficult-to-predict policies; uncertainty associated with negotiating post-Brexit arrangements; and evolving political processes, including elections in several large advanced and emerging market economies weigh on global growth.	High	High Increased investor uncertainty and lower investment, undermining the cyclical recovery and medium-term growth prospects. Lower growth due to trade barriers. Escalation of euro skepticism, leading to less cooperation and a reversal of integration.	Accelerate structural reforms to support investment and growth. Strengthen fiscal policy adjustment to support investor confidence. Step up efforts to clean up corporate and bank balance sheets.

Source of Risks	Relative Likelihood	Impact	Policy response
Financial conditions: • **Tighter global financial conditions.** Fed normalization and tapering by ECB increase global rates and term premia, strengthen the U.S. dollar and the euro vis-à-vis the other currencies, and correct market valuations. Adjustments could be disruptive if there are policy surprises. Higher debt service and refinancing risks could stress leveraged firms, households, and vulnerable sovereigns, including through capital account pressures in some cases.	**High**	**High** Loss of market confidence, leading to wider spreads. Less favorable financial conditions as global conditions tighten.	Step up efforts to implement policies that support growth, lasting fiscal adjustment, and a strong banking system, which would contribute to shoring up investor confidence, and ease financing conditions and restraints.
• **European bank distress:** Strained bank balance sheets amid a weak profitability outlook could lead to financial distress in one or more major banks with possible knock-on effects on the broader financial sector and for sovereign yields in vulnerable economies.	**Medium**	Given its high corporate and private debt levels, Portugal would be highly susceptible to financial contagion. The result would be heightened financial stress in the Portuguese banking system, as balance sheet fragilities in both banking and corporate sectors are still significant.	Proactive bank supervision to ensure balance sheet clean-up, a build-up of capital buffers in banks and of fiscal buffers. Strengthen oversight of banks' risk management practices. Shore up the banks using the existing toolkit, while ensuring public debt dynamics are not compromised.
Weaker-than-expected global growth: • **Structurally weak growth in key advanced economies:** Low productivity growth (U.S., the Euro Area, and Japan), a failure to fully address crisis legacies and undertake structural reforms, and persistently low inflation (the Euro Area, and Japan) undermine medium-term growth in advanced economies.	**Medium (US, euro area, and Japan)** **Medium (Emerging Markets)**	**High** Low growth would imperil debt dynamics in all sectors: with the euro area accounting for 60 percent of total exports, the current account balance and IIP would be at risk.	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
• **Lower energy prices,** driven by stronger-than-expected U.S. shale and/or recovery of oil production in the African continent.	Low	Medium A low fuel import bill is potentially offset by greater difficulties in Angola, a key economic and financial partner.	Step up efforts to clean up corporate balance sheets, including the reduction of exposures to Angola. Shore up the banks using the existing toolkit, while ensuring public debt dynamics are not compromised. Renewed structural reform effort to expand exports to other markets.

Note: The Risk Assessment Matrix shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of the staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more).