INTERNATIONAL MONETARY FUND

IMF Country Report No. 16/97

PORTUGAL

March 2016

THIRD POST-PROGRAM MONITORING DISCUSSIONS—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR PORTUGAL

In the context of the 2016 Third Post-Program 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 March 30, 2016, following discussions that ended on February 3, 2016, with the officials of Portugal on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on March 15, 2016.
- A **Statement by the Executive Director** for Portugal.

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Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

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Press Release No. 16/147
FOR IMMEDIATE RELEASE
April 1, 2016

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

IMF Executive Board Concludes Third Post-Program Monitoring with Portugal

On March 30, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Third Post-Program Monitoring with Portugal[1].

Highly accommodative macroeconomic conditions have generated only modest growth in the presence of remaining structural impediments. In 2015, low interest rates, a weak euro, and low oil prices—noted in earlier staff reports—remained largely in place, allowing growth to reach 1.5 percent. As the consumption-driven recovery is losing momentum, however, GDP is projected to expand by only 1.4 percent this year and to moderate to 1.2 percent over the medium term.

Portugal appears to have missed the 2015 fiscal deficit target, and is expected to remain in the EU's Excessive Deficit Procedure. Staff estimates a full-year deficit of 4.4 percent of GDP, compared to the budget target of 2.7 percent, implying a loosening of 0.5 percent of GDP in the structural primary terms. The deficit exceeded the budget plan despite larger-than-expected savings on interest and social expenditures (reflecting the fall in unemployment), as revenues fell well short of the authorities' ambitious targets.

The banking system is hobbled by low profitability and poor asset quality, and required public support as recently as December 2015. At the same time, Portugal's stock of corporate debt remains one of the highest in the EU, thereby precluding the allocation of credit to new productive sectors of the economy. On the structural side, the policy changes—already implemented or under consideration—imply at least a partial reversal of structural measures introduced during the Fund-supported program.

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

Executive Board Assessment[2]

Executive Directors welcomed the successful stabilization of Portugal's economy under the Fund-supported program which has paved the way for the ongoing recovery and a decline in unemployment. They noted, however, that significant challenges remain, particularly those arising from the high level of public and corporate debt, unresolved structural impediments, the need to raise the underlying growth potential, and from the uncertain global environment. Directors encouraged the authorities to build on the progress made thus far and to continue to pursue prudent policies and reforms to secure sustainability of public finances, maintain market confidence, address financial sector vulnerabilities, and boost competitiveness and potential growth.

Directors welcomed the authorities' commitment to fiscal and debt sustainability and encouraged them to follow through with the adjustment process while supporting recovery. To guard against fiscal risks and to maintain market confidence, they highlighted the importance of developing contingency plans to ensure that the 2016 budget targets are met, rationalizing public spending to contain pressures from public wages and pensions, and maintaining fiscal buffers.

Directors noted that while Portugal's banking system has made progress, further efforts are needed to strengthen bank balance sheets. They encouraged the authorities to build on past measures to improve bank profitability, asset quality, and governance. Maintaining confidence in the financial sector will require vigilance, a build-up of fiscal buffers, and greater transparency with regard to financial sector operations. Directors recommended a more comprehensive strategy to address nonperforming loans along with an ambitious approach to corporate debt workouts, noting that the debt overhang holds back the economy's growth potential.

Directors emphasized that continued progress on structural reforms is critical to enhance medium-term growth prospects, employment, and income. They encouraged the authorities to keep making progress on labor market and public administration reforms, and avoid any perception of reversal of recent and complex reforms so as to maintain investor confidence and boost the economy's growth potential.

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

Portugal: Selected Economic Indicators, 2014–17

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

		Est.	Projections	
	2014	2015	2016	2017
Real GDP	0.9	1.5	1.4	1.3
Private consumption	2.2	2.6	1.5	1.3
Public consumption	-0.5	0.8	0.0	0.5
Gross fixed capital formation	2.8	3.7	3.0	2.5
Exports	3.9	5.1	4.2	4.3
Imports	7.2	7.3	4.0	4.5
Contribution to growth (Percentage points)				
Total domestic demand	2.2	2.5	1.5	1.4
Foreign balance	-1.3	-1.0	0.0	-0.2
Resource utilization				
Employment	1.6	1.1	1.0	0.5
Unemployment rate (Percent)	13.9	12.4	11.6	11.1
Prices				
GDP deflator	1.0	1.9	1.5	1.4
Consumer prices (Harmonized index)	-0.2	0.5	0.7	1.2
Money and credit (End of period, percent change)				
Private sector credit	-8.0	-4.1	0.3	0.6
Broad money	-0.9	3.9	2.4	2.2
Fiscal indicators (Percent of GDP)				
General government balance[1]	-7.2	-4.4	-2.9	-2.9
Primary government balance	-2.3	0.3	1.7	1.6
Structural primary balance (Percent of potential GDP)	3.5	3.0	2.5	2.0
General government debt	130.2	128.8	127.9	127.3
Current account balance (Percent of GDP)	0.1	0.5	0.9	0.4
Nominal GDP (Billions of euros)	173.4	179.4	184.6	189.6

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

[1]In 2014, one-off measures from SOE and banking sector support operations, CIT credit, and the upfront costs of mutual agreements amounted to 3.7 percent of GDP. In 2015, fiscal cost from the resolution of Banif amounted to 1.2 percent of GDP.

INTERNATIONAL MONETARY FUND

PORTUGAL

THIRD POST-PROGRAM MONITORING

March 15, 2016

KEY ISSUES

Highly accommodative macroeconomic conditions have generated only modest growth in the presence of remaining structural impediments. In 2015, low interest rates, a weak euro, and low oil prices remained largely in place, allowing growth to reach 1.5 percent. However, the consumption-driven recovery is losing momentum as the savings rate reaches historic lows, the rapid decline in the unemployment rate comes to an end, and improvements in high-frequency indicators taper off. GDP is projected to expand by 1.4 percent this year and moderate to 1.2 percent over the medium term.

The 2016 budget proposal appears insufficiently ambitious to put public debt on a firmly downward trajectory, with significant risks to execution. In the absence of additional measures, staff projects an overall deficit of around 2.9 percent of GDP and a primary structural easing of 0.5 percent of GDP. Spending reforms are needed to contain pressures from public wages and pensions (about 25 percent of GDP). Recently adopted tax policy changes will hinder the rebalancing of the economy, with the focus shifting from improving competitiveness to supporting non-exporting sectors.

Bank balance sheets need to be strengthened to avoid further negative surprises and protect taxpayers. Recent developments underscore the need to continue to build on efforts to improve bank profitability, asset quality, and governance. These efforts need to be complemented with a more ambitious approach to corporate debt workouts. A substantial share of banking system assets remains tied up in low productivity activities, holding back the economy's growth potential.

Envisaged labor and product market policies imply at least a partial reversal of structural measures introduced during the Fund-supported program. A weakening of reforms that have improved labor market flexibility could diminish medium-term prospects for growth, employment, and income.

Further policy reversals would undermine investor confidence. The risks to Portugal's capacity to repay the Fund are expected to be manageable under the baseline, but are rising. Rising bond yields—including the sharp spike in February—underline the need for stability in the policy framework.

Approved By
Mahmood Pradhan and Seán Nolan

Discussions took place in Lisbon during January 27 – February 3, 2016. The staff team comprised S. Lall (head), M. Gaertner, D. Gershenson, I. Yackovlev (all EUR); K. Wiseman (SPR); M. Queyranne (FAD); and A. Bouveret (MCM). D. Smith and D. Santos (both EUR) provided assistance from headquarters.

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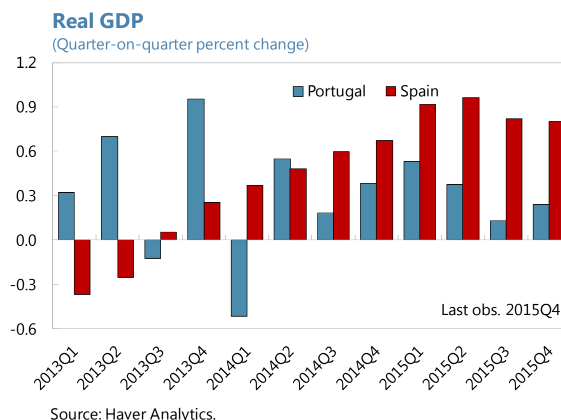
RECENT DEVELOPMENTS, OUTLOOK AND RISKS

1. **Since the second Post-Program Monitoring, a new government assumed office on November 26.** The minority government–led by the center-left Socialist party and supported by two smaller left-wing parties—has pledged to boost growth and household incomes through a menu of policy measures as described further in this report. Presidential elections were also held on January 24, with the centre-right candidate elected in the first round of balloting.

Real GDP
(Quarter-on-quarter percent change)



Source: Haver Analytics.

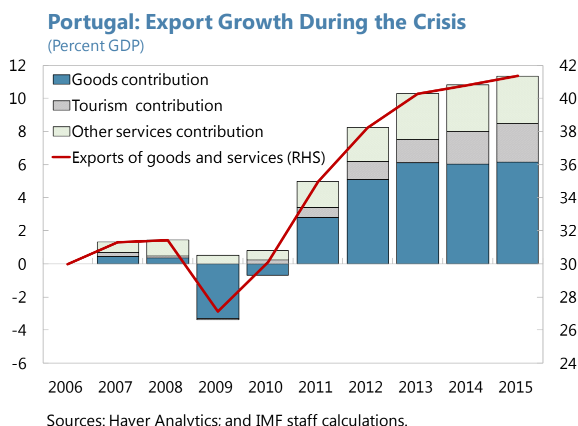
2. **Highly accommodative macroeconomic conditions generated only modest growth in the presence of remaining structural impediments.** In 2015, low interest rates, a weak euro, and low oil prices remained largely in place. Aided by this favorable environment, an expansionary fiscal stance at home, and strong growth in Spain—Portugal's largest export market—real GDP grew by 1.5 percent.

Contributions to Year-on-Year Growth
(Percentage points, unless indicated otherwise)

	2014	2015
Total domestic demand	**2.2**	**2.5**
Final consumption expenditure	1.4	1.9
Public	-0.1	0.1
Private	1.5	1.7
Gross fixed capital formation	0.4	0.6
Changes in inventories	0.4	0.0
Foreign balance	**-1.3**	**-1.0**
Exports, goods and services	1.6	2.1
Imports, goods and services	-2.9	-3.1
Real GDP growth (Percent)	**0.9**	**1.5**

3. **The consumption-driven recovery is running out of steam.** With investment constrained by the overhang of public and private debt and by weaknesses in the banking system, private consumption has been the engine of the current recovery. Although high taxes are necessary due to limited fiscal space, they inhibit the growth of disposable income. Consumption nevertheless grew briskly—on account of falling unemployment and declining uncertainty— facilitated by lower savings. In recent months, however, the rapid decline in the unemployment rate came to an end (Box 1), the savings rate reached historic lows, and high-frequency indicators stabilized.

Portugal: Export Growth During the Crisis
(Percent GDP)



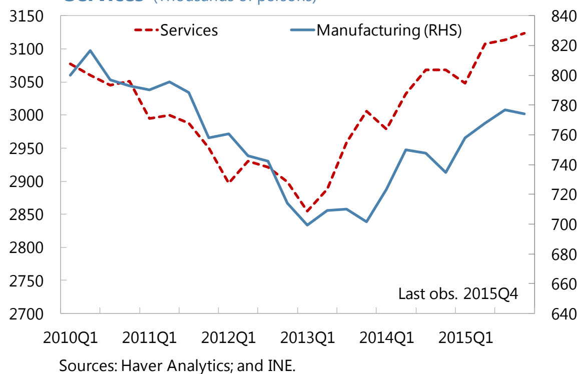
Sources: Haver Analytics; and IMF staff calculations.

4. **The export sector remains a bright spot.** In 2015, credit to exporters increased despite contracting overall, suggesting benefits from structural reforms and from improvements in

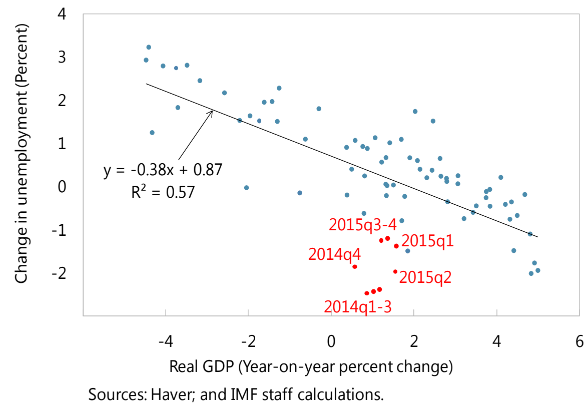
Box 1. Portugal: Employment Trends

Following a spike in the unemployment rate in early 2013 and its subsequent sharp decline, the unemployment rate has stabilized. Employment is now close to its mid-2014 level, and the unemployment rate has been around 12 percent in the last three quarters of 2015. The post-crisis decline in the unemployment rate—driven by services (especially, transport, health, and hotel subsectors) and manufacturing—has moderated and is now more in line with the pace of recovery.

Portugal: Employment in Manufacturing and Services (Thousands of persons)

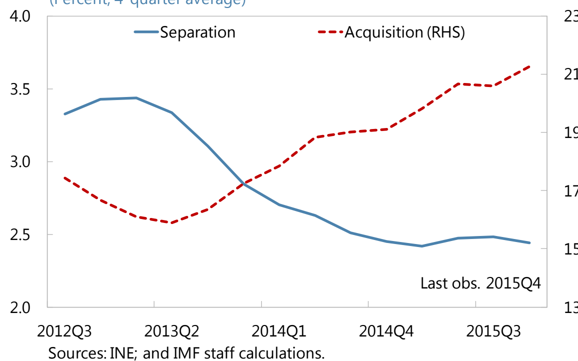


Portugal: Okun Relationship, 1996Q1–2015Q4

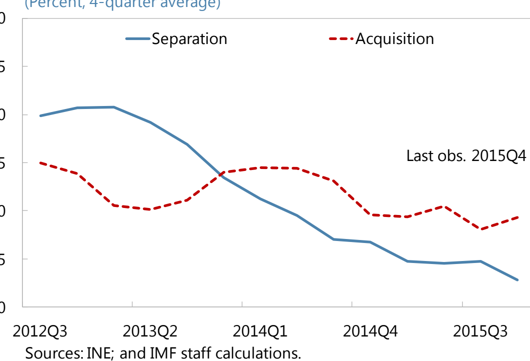


A fundamental issue facing Portugal is a decline in the working-age population (and in the labor force) driven by aging and emigration. This is underscored by trends in the job separation and acquisition rates. Excluding the movements in and out of the labor force, the separation rate declined, while the acquisition rate increased, as would normally be expected in a recovery.[1] Including the movements in and out of the labor force, both the separation rate and the acquisition rate declined, reflecting the contraction in labor force during this period.[2]

Portugal: Rates of Job Separation and Acquisition Excluding Movements in and out of Labor Force
(Percent, 4-quarter average)



Portugal: Rates of Job Separation and Acquisition Including Movements in and out of Labor Force
(Percent, 4-quarter average)

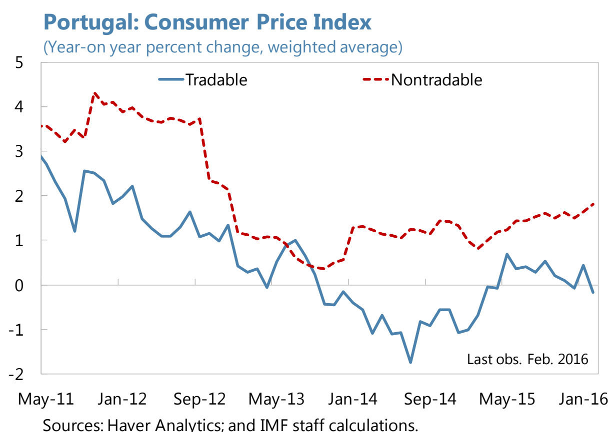


[1]Excluding movements in and out of labor force, the separation rate is the ratio of (A) people who transition from employment to unemployment to (B) employment in the preceding quarter. The acquisition rate is the ratio of (A) people who transition from unemployment to employment to (B) the number of people who were unemployed in the preceding period.

[2]Including movements in and out of labor force, the separation rate is the ratio of (A) people who either (i) transition from employment to unemployment or (ii) lose employment and leave the labor force to (B) employment in the preceding quarter. The acquisition rate is the ratio of (A) people who transition either (i) from unemployment to employment or (ii) from outside labor force to employment to (B) the number of people who were either unemployed or outside the labor force in the preceding period.

competitiveness relative to the pre-crisis era. The share of exports in GDP has risen from below 30 percent before the crisis to the current 41 percent. This growth has been broad-based, with contributions from both goods and services, especially tourism. The current account registered a third consecutive yearly surplus following two decades of deficits. The fall in oil prices has contributed to the surplus in spite of lower export demand from Angola and other countries dependent on extractive industries.

5. **Inflation in Portugal is rising compared with its European peers.** Portugal has migrated from the low to the high end of the euro area's inflation spectrum. This is primarily driven by inflation in the nontradables sector, which continues to outpace that of tradables. While overall higher inflation would be welcome given the high debt overhang, if the composition remains tilted towards nontradables it could undermine recent efforts to rebalance the economy and improve competitiveness.



Sources: Haver Analytics; and IMF staff calculations.

6. **Downside risks are rising from both domestic and external sources.** Growing market concerns about Portugal's hard-won policy credibility—due to recent events in the banking sector and the risk of reform reversals—are exerting upward pressure on public borrowing costs as evidenced in higher yields since October 2015. These developments are unfolding against the backdrop of rising global risk aversion. Additional negative surprises in the domestic economy or a deterioration in the global outlook (e.g. disappointing export-partner growth) could further undermine investor confidence (see RAM). Over the medium term, lower-than-expected productivity growth arising from stalled structural reforms, or disappointing growth in major trading partners, would also put debt sustainability at risk.

7. **A downgrade in Portugal's sole investment grade credit rating to sub-investment grade constitutes a near-term risk with potentially large consequences.** Continued debt purchases under the ECB's Public Sector Purchase Program (PSPP) and the use of sovereign debt as collateral for ECB financing to banks both depend on Portugal's credit rating remaining above investment grade with at least one rating agency. At the moment, this condition is being met by rating agency DBRS's investment grade rating, which is due for review on April 29.

Staff views

8. **The economy appears to have reached the upper speed limit of its post-crisis growth momentum.** GDP is projected to expand by 1.4 percent this year under continued generally supportive external conditions assumed under the baseline. While the increase in the share of exports to GDP since 2011 has helped stabilize the current account, further gains in external competitiveness are not envisaged under the baseline. Growth is expected to moderate to

1.2 percent over the medium term, as the recent pattern of declining savings—which has been financing higher consumption—reaches its natural limit, and cyclical conditions normalize. The large overhang of corporate debt and structural impediments to growth limit the upside to the central forecast, while downside risks are somewhat more pronounced due to the increasingly uncertain external environment, continued weakness in the financial sector, and likely negative impact from the rollback of some structural reforms such as possibly less flexible collective bargaining, and higher minimum wages.

9. The policy framework put in place in previous years has helped restore the sovereign's market access at favorable yields and ensured Portuguese banks' ability to tap liquidity, and preserving this remains a key policy priority. Loss of investment-grade status would have serious repercussions going beyond the first-round effects on investor sentiment. The investor base for sovereign bonds would narrow, with some foreign institutional investors potentially obligated to cut their holdings of Portuguese paper. Absent a policy change by the ECB, further PSPP purchases would have to be halted. Banks would face the impact of the downgrade on their collateral buffers.

10. Outstanding risks underscore the need to build fiscal buffers and to demonstrate a commitment to hard-won reforms. As the recent spike in bond yields highlighted, Portugal's ongoing refinancing operations remain highly vulnerable to shifts in market sentiment. Maintaining a healthy cash buffer and identifying concrete measures to be activated in case of fiscal underperformance would help reinforce credibility and reassure markets.

Authorities' views

11. The authorities were of the view that a consumption-friendly 2016 budget will boost demand and growth. They saw the planned measures to support lower income households and the shift from direct to indirect taxes as benefitting those with a higher marginal propensity to consume, leading to an expansion of GDP of 1.8 percent. The authorities indicated that this would provide a bridge to sustainable investment-driven growth, which is expected to pick up as the structural reforms that were implemented under the 2011–14 program bear fruit.[1]

Portugal: Macroeconomic Projections, 2016
(Year-on-year percent change)

	Min. of Finance	IMF staff
GDP	**1.8**	**1.4**
Private consumption	2.4	1.5
Public consumption	0.2	0.0
Gross fixed capital formation	4.9	3.0
Exports (goods and services)	4.3	4.2
Imports (goods and services)	5.5	4.0

Sources: Ministry of Finance 2016 Budget Proposal; and IMF staff estimates.

[1] The authorities' views on the medium-term growth prospects remain as outlined in *IMF Country Report 15/226.*

POLICY DISCUSSIONS

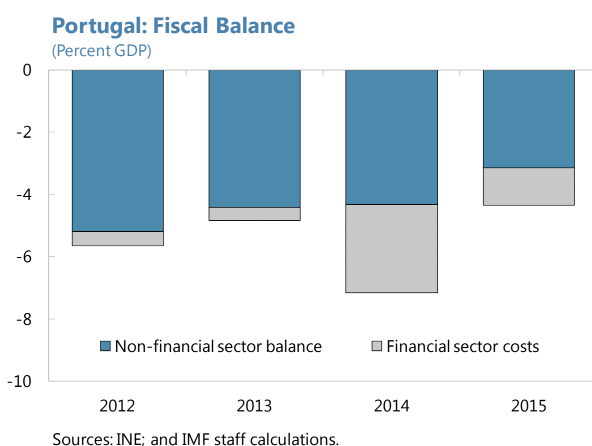
A. Preserving Debt Sustainability Anchored by European Commitments

12. Portugal appears to have missed the 2015 fiscal deficit target, and is expected to remain in the EU's Excessive Deficit Procedure. Staff estimates a full-year deficit of 4.4 percent of GDP,[2] compared to the budget target of 2.7 percent, implying a loosening of 0.5 percent of GDP in the structural primary fiscal balance. The deficit exceeded the budget plan despite larger-than-expected savings on interest and social expenditures (reflecting the fall in unemployment), as revenues fell well short of the authorities' ambitious targets.

13. The weak financial sector continued to require budgetary support. The resolution of Banif in December 2015 amounted to a fiscal cost of at least 1.2 percent of GDP.[3] In addition, the 2014 fiscal outturn has been revised to reclassify the loan provided to the Portuguese Resolution Fund for the recapitalization of Novo Banco as a fiscal outlay, increasing the deficit to 7.2 percent of GDP from the 4.5 percent that was initially reported.

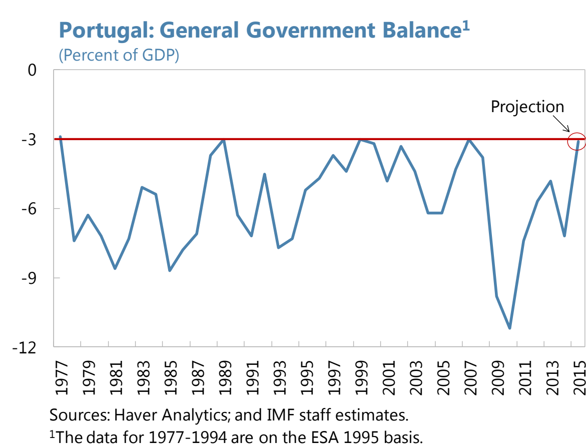
14. The 2016 budget proposal represents a clear departure from Portugal's medium-term fiscal commitments under the 2015 Stability Program. It targets a fiscal deficit of 2.2 percent of GDP, compared with 1.8 percent in the Stability Program submitted to the EU last April. The budget proposal relies on more optimistic macroeconomic projections than in staff's baseline, and calls for increases in a range of indirect taxes and one-off levies to accommodate the expiration of several program measures. In addition, the budget projects sizable expenditure savings from phasing-out several social and vocational training programs, cutting back on active labor market policies, and introducing a nominal freeze on intermediate consumption. Fiscal policy is geared toward increasing households' income by fully reversing public sector wage cuts this year and scaling back the personal income tax surcharge.

Portugal: Fiscal Balance
(Percent GDP)



Sources: INE; and IMF staff calculations.

Portugal: General Government Balance[1]
(Percent of GDP)



Sources: Haver Analytics; and IMF staff estimates.
[1]The data for 1977-1994 are on the ESA 1995 basis.

[2] Including fiscal costs related to the resolution of Banif.

[3] The final fiscal cost will be calculated by the National Institute of Statistics once the liquidation of Banif is complete.

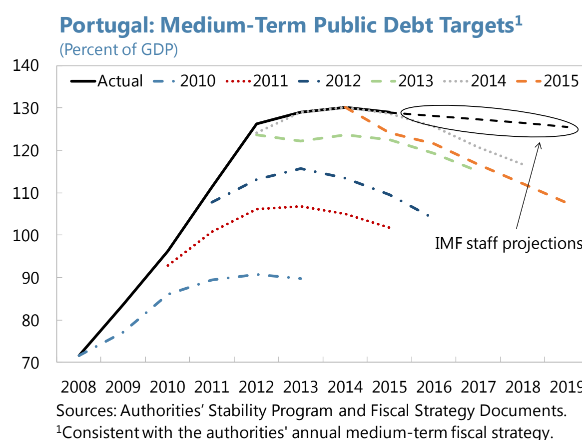
15. The authorities have committed to prepare additional measures if required to achieve this year's budget target. The original draft budget had proposed a fiscal deficit of 2.6 percent of GDP. This was subsequently revised to the current target of 2.2 percent after the European Commission (EC) expressed concerns that the implied structural adjustment fell well short of the 0.6 percent of GDP adjustment required under the Stability and Growth Pact. The EC accepted the revised budget plan, despite the implied adjustment of only 0.2 percent of GDP (if the target is met), but agreed with the authorities that an additional set of measures would be prepared to be implemented when needed.

Staff views

16. The budget appears insufficient to put public debt on a firmly downward trajectory, with significant risks to execution. The projected revenue yield from indirect tax increases appears optimistic, while across-the-board measures to limit spending growth lack specificity. In particular, enforcing a nominal across-the-board freeze in intermediate consumption is likely to be challenging, and will require stronger controls at all levels of government. Health sector arrears should also be closely monitored, as hospitals will not receive further support to clear their outstanding stock or contain further accumulation. In the absence of additional measures, staff projects an overall deficit of around 2.9 percent of GDP under its baseline and an implied primary structural easing of 0.5 percent of GDP. This would do little to reduce Portugal's high public debt, which amounted to nearly 129 percent of GDP at end-2015, and leave the country vulnerable to shifts in market sentiment.

17. Expenditure reforms are needed to rein in pressures from public sector wages and pensions (about 25 percent of GDP). After achieving a 10 percent reduction in public employment during 2011–14, further rationalization will prove challenging given recruitment needs in some sectors, notably health care. In addition, the reinstatement of the 35-hour week could generate additional wage spending arising from increased overtime pay. Finally, the savings on pensions projected in the 2015 Stability Program (0.3 percent of GDP in 2016) will not materialize, and past pension reforms could be partially reversed. Additional measures will be needed to contain spending pressures arising from the wage bill and age-related spending.

Portugal: Medium-Term Public Debt Targets[1]
(Percent of GDP)



Sources: Authorities' Stability Program and Fiscal Strategy Documents.
[1]Consistent with the authorities' annual medium-term fiscal strategy.

18. Recently adopted tax policy changes will hinder the rebalancing of the economy by shifting from improving competitiveness to support of the nontradables sector. The suspension of further reductions in corporate income tax rates and the partial reversal of reforms to international tax provisions and the corporate income tax (CIT) regime are expected to reduce Portugal's capacity to attract and retain large international companies. Lower value added tax rates

on restaurants and the reduction in social security contributions related to the increase in the minimum wage will mostly benefit the nontradables sector.

Box 2. Portugal: December 2015 Financial Sector Operations

The banking sector's performance was punctuated by two shocks in late-2015: the resolution of Banco Internacional do Funchal (Banif) and the transfer of select senior debt obligations of Novo Banco to Banco Espírito Santo (BES).

- On December 20, the authorities announced the resolution of Banif and the transfer of the majority of its assets and liabilities to Santander Totta. Assets with a book value of €2.2 billion were transferred from Banif to an asset management vehicle (AMC) owned by the Resolution Fund. A total of €2.255 billion was injected into the bank by the Treasury (€1.766 billion) and by the Resolution Fund (€489 million); the bank was then sold to Santander Totta for €150 million. Santander Totta also received €746 million in bonds issued by the AMC, guaranteed by the Resolution Fund and counter-guaranteed by the Treasury. As a result of this operation, the Resolution Fund's liabilities have increased significantly, and this will entail further contributions from the banking sector in the future. All depositors and senior bondholders were protected. While the resolution was anticipated for some time, its high fiscal cost to taxpayers (1.2 percent of GDP in 2015) was a surprise. On February 24, the government issued a medium-term note of €1.8 billion to Santander Totta in a quid pro quo for the December capital injection into Banif.

- On December 29, the resolution authority approved a number of decisions that completed the resolution of BES. Five issuances of senior debt obligations (out of more than 50) valued at €2.0 billion (4 percent of total liabilities) were transferred from Novo Banco back to its predecessor BES. This action increased Novo Banco's capital by €2.0 billion, leaving it with a CET1 ratio of approximately 13 percent, and covering the €1.4 billion shortfall identified by the November 2015 stress test (under the adverse scenario). The transfer of a subset of senior debt obligations of Novo Banco has bolstered the bank's capital but also given rise to litigation and reputational risks for the banking system. This measure came as a surprise to some investors, and bondholders whose claims were transferred signaled their intention to litigate the decision on the grounds that it violates *pari passu*.

19. The authorities need to prepare a specific set of contingency measures to be activated if there is evidence that the budget deficit target of 2.2 percent of GDP cannot be attained. This would entail scaling back and/or undoing some of the measures in the 2016 budget. On the expenditure side, proposals regarding the full reversal of civil service wage cuts this year would need to be reconsidered over a longer time horizon, while more concrete proposals to reduce expenditures should be developed in parallel. Similarly, the reversal of the PIT surcharge and reduction of VAT in some categories would need to be postponed until appropriate fiscal space can be identified.

Authorities' views

20. The authorities acknowledged the importance of debt reduction, but emphasized the need to address the low level of household disposable income and the rise in poverty. They considered the 2016 budget as striking an appropriate balance in this regard, while noting that the eventual reversal of public wage cuts was required under the Constitutional Court ruling of 2014. The authorities emphasized their intention to stabilize public sector employment over the medium

term and noted that planned increases in social benefits would be accompanied by a shift toward means-tested programs that would achieve greater efficiency in poverty reduction. The authorities were confident that the revenue projections in the budget were well within reach, and contended that the shift from direct to indirect taxation would support growth.

B. Maintaining Financial Sector Stability

21. Low profitability, lackluster asset quality and banks' internal corporate governance issues are holding back the financial sector's recovery and exposing the banking system to heightened risk. Banks continue to struggle to increase profitability due to the slow pace of cost reduction and dwindling income from international and trading activity. The return on assets of the banking system is positive, but remains very low, reflecting underlying weaknesses in the quality of assets (Figure 4). Impairment charges during January-September 2015 totaled €2.2 billion for the eight largest banks, and non-performing loans continued to increase, although coverage levels remained fairly stable. Despite these challenges, banks' Common Equity Tier 1 (CET1) capital remained broadly stable. Banks' loan-to-deposit ratio declined to 104 percent on average, whereas the steady decline in Eurosystem financing that began in March 2015 abated, with Eurosystem financing rising by €2.85 billion in December 2015 to €29.6 billion (equivalent to 7.6 percent of bank assets). This rise reflects in part liquidity pressures following two shocks: the resolution of Banif and the transfer of select senior debt obligations of Novo Banco back to its predecessor, Banco Espírito Santo (Box 2). These developments, coupled with low profitability and subsequent search-for-yield behavior, have placed risk governance and data quality issues in the spotlight for both regulators and market participants.

22. A tightening of capital requirements began in 2015 with the supervisory review and evaluation process (SREP) conducted by the European authorities, and it has continued with the add-on of a capital conservation buffer and additional systemic capital buffers by the Bank of Portugal on January 1, 2016. The minimum capital requirement resulting from the SREP assessment reflects the up-to-date supervisory view of each institution's risks. The macroprudential toolkit includes requirements for all banks to implement a capital conservation buffer of 2.5 percentage points of CET1 and for other systemically important institutions to hold a capital reserve of up to 1 percentage point of CET1, from January 1, 2017. These measures are intended to further adjust capital requirements to account for the risk of contagion. Given the challenges facing Portugal's banking system, most banks are now required to hold capital well in excess of the regulatory minimum.

Staff views

23. Bank balance sheets need to be strengthened to avoid further negative surprises and protect taxpayers. Recent developments underscore the need to continue to build on past efforts to improve bank profitability, asset quality, and governance.[4]

- In broad terms, banks need to reduce operating costs, divest from non-core and unprofitable activities, and improve asset quality in the context of the SREP assessment.
- In order to implement more ambitious restructuring plans, to address contingent liabilities, and to make necessary improvements to asset quality, banks need to move decisively on several fronts. They should reinforce their loss absorption capacity by increasing capital buffers. In the first instance, raising capital should be the responsibility of banks themselves, with recourse to public funds only when private capital is not forthcoming. Second, banks should also make steady progress on changing the composition of their balance sheets to meet the Minimum Requirement for Own Funds and Liabilities (MREL) by the end of 2019.
- Banks also need to pay increased attention to improving their structural liquidity position, in light of underlying vulnerabilities and rising risks that may strain banks' access to liquidity in the future.
- Both supervisory authorities and shareholders should continue their efforts to strengthen bank governance, identifying and addressing problems early on. The process of selection and appointment of Board members and management should be reviewed to ensure that, in addition to meeting fit and proper requirements, appointees are incentivized to make operations more profitable at a faster pace. The role of the risk management and audit committees should continue to be strengthened to minimize credit risk and ensure proper accountability.
- Adequate fiscal buffers and greater transparency with regard to financial sector operations will be essential to maintaining confidence. Coordination between supervisors, competition authorities and banks' management will remain central to ensuring banking system issues are addressed expeditiously. More broadly, the banking system's significant challenges call for continued vigilance by supervisory and regulatory authorities and the banks themselves to prevent further negative surprises.

[4] Beyond the broad financial sector priorities outlined in this paragraph, access to more granular data and with shorter time lags would facilitate more effective surveillance by Fund staff with regard to the banking system, thereby leading to more targeted policy advice. In this context, a review by supervisory authorities of the legal impediments to information sharing with the Fund is encouraged.

Authorities' views

24. There is a growing domestic consensus on the key risks confronting the financial system in terms of asset quality, profitability, capital and governance. As part of the SREP assessment, banks will be required to submit funding and capital plans consistent with stable funding, a return to profitability and a reinforcement of capital. Improvements in asset quality are also seen as important, and the authorities are contemplating measures to incentivize banks to dispose of NPEs, including through higher provisions and impairments. Regarding governance and risk management, the authorities acknowledge that the role and organization of audit and risk committees at several banks could be improved.

Box 3. The EU Bank Recovery and Resolution Directive

The EU Bank Recovery and Resolution Directive (BRRD) provides authorities with a comprehensive toolkit to deal with failing banks at the national level, as well as defined mechanisms for cooperation in cross-border bank failures. The European resolution framework aims to protect certain critical stakeholders and functions of the failing bank (such as depositors and payment systems), considered key to financial stability. A hallmark of the framework is the expectation that shareholders and debt holders will bear an appropriate share of the losses (up to 8 percent of bank liabilities) in the event of a failure, to minimize the use of taxpayer money in support of failed banks. The BRRD allows for only limited flexibility of the bail-in powers in exceptional circumstances allowing resolution authorities to exclude or partially exclude certain liabilities from the application of the write-down or conversion powers.

As of January 1, 2016, the BRRD is fully in force across the EU, and use of the BRRD bail-in toolkit will now be required for any bank resolution. In Portugal, where it was transposed in March 2015, bank resolutions will now follow the requirements and procedures laid out in the BRRD, as applied under the Single Resolution Mechanism (SRM). Any use of public funds in resolution continues to be subject to the monitoring and approval of the Directorate General of Competition at the EC.

The Portuguese Resolution Fund will continue to play an important role in implementing resolution and restructuring actions under BRRD, directly for less significant institutions and under the direction of the Single Resolution Board (SRB) for significant institutions and cross-border banking groups. Portuguese banks will now be required to meet MREL, which will be decided upon bank-by-bank by the SRM over the coming year, with a transitional period of up to 48 months. MREL is designed to ensure that banks have sufficient liabilities to bail-in should resolution become necessary. The creditor hierarchy will continue to be as specified in Portuguese insolvency law.

C. Boosting Growth and Reducing Downside Risks

Corporate Debt Overhang: Time to Act

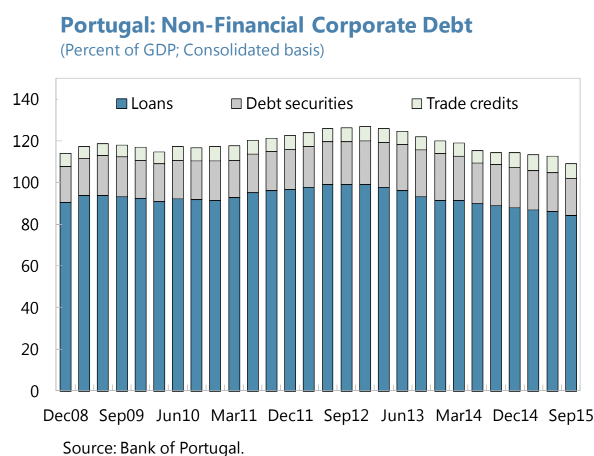
25. Portugal's stock of non-financial corporate (NFC) debt remains one of the highest in the EU (110 percent of GDP on a consolidated basis as of end-September 2015). Recent NFC debt developments are in line with staff's long-standing views that disincentives confronting both banks and NFCs act as a brake on the pace of deleveraging. At the same time, debt overhang does not allow credit to be allocated to new productive sectors of the economy.

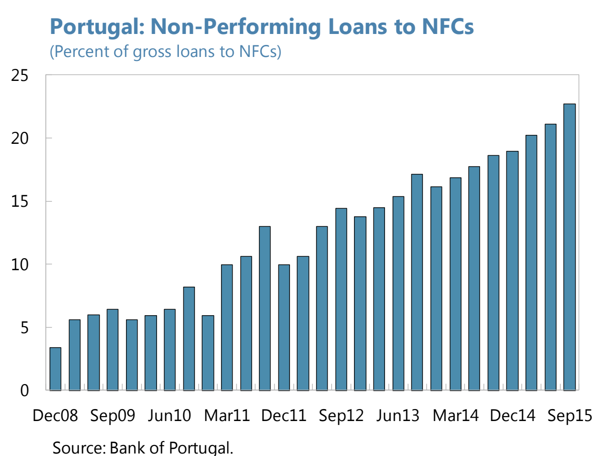
Staff views

26. As staff has emphasized since late 2013, a more ambitious approach to corporate debt workouts is needed. A substantial share of banking system assets remains tied up in low productivity activities, holding back the economy's growth potential. At the same time, limited incentives to deleverage for both banks and their clients have weighed on the pace of corporate debt reduction. Raising capital above the regulatory minimum would create the space for accelerated write-offs and a faster reduction of legacy loans. Provisions and impairments on NPLs should be increased, especially for loans which have been non-performing for several years, to incentivize banks to dispose of those assets, either by a sale or foreclosure. Further progress in debt reduction would help free up credit for new and higher productivity firms. The authorities' recognition of corporate debt restructuring as a key policy challenge is a step in the right direction. The ongoing work by supervisory authorities to study options for accelerated debt restructuring is most welcome, but a comprehensive restructuring approach will require close coordination among stakeholders—including the corporate sector, banks, and European authorities.

Authorities' views

27. The authorities agree that excessive private corporate debt remains an important challenge. They acknowledged that the stock of NPLs further impedes banks' profitability. The authorities want to address the high level of NPLs through a series of measures, including further supervisory actions on a bank-by-bank basis, possibly through additional provisioning and write-offs of NPLs.





Structural reforms: Risks from policy reversals

28. Significant policy changes already implemented or under consideration imply at least a partial reversal of structural measures introduced during the Fund-supported program. The minimum wage was raised by 5 percent on January 1 (to €530 per month), with further increases under consideration, while four public holidays eliminated under the program are being restored. The authorities also aim to rein in recent increases in temporary contracts and self-employment, and

are considering proposals to roll back the decentralization of collective bargaining implemented during the Economic Assistance Program. The new government has halted recent public transport concessions and renegotiated the privatization of the national airline TAP to retain a 50 percent stake. Some other ongoing privatization processes will be either cancelled or not pursued. Implementation of the new Budget Framework Law (BFL) adopted in September 2015 has already faced delays.

Staff views

29. A weakening of recent and complex reforms to improve labor market flexibility could diminish medium-term prospects for growth, employment, and income. In a monetary union, structural reforms are essential to increase flexibility and competitiveness, while safeguarding against downside risks. As labor market reforms are critical to spur job creation, changes to policies that have made hiring and collective bargaining more flexible could adversely affect prospects for the unemployed. Should earlier efforts in this area be unwound, staff would have to revise down projections for potential growth, currently approaching 1.0 percent in the medium term.

30. It is important to forge ahead with structural reforms based on an appropriately inclusive social dialogue. In this context, the government has initiated discussions on several fronts with social partners. However, for reforms to enjoy broad support, it is important to ensure that all stakeholders are appropriately represented in this dialogue—including the unemployed, the broader labor force, and a wider cross-section of employers.

31. Revisiting privatization and concession agreements risks harming investor confidence, and generating additional fiscal costs to make public companies viable. While the renegotiation with the private consortium that had agreed to buy a controlling stake in TAP will have a limited upfront cost, the authorities agreed to contribute to TAP's investment plan as part of the deal. In addition, keeping transport concessions in public hands will leave the state responsible for operating and financing these loss-making entities. Further, a comprehensive reform of the public administration has been identified as necessary for unlocking the private sector's ability to foster investment, employment, and growth.

Authorities' views

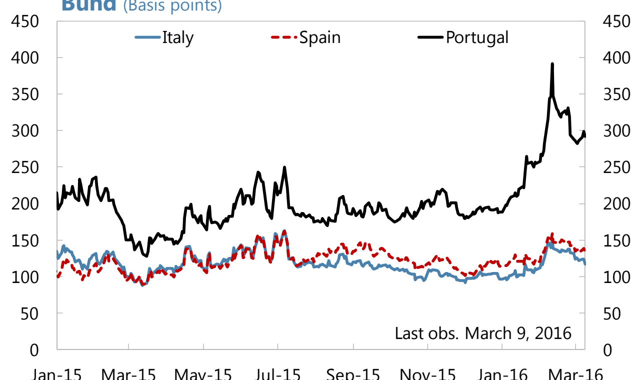
32. The authorities emphasized their commitment to further structural reforms, but considered this an appropriate juncture to assess the impact of reforms thus far. The authorities agreed with the importance of continuing to improve competiveness to underpin medium-term growth prospects, but noted their concerns about growing labor market segmentation and the erosion of labor protection. The authorities also stressed that the reconsideration of recent privatization concession agreements is guided by legal concerns, and the need to safeguard the quality of public service delivery and protect national interests. They also emphasized their commitment to operate efficiently any enterprises that remain state-owned.

POST-PROGRAM MONITORING AND CAPACITY TO REPAY

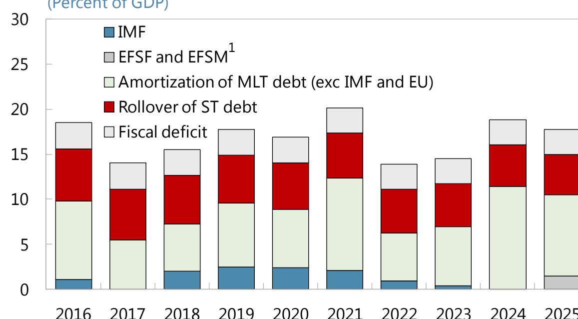
33. The risks to Portugal's capacity to repay are expected to be manageable under the baseline, but are rising. Portugal has benefited from the ECB's PSPP. The PSPP has contributed to the compression in bond yields in the short-run and helped reduce volatility. Further purchases are expected to offset around eighty percent of new issuance in 2016. With a successful syndicated loan issuance in January, Portugal is now financed through September 2016. Average long-term debt redemption of about €11 billion a year (7 percent of GDP) is expected over the next 5 years, of which about a quarter is due to the IMF.

34. The authorities have improved the profile of public debt in the last year, notwithstanding its still high stock. They made early Fund repurchases of SDR 8.2 billion, amounting to more than a third of outstanding Fund obligations. These repayments will result in some interest savings; the next repurchase is not due until September 2018. In addition, Portugal carried out several debt buy-backs together with new longer-term issuance in 2015, resulting in a lengthening of the average maturity of its market debt from 5.9 to 6.8 years and a smoother repayment profile over the next 5 years. Depending on financing conditions, and fiscal developments, and subject to agreement with their European partners, the authorities plan to repay up to SDR 2 billion more in the remainder of 2016. Staff remains of the view that the authorities should ensure that funding conditions remain stable and downside risks are contained, and that Portugal maintains an adequate cash buffer when considering additional early repurchases.

10-Year Government Bond Spreads vs. German Bund (Basis points)



Portugal: General Government Gross Financing Need (Percent of GDP)



Source: IMF Staff calculations.

[1]Assumes EFSM payments delayed by seven years, no additional early repurchases to the IMF.

35. Recent political and financial events underline that there are significant downside risks to the baseline beyond 2016. An increase in average debt maturity, smoother repayment profile, and a reasonable cash buffer have helped prepare Portugal for potential market volatility going forward, but the risk of a sustained rise in yields remains. Portuguese spreads have risen notably more than other southern European peers since October. Of the 90 basis point increase in yields over this period, more than 70 basis points is due to Portugal-specific factors, according to IMF staff

estimates. This divergence could accelerate if there is a renewed period of political instability, or if the government's fiscal consolidation outlook proves optimistic. Further pressure may also result from negative surprises in the financial sector or a ratings downgrade. In this context, sovereign-bank linkages remain an important channel for the transmission of risks. An extension of the PSPP may be insufficient to offset the impact of these shocks since the ECB is projected to reach its purchasing limit of 33 percent of Portuguese debt in the next 9 months.

STAFF APPRAISAL

36. Now entering the fourth year of economic recovery, Portugal's growth has leveled off. The successful stabilization of Portugal's economy under the EFF paved the way for the ongoing recovery and a sharp drop in unemployment. Growth is expected to ease gradually as the impact of supportive external conditions fades. Risks to the outlook are tilted to the downside, underscored by the rise in sovereign risk premia, elevated uncertainty regarding global growth, and recent financial sector developments.

37. Portugal's growth prospects remain constrained by high debt and unresolved structural bottlenecks. Portugal's credit rating is also vulnerable to a negative reappraisal which would have significant fiscal, financial, and macroeconomic repercussions given still persistent sovereign-bank linkages. The Portuguese authorities will need to take decisive actions to guard against these risks.

38. Portugal needs to build on the progress made in recent years in stabilizing the level of public debt through its successful fiscal adjustment. Looking forward, a continuation of these efforts would help maintain market confidence. The recent volatility in sovereign yields underscores market sensitivity to perceptions of Portugal's commitment to ensure robust public finances. In this context, the authorities' commitment to medium term fiscal consolidation is welcome, but it needs to be supported by a clear articulation of medium-term policies.

39. The 2016 budget implies a loosening of the fiscal stance. In the absence of additional measures, staff projects an overall deficit of around 2.9 percent of GDP and a primary structural easing of 0.5 percent of GDP. This would do little to reduce Portugal's high public debt, which amounted to nearly 129 percent of GDP at end-2015, and leaves the country vulnerable to shifts in market sentiment. The authorities need to articulate near-term contingency plans to ensure that the 2016 budget targets would not be at risk under the baseline, and need to guard against other fiscal risks, including additional fiscal costs resulting from proposals such as the 35-hour work week for public sector employees or any contingent liabilities arising from the financial sector.

40. Banks need to strengthen their balance sheets to avoid further negative surprises and protect taxpayers. Recent developments underscore the need to continue to build on past efforts to improve bank profitability, asset quality, and governance. Maintaining confidence in the financial sector will require maintaining a high level of vigilance, timely action, the build-up of fiscal buffers, and greater transparency with regard to financial sector operations. Coordination between supervisors, competition authorities and banks' management is central to the solution.

41. A more ambitious approach to corporate debt workouts is needed. A substantial share of banking system assets remains tied up in low-productivity activities, holding back the economy's growth potential. At the same time, limited incentives to deleverage on the part of both banks and their clients have weighed on the pace of corporate debt reduction. Further progress in debt reduction would help free up credit for new and higher productivity firms.

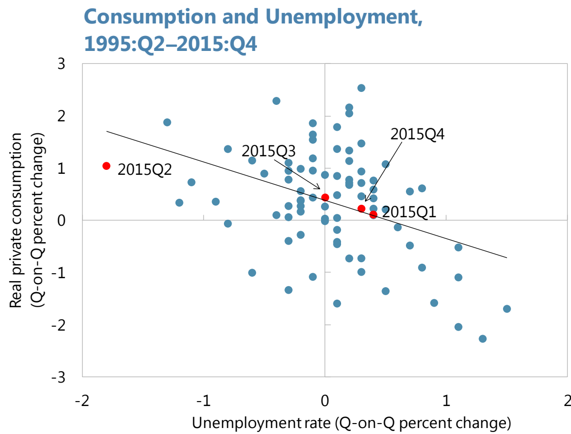
42. Structural impediments continue to weigh on growth and further reforms are necessary. In a monetary union, reforms to labor and product markets are essential to increase flexibility and competitiveness, while safeguarding against downside risks. As labor market reforms are critical to spur job creation, changes to policies that have made hiring and collective bargaining more flexible could adversely affect prospects for the unemployed. Efforts to strengthen the social safety net are welcome, although the recent increase in the minimum wage could make it more difficult for the low-skilled to find employment. Reversal of recent and complex reforms would have adverse consequences for Portugal's growth outlook and confidence.

43. Recent political and financial events underline that there are significant downside risks to the baseline beyond 2016. An increase in average debt maturity, a smoother repayment profile, and a reasonable cash buffer have helped prepare Portugal for potential market volatility going forward, but the risk of a sustained further rise in yields remains and needs to be contained.

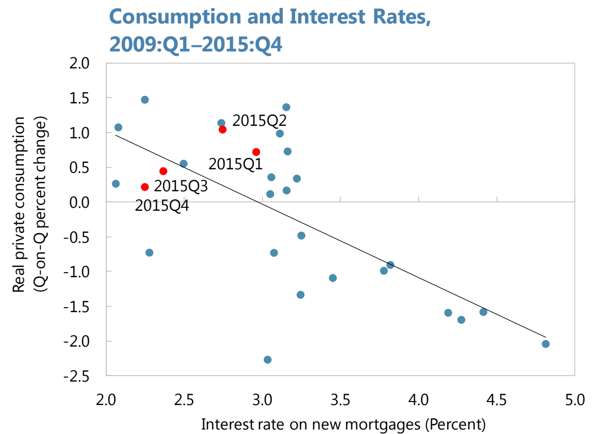
44. The 2016 Article IV Consultation discussions are expected to take place in May 2016. The next Post-Program Monitoring mission is scheduled to take place in summer 2016.

Figure 1. Portugal: Selected Macroeconomic Developments

Falling unemployment is supporting consumption…



…as are low interest rates.



Still-high debt constrains disposable income growth…

Composition of Non-Financial Sector Debt[1]

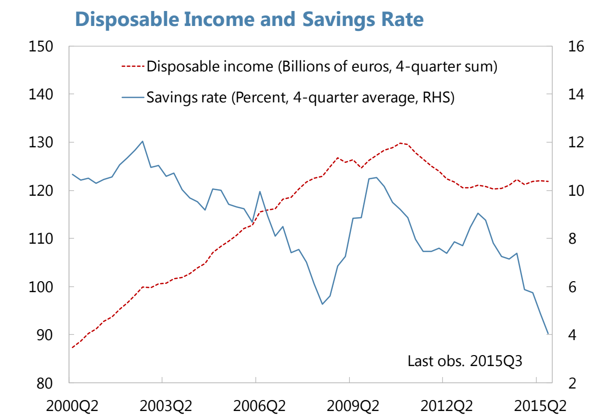
(Percent of GDP, unless otherwise indicated)

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

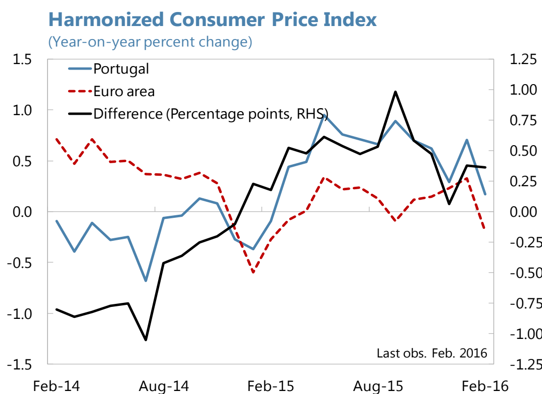
Source: Haver.

[1]Unconsolidated basis.

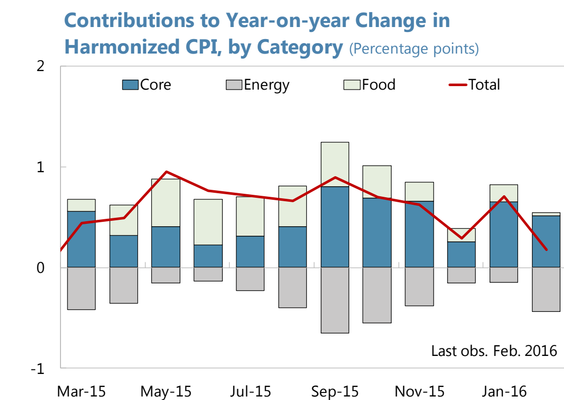
…and the savings rate has fallen to a historically low level.



Inflation is back in positive territory…



…driven by positive core inflation.

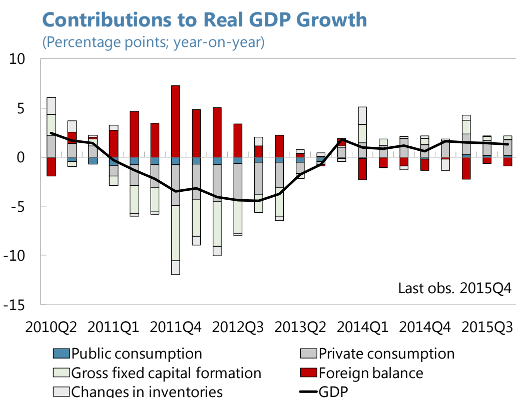


Sources: Haver Analytics; INE; and IMF staff calculations.

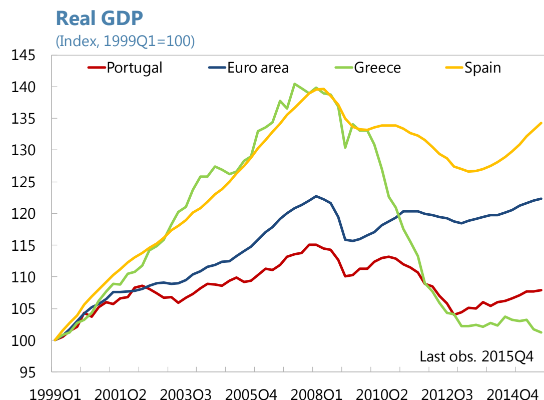
[1]Non-consolidated basis.

Figure 2. Portugal: Real Sector Indicators

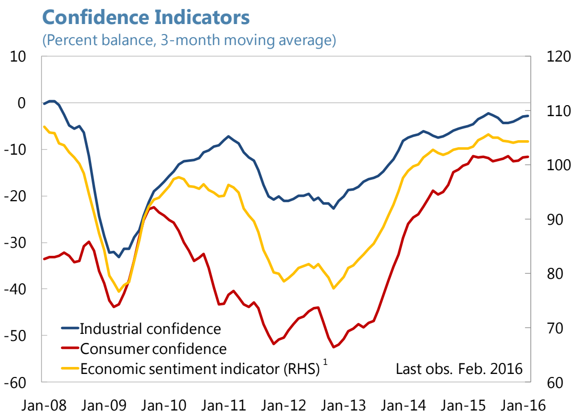
Investment has picked up beginning in 2014.



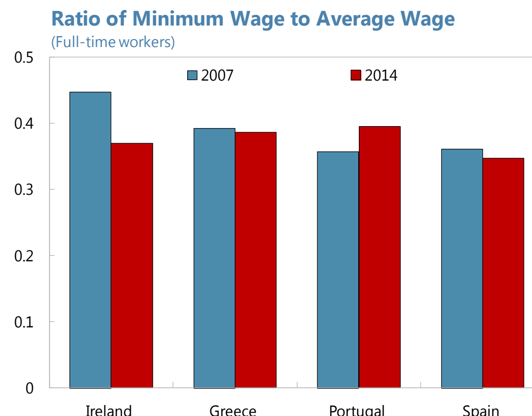
Portugal is growing at par with the euro area, but is not converging.



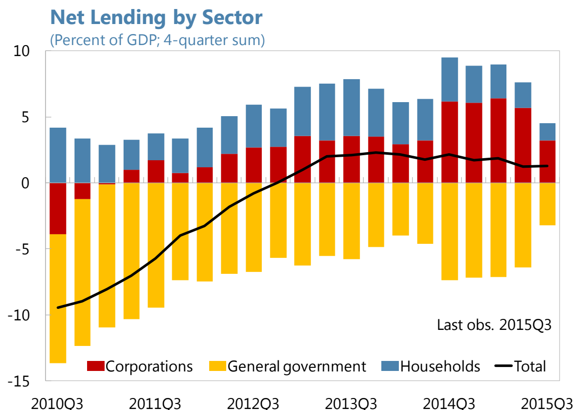
Confidence indicators remain strong.



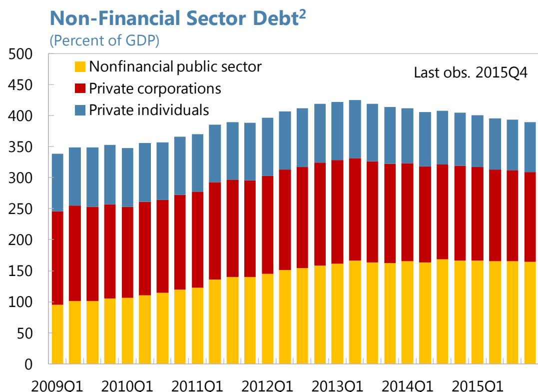
Minimum wages increased faster than average wages.



The country stopped borrowing...



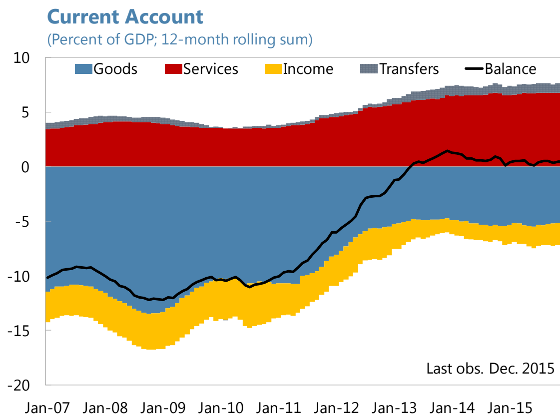
...but debt is declining only gradually.



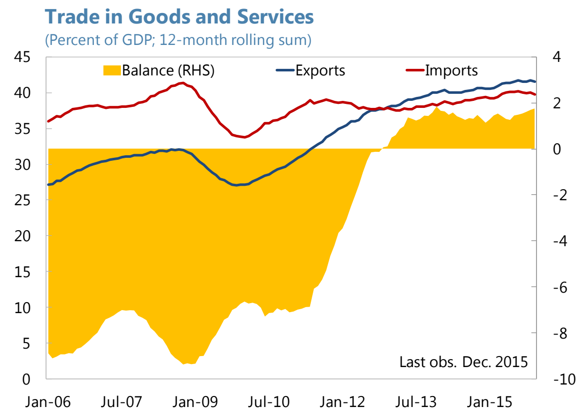
Sources: Bloomberg; Eurostat; Haver Analytics; INE; and IMF staff calculations.
[1]Long term average = 100.
[2]Non-consolidated basis.

Figure 3. Portugal: Balance of Payments Developments

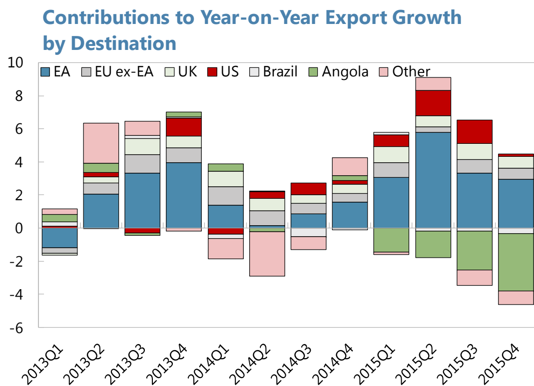
The current account has achieved a thin surplus ...



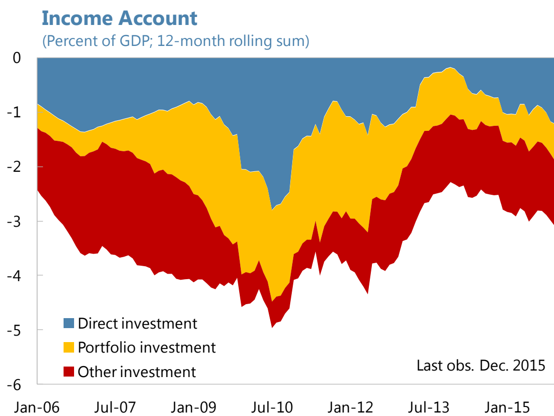
... driven by sustained performance in exports...



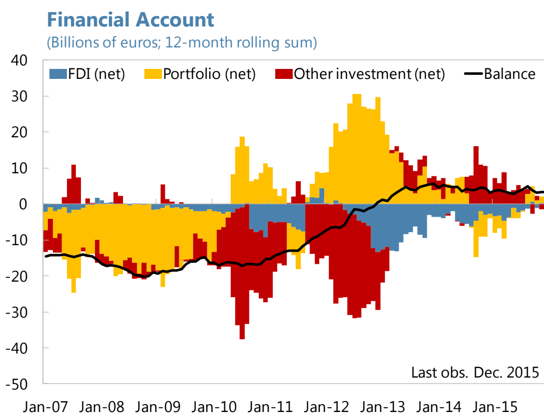
... mostly to the euro area.



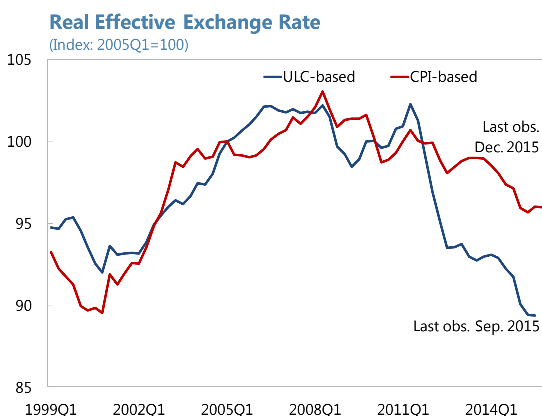
Income payments have declined with interest rates...



... with foreign investors investing in portfolio assets again.



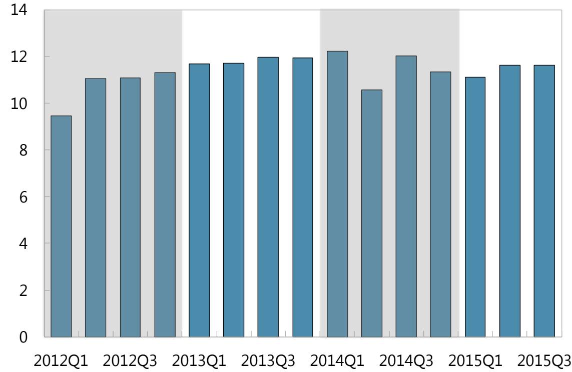
Competitiveness indices have begun to improve, though sluggishly.



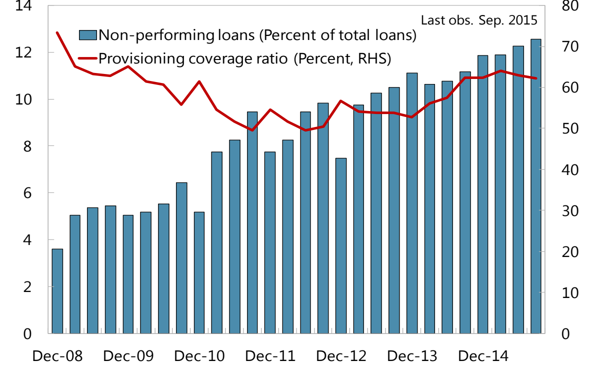
Sources: INE; Bank of Portugal; OECD; Eurostat; and IMF staff calculations.

Figure 4. Portugal: Financial Sector Developments

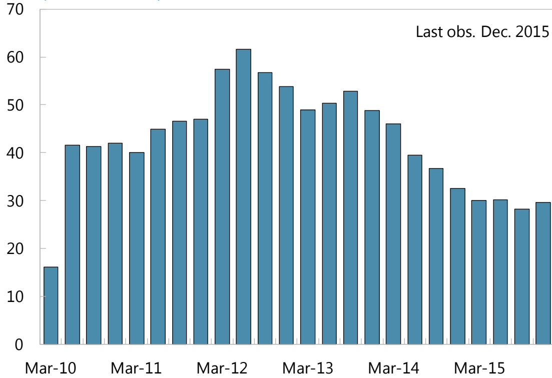
Capital is broadly stable…



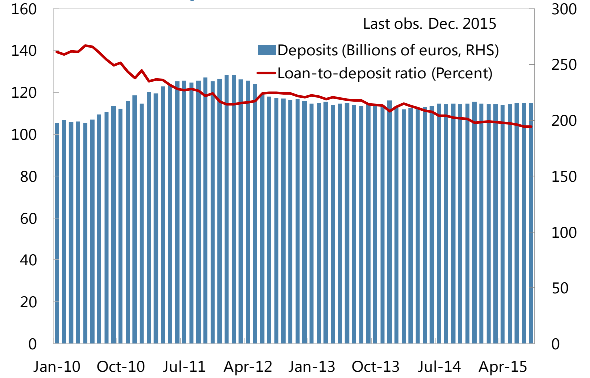
…but NPLs continue to rise as provisioning levels off.



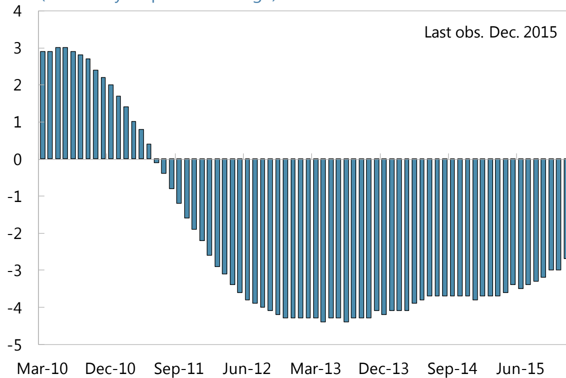
Reliance on Eurosystem financing has stabilized at a lower level…



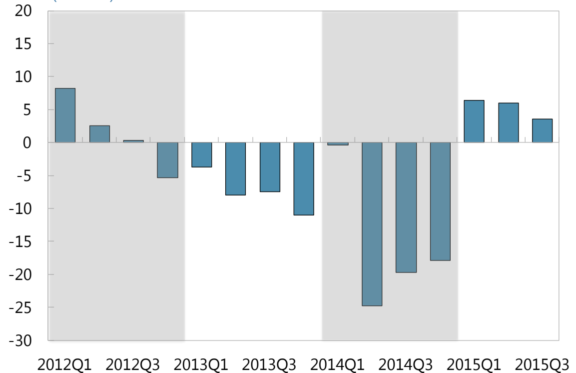
…and loan-to-deposit ratios are falling.



Lending continues to contract…



…and profitability remains weak.



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

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

	2013	2014	Estimate 2015	Projections 2016 2nd PPM	2016 3rd PPM	2017	2018	2019	2020	2021
Real GDP	-1.1	0.9	1.5	1.5	1.4	1.3	1.2	1.2	1.2	1.2
Total domestic demand	-2.0	2.2	2.4	1.6	1.4	1.4	1.3	1.2	1.2	1.3
Private consumption	-1.2	2.2	2.6	1.6	1.5	1.3	1.2	1.1	1.1	1.1
Public consumption	-2.0	-0.5	0.8	0.9	0.0	0.5	0.4	0.6	0.6	0.6
Gross fixed investment	-5.1	2.8	3.7	2.5	3.0	2.5	2.4	2.4	2.4	2.4
Private	-3.3	3.0	3.4	2.2	3.3	2.7	2.6	2.6	2.6	2.6
Government	-14.3	1.5	5.3	3.7	1.0	1.3	1.1	1.2	1.2	1.1
Exports	7.0	3.9	5.1	4.8	4.2	4.3	4.3	4.3	4.4	4.3
Imports	4.7	7.2	7.3	4.8	4.0	4.5	4.5	4.3	4.4	4.3
Contribution to Growth										
Total domestic demand	-2.0	2.2	2.5	1.6	1.5	1.4	1.3	1.3	1.3	1.3
Private consumption	-0.8	1.5	1.7	1.1	1.0	0.9	0.8	0.8	0.8	0.7
Public consumption	-0.4	-0.1	0.1	0.2	0.0	0.1	0.1	0.1	0.1	0.1
Gross fixed investment	-0.8	0.4	0.6	0.4	0.5	0.4	0.4	0.4	0.4	0.4
Foreign balance	0.8	-1.3	-1.0	0.0	0.0	-0.2	-0.2	-0.1	-0.1	-0.2
Savings-investment balance (Percent of GDP)										
Gross national savings	15.2	15.3	15.6	16.0	15.4	15.6	15.7	15.9	16.2	16.6
Private	18.1	20.4	17.9	16.3	16.4	16.6	16.5	16.7	17.1	17.4
Public	-2.8	-5.1	-2.3	-0.3	-0.9	-1.0	-0.9	-0.8	-0.8	-0.8
Gross domestic investment	14.6	15.1	15.1	15.2	14.5	15.2	15.6	16.1	16.6	17.2
Private	12.6	13.0	13.0	12.8	12.5	13.2	13.6	14.0	14.5	15.1
Public	2.1	2.1	2.1	2.4	2.0	2.0	2.0	2.1	2.1	2.1
Resource utilization										
Potential GDP	-0.4	-0.4	-0.1	0.1	0.2	0.4	0.6	0.9	0.9	1.0
Output Gap (Percent of potential)	-5.9	-4.7	-3.2	-1.8	-2.0	-1.2	-0.6	-0.4	-0.1	0.0
Employment	-2.6	1.6	1.1	0.6	1.0	0.5	0.5	0.5	0.5	0.5
Unemployment rate (Percent)	16.2	13.9	12.4	12.9	11.6	11.1	10.7	10.2	9.8	9.3
Prices										
GDP deflator	2.3	1.0	1.9	1.3	1.5	1.4	1.4	1.6	1.7	1.7
Consumer prices (Harmonized index)	0.4	-0.2	0.5	1.3	0.7	1.2	1.4	1.5	1.6	1.8
Compensation per worker (Whole economy)	4.0	-0.9	1.8	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Labor productivity	1.7	-1.5	0.4	1.0	0.4	0.7	0.7	0.7	0.6	0.6
Unit labor costs (Whole economy)	2.2	0.6	1.4	0.6	1.1	0.8	0.8	0.8	0.8	0.8
Money and credit (End of period, percent change)										
Private sector credit	-5.3	-8.0	-4.1	0.3	0.3	0.6	1.2	1.6	1.6	1.6
Broad money	0.2	-0.9	3.9	2.4	2.4	2.2	2.1	2.2	2.3	2.4
Interest rates (Percent)[1]										
Short-term deposit rate	2.1	1.6	0.8	…	…	…	…	…	…	…
Government bond rate, 10-year	6.3	3.8	2.3	…	…	…	…	…	…	…
Fiscal indicators (Percent of GDP)										
General government balance[2]	-4.8	-7.2	-4.4	-2.7	-2.9	-2.9	-2.8	-2.8	-2.8	-2.8
Revenues	45.1	44.5	43.9	44.8	43.6	43.2	43.1	43.0	42.8	42.6
Expenditures	49.9	51.7	48.2	47.5	46.5	46.1	45.9	45.8	45.6	45.4
Primary government balance	0.0	-2.3	0.3	1.8	1.7	1.6	1.6	1.6	1.5	1.5
General government debt	129.0	130.2	128.8	124.4	127.9	127.3	126.4	125.6	124.5	123.8
External sector (Percent of GDP)										
Trade balance (Goods)	-4.7	-5.5	-5.1	-5.2	-4.5	-5.3	-5.9	-6.5	-7.0	-7.5
Trade balance (Goods and Services)	1.8	1.1	1.7	2.2	2.7	2.2	1.8	1.4	1.1	0.8
Current account balance	1.5	0.1	0.5	0.8	0.9	0.4	0.1	-0.2	-0.4	-0.6
Net international investment position	-116.5	-114.4	-109.4	-101.4	-104.1	-99.8	-96.0	-92.5	-89.2	-86.2
REER based on ULC (1999=100)	102.9	102.7	101.2	84.7	103.9	103.7	103.6	103.6	103.9	103.9
(Rate of growth)	1.7	-0.2	-1.4	0.2	2.7	-0.2	-0.1	0.0	0.3	0.0
REER based on CPI (1999=100)	107.4	106.9	106.4	88.4	108.9	109.1	109.3	109.5	109.7	110.0
(Rate of growth)	0.1	-0.5	-0.4	0.1	2.4	0.1	0.2	0.2	0.2	0.2
Nominal GDP (Billions of euros)	170.3	173.4	179.4	182.6	184.6	189.6	194.5	199.8	205.5	211.4

Sources: Bank of Portugal; Ministry of Finance; INE; Eurostat; and IMF staff projections.
[1] In 2015, actual.
[2] In 2013, includes the increase in the share capital of Banif (0.4 percent of GDP). In 2014, includes one-off measures from SOE and banking sector support operations, CIT credit, and the upfront costs of mutual agreements totaling 3.7 percent of GDP. In 2015, includes the fiscal cost of Banif (1.2 percent of GDP).

Table 2a. Portugal: General Government Accounts, 2013–2021[1]

(Billions of euros)

	2013	2014	Estimate 2015	Projections 2016	2017	2018	2019	2020	2021
Revenue	76.8	77.2	78.7	80.5	81.9	83.8	85.8	87.9	90.1
Taxes	42.7	43.6	45.7	46.1	47.4	48.7	50.0	51.4	52.8
Taxes on production and imports	23.3	24.6	26.1	27.1	27.9	28.7	29.4	30.2	31.0
Current taxes on income, wealth, etc. and capital taxes	19.4	19.0	19.6	19.0	19.5	20.0	20.6	21.2	21.8
Current taxes on income, wealth, etc.	19.4	19.0	19.6	19.0	19.5	20.0	20.6	21.2	21.8
Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	20.4	20.4	20.4	21.2	20.9	21.3	21.6	21.9	22.2
Grants and other revenue	13.6	13.3	12.7	13.2	13.5	13.9	14.2	14.6	15.1
Property income	2.1	1.7	1.8	1.7	1.7	1.8	1.8	1.9	1.9
Sales of goods and services	6.5	6.5	6.8	7.0	7.2	7.4	7.6	7.8	8.0
Other current revenue	3.1	3.6	2.7	2.8	2.9	2.9	3.0	3.1	3.2
Capital transfers and investment grants	1.9	1.4	1.4	1.7	1.7	1.7	1.8	1.8	1.9
Expenditure	85.0	89.7	86.6	85.9	87.4	89.3	91.5	93.7	96.1
Expense	86.3	91.2	88.2	87.8	89.4	91.3	93.5	95.8	98.2
Compensation of employees	21.3	20.5	20.1	20.7	20.8	21.3	21.8	22.3	22.8
Use of goods and services	9.6	10.1	10.8	11.5	11.8	12.1	12.5	12.8	13.2
Consumption of fixed capital	5.1	5.1	5.4	5.5	5.7	5.8	6.0	6.2	6.3
Interest	8.3	8.5	8.4	8.5	8.5	8.6	8.7	9.0	9.1
Subsidies	1.0	1.2	1.2	1.1	1.1	1.2	1.2	1.2	1.2
Social benefits	34.8	34.1	34.2	34.9	35.6	36.4	37.3	38.2	39.2
Grants and other expense	6.2	11.7	8.1	5.6	5.7	5.9	6.0	6.2	6.4
Other current expense	4.6	4.9	4.6	4.7	4.9	5.0	5.1	5.3	5.4
Capital transfers	1.5	6.8	3.5	0.8	0.9	0.9	0.9	0.9	1.0
Net acquisition of nonfinancial assets	-1.2	-1.5	-1.6	-1.9	-1.9	-2.0	-2.0	-2.1	-2.2
Gross fixed capital formation	3.8	3.6	3.8	3.7	3.8	3.9	4.0	4.1	4.2
(-) Consumption of fixed capital	-5.1	-5.1	-5.4	-5.5	-5.7	-5.8	-6.0	-6.2	-6.3
Acquisitions less disposals of other nonfinancial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance[2]	-4.4	-8.9	-4.0	-1.7	-1.8	-1.7	-1.7	-1.7	-1.7
Net lending (+)/borrowing (–)	-8.2	-12.4	-7.8	-5.4	-5.6	-5.5	-5.6	-5.8	-5.9
Net acquisition of financial assets	-2.4	-6.9	...	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	...	...	...	...	...	...	...
Currency and deposits	1.2	0.0	...	...	...	...	...	...	...
Debt securities	-1.0	-4.8	...	...	...	...	...	...	...
Loans	0.0	-0.3	...	...	...	...	...	...	...
Equity and investment fund shares	-0.8	-2.1	...	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	...	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.1	...	...	...	...	...	...	...
Other accounts receivable	-1.9	0.1	...	...	...	...	...	...	...
Net incurrence of liabilities	5.8	5.5	...	...	...	...	...	...	...
SDRs	0.0	0.0	...	...	...	...	...	...	...
Currency and deposits	1.2	4.9	...	...	...	...	...	...	...
Debt securities	-2.9	-1.7	...	...	...	...	...	...	...
Loans	9.0	3.5	...	...	...	...	...	...	...
Equity and investment fund shares	0.0	0.0	...	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	...	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	...	...	...	...	...	...	...
Other accounts payable	-1.5	-1.2	...	...	...	...	...	...	...
Memorandum items:									
Primary balance	0.0	-3.9	0.6	3.1	2.9	3.1	3.1	3.1	3.2
Debt at face value (EDP notification)	219.6	225.8	231.1	236.2	241.4	245.9	251.0	255.8	261.7
Nominal GDP	170.3	173.4	179.4	184.6	189.6	194.5	199.8	205.5	211.4

Sources: INE; and IMF staff projections.

[1]GFSM 2001 presentation.

[2]In 2013, includes the increase in the share capital of Banif (0.4 percent of GDP). In 2014, includes one-off measures from SOE and banking sector support operations, CIT credit, and the upfront costs of mutual agreements totaling 3.7 percent of GDP. In 2015, includes the fiscal cost of Banif (1.2 percent of GDP).

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

			Estimate	Projections					
	2013	2014	2015	2016	2017	2018	2019	2020	2021
Revenue	45.1	44.5	43.9	43.6	43.2	43.1	43.0	42.8	42.6
Taxes	25.1	25.1	25.5	25.0	25.0	25.0	25.0	25.0	25.0
Taxes on production and imports	13.7	14.2	14.5	14.7	14.7	14.7	14.7	14.7	14.7
Current taxes on income, wealth, etc. and capital taxes	11.4	10.9	10.9	10.3	10.3	10.3	10.3	10.3	10.3
Social contributions	12.0	11.7	11.4	11.5	11.0	10.9	10.8	10.7	10.5
Grants and other revenue	8.0	7.7	7.1	7.1	7.1	7.1	7.1	7.1	7.1
Property income	1.3	1.0	1.0	0.9	0.9	0.9	0.9	0.9	0.9
Sales of goods and services	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8
Other current revenue	1.8	2.1	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Capital transfers and investment grants	1.1	0.8	0.8	0.9	0.9	0.9	0.9	0.9	0.9
Expenditure	49.9	51.7	48.2	46.5	46.1	45.9	45.8	45.6	45.4
Expense	50.7	52.6	49.1	47.5	47.1	47.0	46.8	46.6	46.5
Compensation of employees	12.5	11.8	11.2	11.2	11.0	10.9	10.9	10.8	10.8
Use of goods and services	5.6	5.8	6.0	6.2	6.2	6.2	6.2	6.2	6.2
Consumption of fixed capital	3.0	2.9	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Interest	4.9	4.9	4.7	4.6	4.5	4.4	4.4	4.4	4.3
Subsidies	0.6	0.7	0.7	0.6	0.6	0.6	0.6	0.6	0.6
Social benefits	20.4	19.7	19.0	18.9	18.8	18.7	18.7	18.6	18.5
Grants and other expense	3.6	6.7	4.5	3.0	3.0	3.0	3.0	3.0	3.0
Other current expense	2.7	2.8	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Capital transfers	0.9	3.9	2.0	0.5	0.5	0.5	0.5	0.5	0.5
Net acquisition of nonfinancial assets	-0.7	-0.9	-0.9	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Gross fixed capital formation	2.3	2.1	2.1	2.0	2.0	2.0	2.0	2.0	2.0
(-) Consumption of fixed capital	-3.0	-2.9	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0
Acquisitions less disposals of other nonfinancial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance[2]	-2.6	-5.1	-2.2	-0.9	-1.0	-0.9	-0.8	-0.9	-0.8
Net lending (+)/borrowing (–)	-4.8	-7.2	-4.4	-2.9	-2.9	-2.8	-2.8	-2.8	-2.8
Net acquisition of financial assets	-1.4	-4.0	...	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	...	...	...	...	...	...	...
Currency and deposits	0.7	0.0	...	...	...	...	...	...	...
Debt securities	-0.6	-2.7	...	...	...	...	...	...	...
Loans	0.0	-0.2	...	...	...	...	...	...	...
Equity and investment fund shares	-0.4	-1.2	...	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	...	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.1	...	...	...	...	...	...	...
Other accounts receivable	-1.1	0.1	...	...	...	...	...	...	...
Net incurrence of liabilities	3.4	3.2	...	...	...	...	...	...	...
SDRs	0.0	0.0	...	...	...	...	...	...	...
Currency and deposits	0.7	2.8	...	...	...	...	...	...	...
Debt securities	-1.7	-1.0	...	...	...	...	...	...	...
Loans	5.3	2.0	...	...	...	...	...	...	...
Equity and investment fund shares	0.0	0.0	...	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	...	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	...	...	...	...	...	...	...
Other accounts payable	-0.9	-0.7	...	...	...	...	...	...	...
Memorandum items:									
Primary balance	0.0	-2.3	0.3	1.7	1.6	1.6	1.6	1.5	1.5
Structural balance (Percent of potential GDP)	-2.2	-1.1	-1.5	-2.0	-2.4	-2.6	-2.7	-2.8	-2.8
Structural primary balance (Percent of potential GDP)	2.3	3.5	3.0	2.5	2.0	1.8	1.7	1.6	1.5
Debt at face value (EDP notification)	129.0	130.2	128.8	127.9	127.3	126.4	125.6	124.5	123.8
Nominal GDP (Billions of euros)	170.3	173.4	179.4	184.6	189.6	194.5	199.8	205.5	211.4

Sources: INE; and IMF staff projections.
[1]GFSM 2001 presentation.
[2]In 2013, includes the increase in the share capital of Banif (0.4 percent of GDP). In 2014, includes one-off measures from SOE and banking sector support operations, CIT credit, and the upfront costs of mutual agreements totaling 3.7 percent of GDP. In 2015, includes the fiscal cost of Banif (1.2 percent of GDP).

Table 3. Portugal: Monetary Survey, 2013–2021

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

	2013	2014	2015	2016	2017	2018	2019	2020	2021
				Projections					
Aggregated Balance Sheet of Monetary Financial Institutions (MFIs)[1]									
Assets	427,412	405,080	389,064	397,256	403,458	407,975	414,464	422,845	429,675
Claims on Bank of Portugal	9,841	5,093	9,353	8,096	7,853	7,617	7,389	7,167	6,952
Claims on non-residents	71,566	70,851	63,324	63,957	64,597	65,243	65,895	66,554	67,220
Claims on non-monetary resident sector	329,203	307,411	294,197	304,964	309,623	313,844	320,215	327,917	334,355
General government	38,691	41,503	39,945	47,425	51,805	53,661	56,157	60,568	63,406
Central government	32,935	34,990	33,634	41,053	45,425	47,217	49,713	53,881	56,689
Loans	1,725	3,092	2,547	5,311	7,966	9,453	13,808	17,493	20,792
Securities	31,210	30,072	29,087	22,993	24,580	30,883	31,284	30,241	29,549
General government, excluding central government	5,756	6,513	6,311	6,372	6,381	6,445	6,444	6,687	6,717
Private sector	241,767	222,379	213,220	213,860	215,143	217,725	221,121	224,659	228,254
Non-financial corporations	115,703	100,721	96,007	96,391	97,079	97,753	98,447	99,164	99,902
Private individuals[2]	126,064	121,658	117,213	117,469	118,064	119,972	122,674	125,495	128,351
Non-monetary financial institutions	46,693	43,327	41,019	43,680	42,675	42,458	42,938	42,690	42,695
Other assets	16,802	21,725	22,190	20,239	21,385	21,271	20,965	21,207	21,148
Liabilities	427,412	405,080	389,064	397,256	403,458	407,975	414,464	422,845	429,675
Liabilities to Bank of Portugal	48,810	32,503	29,616	28,728	27,866	27,030	26,219	25,432	24,669
Liabilities to non-residents	70,135	67,639	58,926	57,747	56,593	55,461	54,351	53,264	52,199
Liabilities to non-monetary resident sector	217,918	216,943	216,870	216,704	218,618	222,513	228,087	233,059	238,487
General government	10,530	10,550	8,474	11,700	9,700	8,800	8,775	8,625	8,515
Central government	9,222	9,120	6,667	9,205	7,631	6,923	6,904	6,786	6,699
General government, excluding central government	1,308	1,430	1,807	2,495	2,068	1,876	1,871	1,839	1,816
Private sector	155,144	156,344	160,847	165,507	170,330	175,321	180,486	185,832	191,365
Non-monetary financial institutions	43,761	41,062	37,091	39,497	38,589	38,392	38,826	38,602	38,607
Securities other than capital	37,858	28,670	24,364	25,095	25,848	26,623	27,422	28,245	29,092
Other liabilities	35,183	37,254	36,940	45,147	50,326	51,870	53,517	57,474	59,447
Capital and reserves	17,508	22,071	22,349	23,835	24,207	24,479	24,868	25,371	25,780
Money and Credit									
Broad money (M3)	147,774	146,488	152,131	155,809	159,201	162,536	166,159	170,030	174,051
Intermediate money (M2)	143,949	143,762	149,202	152,809	156,136	159,407	162,960	166,757	170,700
Narrow money (M1)	50,475	54,989	65,971	67,566	69,037	70,483	72,054	73,733	75,477
Private sector credit	241,767	222,379	213,220	213,860	215,143	217,725	221,121	224,659	228,254
Public sector credit	38,691	41,503	39,945	47,425	51,805	53,661	56,157	60,568	63,406
(Percent of GDP)									
Broad money	86.8	84.5	84.8	84.4	84.0	83.6	83.2	82.8	82.3
Private sector credit	142.0	128.2	118.8	115.8	113.5	111.9	110.7	109.3	108.0
Public sector credit	22.7	23.9	22.3	25.7	27.3	27.6	28.1	29.5	30.0
(Percentage change)									
Broad money	0.2	-0.9	3.9	2.4	2.2	2.1	2.2	2.3	2.4
Private sector credit	-5.3	-8.0	-4.1	0.3	0.6	1.2	1.6	1.6	1.6
Public sector credit	-0.2	7.3	-3.8	18.7	9.2	3.6	4.7	7.9	4.7
Memorandum items:									
ECB access (Percent of assets)	11.4	8.0	7.6	7.2	6.9	6.6	6.3	6.0	5.7
Credit to deposits (Percent)	128.7	121.6	116.7	120.6	122.1	122.0	121.6	122.4	122.3
Loan to deposits (Percent)	111.0	105.4	100.7	102.3	103.3	103.3	104.2	105.1	105.6
Wholesale market funding (Percent of assets)[3]	21.4	19.6	16.6	16.8	17.0	17.3	17.6	17.7	18.0

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

[1]Excludes Bank of Portugal.

[2]Including emigrants.

[3]Includes foreign interbank borrowing and securities issued.

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

	2013	2014	Est. 2015	Projections 2016	2017	2018	2019	2020	2021
				(Billions of euros)					
Current account	2.5	0.2	0.8	1.7	0.8	0.2	-0.3	-0.7	-1.2
Balance of goods and services	3.1	2.0	3.1	5.0	4.1	3.4	2.8	2.3	1.6
Trade balance	-8.1	-9.5	-9.2	-8.3	-10.0	-11.4	-13.0	-14.4	-15.8
Exports fob	46.5	47.2	49.0	47.2	50.5	53.7	56.8	59.8	62.8
Imports fob	54.5	56.7	58.2	55.5	60.5	65.2	69.8	74.3	78.6
Services, net	11.2	11.5	12.3	13.3	14.1	14.9	15.7	16.7	17.4
Exports	22.1	23.5	25.1	26.8	28.3	29.9	31.6	33.6	35.0
Imports	10.9	12.1	12.8	13.4	14.2	15.0	15.9	16.9	17.6
Of which:									
Tourism	6.1	7.1	7.8	8.3	8.8	9.3	9.9	10.5	10.9
Exports	9.2	10.4	11.4	12.1	12.8	13.5	14.3	15.2	15.9
Imports	3.1	3.3	3.6	3.8	4.0	4.2	4.5	4.8	5.0
Primary income, net	-2.2	-3.0	-3.8	-4.6	-4.6	-4.6	-4.5	-4.4	-4.2
Secondary income, net	1.5	1.3	1.6	1.3	1.3	1.3	1.4	1.4	1.5
Private remittances, net	3.1	3.0	3.2	3.0	3.1	3.1	3.2	3.3	3.4
Official transfers, net	-1.6	-1.7	-1.6	-1.7	-1.7	-1.8	-1.8	-1.9	-1.9
Capital account	2.8	2.6	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Financial account	17.2	8.4	3.3	4.0	3.1	2.5	1.9	1.5	1.1
Direct investment	-3.6	-2.6	1.9	2.0	2.0	2.0	2.1	2.1	2.2
Direct investment assets	5.1	7.2	0.7	0.7	0.8	0.8	0.8	0.9	0.9
Direct investment liabilities	8.7	9.8	-1.2	-1.2	-1.2	-1.3	-1.3	-1.3	-1.3
Portfolio investment, net	3.8	-1.3	-2.4	-2.4	-2.5	-2.6	-2.6	-2.7	-2.9
Financial derivatives	1.0	1.9	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Other investment, net	15.6	8.7	1.9	3.4	2.9	2.5	2.1	1.8	1.5
Reserve assets	0.4	1.7	1.5	0.7	0.4	0.2	0.1	0.0	0.0
Errors and omissions	0.3	0.4	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	11.7	5.2	...	...	...	...	...	...	...
European Union	8.2	3.5	...	...	...	...	...	...	...
IMF	3.4	1.8	...	...	...	...	...	...	...
Memorandum items:									
Net international investment position[1]	-198.3	-198.4	-196.2	-192.2	-189.1	-186.7	-184.8	-183.2	-182.1
Direct investment, net	-46.8	-47.9	-46.5	-44.6	-42.6	-40.5	-38.4	-36.3	-34.1
Portfolio investment, net	-18.4	-20.6	-23.4	-25.8	-28.4	-30.9	-33.6	-36.3	-39.2
Financial derivatives	-3.1	-1.8	0.1	0.4	0.7	1.0	1.3	1.6	1.9
Other investment, net	-142.7	-144.2	-144.2	-140.8	-137.8	-135.4	-133.3	-131.5	-130.1
Reserve assets	12.7	16.2	17.8	18.6	18.9	19.1	19.2	19.2	19.3
Nominal GDP	170.3	173.4	179.4	184.6	189.6	194.5	199.8	205.5	211.4
				(Percentage of GDP)					
Current account	1.5	0.1	0.5	0.9	0.4	0.1	-0.2	-0.4	-0.6
Current account (Including capital transfers)	3.1	1.6	1.7	2.1	1.6	1.3	1.0	0.7	0.5
Of which: Balance of goods and services	1.8	1.1	1.7	2.7	2.2	1.8	1.4	1.1	0.8
Net international investment position[1]	-116.5	-114.4	-109.4	-104.1	-99.8	-96.0	-92.5	-89.2	-86.2
Direct investment, net	-27.5	-27.6	-25.9	-24.1	-22.5	-20.8	-19.2	-17.7	-16.1
Portfolio investment, net	-10.8	-11.9	-13.0	-14.0	-15.0	-15.9	-16.8	-17.7	-18.5
Financial derivatives	-1.8	-1.0	0.1	0.2	0.4	0.5	0.7	0.8	0.9
Other investment, net	-83.8	-83.2	-80.4	-76.2	-72.7	-69.6	-66.7	-64.0	-61.5
Reserve assets	7.5	9.3	9.9	10.0	10.0	9.8	9.6	9.4	9.1

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

Table 5. Portugal: Financial Soundness Indicators, 2012:Q1–2015:Q3[1]

(Percent)

	2012				2013				2014				2015		
	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.
Capital adequacy															
Regulatory capital to risk-weighted assets	10.7	12.3	12.3	12.6	13.0	13.1	13.4	13.3	12.3	12.0	13.0	12.3	12.0	12.5	12.6
Common Equity Tier 1 capital to risk-weighted assets									12.2	10.6	12.0	11.3	11.1	11.6	11.6
Regulatory tier 1 capital to risk-weighted assets	9.5	11.0	11.1	11.3	11.7	11.7	12.0	11.9	11.1	10.7	12.1	11.4	11.2	11.7	11.7
Capital to assets[2]	5.8	6.2	6.6	6.7	6.9	6.7	6.9	6.9	7.4	7.2	8.1	7.7	8.0	7.8	8.1
Asset composition and quality															
Non-performing loans to total gross loans[3]	8.0	9.2	9.8	9.8	10.4	10.6	11.2	10.6	10.8	11.2	12.0	12.0	12.3	12.6	12.9
Sectoral distribution of loans															
Residents	83.2	82.4	82.5	83.3	83.2	83.9	86.7	86.8	86.1	85.8	84.8	85.6	85.7	85.8	87.7
Nonresidents	16.8	17.6	17.5	16.7	16.8	16.1	13.3	13.2	13.9	14.2	15.2	14.4	14.3	14.2	12.3
Earnings and profitability															
Return on assets	0.5	0.1	0.0	-0.3	-0.3	-0.5	-0.5	-0.7	0.0	-1.8	-1.5	-1.3	0.5	0.5	0.3
Return on equity	8.2	2.5	0.3	-5.4	-3.7	-8.0	-7.5	-11.0	-0.4	-24.8	-19.8	-17.9	6.4	6.0	3.6
Interest margin to gross income	51.3	47.9	46.6	46.7	41.7	43.4	46.0	47.7	46.3	47.9	49.1	50.1	44.7	46.2	49.2
Noninterest expenses to gross income	58.2	55.0	57.0	59.6	66.2	66.6	68.5	70.4	59.5	66.9	67.0	67.4	53.3	55.0	59.8
Liquidity															
Liquid assets to total assets[4]	11.2	12.7	13.7	14.8	15.4	16.0	15.7	16.9	16.7	16.2	17.2	22.0	19.4	19.4	18.8
Liquid assets to short-term liabilities[4]	90.5	101.5	123.2	140.0	145.9	150.7	155.1	170.3	155.6	157.3	146.8	154.2	154.7	169.4	178.5
Loans to deposits[5]	136.9	136.3	133.3	127.9	124.0	122.6	120.7	116.9	117.2	113.9	111.9	107.2	106.9	106.0	104.2
Foreign-currency-denominated liabilities to total liabilities	3.9	3.9	4.0	4.2	4.5	4.4	4.4	4.3	4.3	4.7	4.8	4.5	4.6	4.5	4.4

Source: Bank of Portugal.

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

[2]On accounting basis; consolidated.

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

[4]Three-month residual maturity.

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

[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, 2013–2021

(Percent of GDP, unless otherwise indicated)

			Est.	Projections						
	2013	2014	2015	2016	2017	2018	2019	2020	2021	Debt-stabilizing non-interest current account[6]
Baseline: External debt	227.1	235.6	229.2	220.9	215.2	211.7	208.2	203.8	201.0	-6.0
Change in external debt	-10.7	8.6	-6.4	-8.3	-5.8	-3.4	-3.5	-4.4	-2.8	
Identified external debt-creating flows (4+8+9)	-3.8	-4.4	-12.9	-8.7	-7.8	-7.1	-6.8	-6.5	-6.1	
Current account deficit, excluding interest payments	-7.1	-5.1	-5.4	-5.9	-4.8	-4.3	-3.9	-3.7	-3.5	
Deficit in balance of goods and services	-1.8	-1.1	-1.7	-2.7	-2.2	-1.8	-1.4	-1.1	-0.8	
Exports	40.3	40.8	41.3	40.1	41.5	43.0	44.3	45.5	46.3	
Imports	38.4	39.7	39.5	37.3	39.4	41.2	42.9	44.4	45.5	
Net non-debt creating capital inflows (negative)	0.2	-0.1	-4.7	-4.6	-4.6	-4.6	-4.6	-4.5	-4.4	
Automatic debt dynamics[1]	3.0	0.8	-2.9	1.8	1.7	1.7	1.7	1.8	1.8	
Contribution from nominal interest rate	5.6	5.0	5.0	5.0	4.4	4.2	4.1	4.1	4.1	
Contribution from real GDP growth	2.7	-2.0	-3.4	-3.1	-2.7	-2.4	-2.4	-2.3	-2.3	
Contribution from price and exchange rate changes[2]	-5.3	-2.1	-4.5	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3)[3]	-6.9	12.9	6.5	0.4	2.0	3.7	3.3	2.1	3.3	
External debt-to-exports ratio (Percent)	563.7	577.7	555.2	551.3	518.0	492.6	470.4	448.2	434.1	
Gross external financing need (Billions of Euros)[4]	180.9	173.7	163.9	160.0	151.0	150.5	156.0	162.7	167.7	
Percent of GDP	106.2	100.2	91.4	86.6	79.6	77.4	78.1	79.2	79.3	
Scenario with key variables at their historical averages[5]				220.9	228.2	237.3	246.6	254.9	264.8	4.7
Key Macroeconomic Assumptions Underlying Baseline										
Real GDP growth (Percent)	-1.1	0.9	1.5	1.4	1.3	1.2	1.2	1.2	1.2	
GDP deflator in Euros (Percent)	2.3	1.0	1.9	1.5	1.4	1.4	1.6	1.7	1.7	
Nominal external interest rate (Percent)	2.4	2.2	2.2	2.2	2.0	2.0	2.0	2.0	2.0	
Growth of exports (Euros, percent)	6.5	3.2	4.7	-0.1	6.4	6.2	5.8	5.6	4.7	
Growth of imports (Euros, percent)	2.0	5.1	3.2	-2.8	8.2	7.4	6.9	6.4	5.6	
Current account balance, excluding interest payments	7.1	5.1	5.4	5.9	4.8	4.3	3.9	3.7	3.5	
Net non-debt creating capital inflows	-0.2	0.1	4.7	4.6	4.6	4.6	4.6	4.5	4.4	

Source: IMF staff calculations.

[1] Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency--not used here), and a = share of domestic-currency denominated debt in total external debt.

[2] The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

[3] For projection, line includes the impact of price and exchange rate changes.

[4] Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

[5] The key variables include real GDP growth; nominal interest rate; deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

[6] Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

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

(Millions of euros, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Disbursements	13,050	8,219	3,406	1,786	...	...	...	...	...	...	...
(Percent of quota)	1,117	670	289	152	...	...	...	...	...	...	...
(Projected debt service to the Fund, based on existing and prospective drawings)											
Total	178	460	621	822	9,211	5,101	2,522	422	2,519	5,034	4,266
Interest and charges	178	460	621	822	861	631	492	422	418	282	95
Repayments	0	0	0	0	8,350	4,470	2,031	0	2,101	4,752	4,171
Total debt service, in percent of											
Exports of goods and services	0.3	0.7	0.9	1.2	12.4	6.9	3.2	0.5	2.8	5.4	4.4
GDP	0.1	0.3	0.4	0.5	5.1	2.8	1.3	0.2	1.3	2.4	2.0
(Projected level of credit outstanding based on existing and prospective drawings)											
Outstanding stock	13,494	21,583	23,998	27,105	20,845	16,036	13,981	13,960	11,816	7,050	2,878
Percent of quota[2]	1,117.1	1,787.1	2,076.2	2,228.0	1,589.1	621.5	542.7	542.7	460.9	275.3	112.4
Percent of GDP	7.7	12.8	14.1	15.6	11.6	8.7	7.4	7.2	5.9	3.4	1.4
Memorandum Items (Billions of euros)											
Exports of goods and services	62	64	69	71	74	74	79	84	88	93	98
GDP	176	168	170	173	179	185	190	195	200	205	211

Source: IMF staff estimates.

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

[2] Quota increase in 2016.

Table 8. Portugal: General Government Financing Requirements and Sources, 2016–2021[1]
(Billions of euros)

	2016	2017	2018	2019	2020	2021
Gross borrowing need	36.7	28.5	26.8	33.1	34.5	42.5
Overall balance	5.4	5.6	5.5	5.6	5.8	5.9
Amortization	31.2	23.1	20.7	26.9	28.7	36.5
Medium- and long-term	16.2	10.5	10.2	14.3	13.4	21.8
Residents	4.1	3.1	4.4	7.3	5.6	12.7
Non-residents	12.2	7.4	5.8	7.0	7.8	9.1
Short-term[2]	10.5	10.5	10.5	10.5	10.5	10.5
Residents	6.7	6.7	6.7	6.7	6.7	6.7
Non-residents	3.8	3.8	3.8	3.8	3.8	3.8
EU and IMF[3]	4.5	2.0	0.0	2.1	4.8	4.2
Other (Net)[4]	0.2	-0.2	0.5	0.5	0.0	0.0
Gross financing sources	36.9	28.6	26.8	33.1	34.7	42.6
Privatization receipts	0.0	0.0	0.0	0.0	0.0	0.0
Market access	36.5	28.3	25.3	32.0	33.7	42.6
Medium- and long-term	25.9	17.8	14.7	21.5	23.2	32.1
Residents	11.5	7.4	6.3	9.7	9.7	15.7
Non-residents	14.4	10.4	8.4	11.8	13.4	16.4
Short-term[2]	10.5	10.5	10.5	10.5	10.5	10.5
Residents	6.7	6.7	6.7	6.7	6.7	6.7
Non-residents	3.8	3.8	3.8	3.8	3.8	3.8
Use of deposits[5]	0.4	0.3	1.5	1.1	1.0	0.0
Net placement (Market access-amortization)	5.3	5.2	4.5	5.1	5.0	6.1
Residents	5.3	3.3	2.0	1.9	2.9	1.9
Medium- and long-term	5.2	3.3	2.0	1.9	2.9	1.9
Short-term (Net increase)	0.1	0.0	0.0	0.0	0.0	0.0
Non-residents	0.0	2.0	2.6	3.2	2.1	4.2
Medium- and long-term	0.0	2.0	2.6	3.2	2.1	4.2
Short-term (Net increase)	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Portuguese authorities; and IMF staff estimates.
[1] The coverage of this table has been expanded to fully reflect all general government (including local and regional governments and SOES) financing operations. However, data are on a non-consolidated basis (with intra-government flows presented where available). On a consolidated basis, they are smaller, by the amount of intra-government transactions.
[2] For projection years, all 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. Projections assume further advanced Fund repurchases in 2016–17, in line with the amount approved by Portugal's European partners. In the absence of additional advanced repurchases, Portugal's next repurchase is not due until September 2018.
[4] Includes use of Bank Solvency Support Facility and other net financial transactions, net financing from retail government securities programs, as well as adjustments for cash-accrual differences and consistency between annual projections and preliminary quarterly accounts.
[5] Changes in government deposits (including deposits in BSSF).

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

(Billions of euros, unless otherwise indicated)

	Projections					
	2016	2017	2018	2019	2020	2021
Gross financing requirements	160.0	151.0	150.5	156.0	162.7	167.7
Current account deficit	-1.7	-0.8	-0.2	0.3	0.7	1.2
Medium- and long-term debt amortization	31.6	27.4	30.9	33.5	36.6	41.1
Public sector	12.2	7.4	5.8	7.0	7.8	9.1
Banks	14.1	15.6	19.7	19.9	20.2	20.5
Other private	5.3	4.4	5.4	6.5	8.7	11.6
Short-term debt amortization	125.6	122.4	119.8	120.0	120.6	121.2
Public sector	74.3	71.0	68.1	67.9	67.6	67.4
Central Bank	70.5	67.2	64.3	64.1	63.8	63.6
Of which: ECB access	28.8	25.5	22.6	22.4	22.2	22.0
General government and SOEs	3.8	3.8	3.8	3.8	3.8	3.8
Banks	35.1	36.7	38.5	40.3	42.2	44.2
Other private	16.3	14.6	13.2	11.8	10.7	9.6
EU and IMF[1]	4.5	2.0	0.0	2.1	4.8	4.2
Sources of financing	160.0	151.0	150.5	156.0	162.7	167.7
Capital account (Net)	2.3	2.3	2.3	2.3	2.3	2.3
Foreign direct investment (Net)	2.0	2.0	2.0	2.1	2.1	2.2
Inward	-1.2	-1.2	-1.3	-1.3	-1.3	-1.3
New borrowing and debt rollover	158.4	151.8	154.6	159.9	164.6	172.5
Medium and long-term borrowing	36.1	32.0	34.5	39.4	43.4	49.9
General government	14.4	10.4	8.4	11.8	13.4	16.4
Banks	15.3	16.8	20.7	21.1	21.3	21.9
Other private	6.4	4.8	5.4	6.5	8.7	11.6
Short-term borrowing	122.4	119.8	120.0	120.6	121.2	122.6
Public sector	71.0	68.1	67.9	67.6	67.4	67.2
Central bank	67.2	64.3	64.1	63.8	63.6	63.4
Of which: ECB access	25.5	22.6	22.4	22.2	22.0	21.7
General government	3.8	3.8	3.8	3.8	3.8	3.8
Banks	36.7	38.5	40.3	42.2	44.2	46.8
Other private	14.6	13.2	11.8	10.7	9.6	8.6
Other (Includes asset operations)	-2.7	-5.1	-8.4	-8.3	-6.3	-9.3
Of which: Net errors and omissions	0.0	0.0	0.0	0.0	0.0	0.0
Rollover rates						
General government	114.2	126.5	126.6	143.9	149.2	157.3
Private	103.1	102.7	102.0	102.4	102.4	103.5
Banks	105.7	105.6	104.9	105.1	104.9	106.1
Other private	97.4	94.6	92.9	93.5	94.5	95.5
Gross external debt	396.8	...	...	...	...	...
General government	162.7	...	...	...	...	...
Of which : short-term	6.0	...	...	...	...	...
Central Bank	80.1	...	...	...	...	...
Private	153.9	...	...	...	...	...
Banks	71.3	...	...	...	...	...
Of which : short-term	36.7	...	...	...	...	...
Non-financial corporates	82.6	...	...	...	...	...
Of which : short-term	14.6	...	...	...	...	...
(Percent of GDP)						
Gross external debt	228.6	...	...	...	...	...
General government	93.8	...	...	...	...	...
Central Bank	46.2	...	...	...	...	...
Banks	41.1	...	...	...	...	...
Non-financial corporations	47.6	...	...	...	...	...

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. Projections assume further advanced Fund repurchases in 2016–17, in line with the amount approved by Portugal's European partners. In the absence of additional advanced repurchases, Portugal's next repurchase is not due until September 2018.

Annex I. Public Debt Sustainability Analysis (DSA)

Staff's analysis, applying the Public DSA framework for Market-Access Countries, suggests that Portugal's gross debt trajectory is subject to significant risks, in the context of a sizable debt burden and gross financing needs. Debt dynamics remain highly vulnerable to adverse yet plausible macro-fiscal and contingent liabilities shocks, including the possible need for further fiscal support for the financial sector. The risk of a contingent liabilities shock materializing appears to have increased over the past six months, in light of financial sector developments in late 2015. Moreover, while staff's baseline projections reflect the authorities' current fiscal policies, additional fiscal consolidation remains critical to anchor debt safely on a downward-sloping path, boosting policy credibility and strengthening the country's resilience to reversals in market sentiment.

I. Baseline Scenario

1. There was a modest decline in public debt in 2015 despite further fiscal slippage and large fiscal costs related to financial sector operations. Public debt fell from 130.2 to 128.8 percent of GDP at end-2015, primarily reflecting a large drawdown of deposits, as the authorities used large cash reserves accumulated in recent years to help finance early Fund repurchases. Portugal's debt net of government deposits rose further to 121.4 percent of GDP from 120 percent of GDP at end–2014. A modest decline in public debt is projected to continue through 2021 as the headline fiscal deficit stabilizes just below 3 percent of GDP, but public debt would still remain elevated at 124 percent of GDP in 2021. The further drawdown of cash deposits from 2016–21 is projected to be modest, reflecting the authorities' intention to maintain cover for 6 months' refinancing needs, while projected proceeds from the sale of the Novo Banco have been removed from the baseline, reflecting sizable uncertainty over prospects for the sale.

II. Risk Assessment

2. Portugal's sizable debt burden and gross financing needs continue to pose significant risks to debt sustainability and leave debt dynamics very sensitive to macro shocks. As shown in Figure 1, Portugal's debt ratio already exceeds the debt burden benchmark for advanced economies of 85 percent of GDP under the baseline scenario. The same applies to Portugal's public financing needs which are above the relevant benchmark of 20 percent of GDP. However, the debt profile is subject to medium to low risks in terms of market perception, projected change in short-

term debt, and the share of public debt held by nonresidents.[1] Moreover, in the case of Portugal, since bank vulnerabilities are below the relevant thresholds identified by the MAC DSA template, the standardized contingent liabilities shock does not apply. Nevertheless, this is replaced by a customized shock given the risks posed by the materialization of contingent liabilities from SOEs and PPPs (please refer to the stress test customized scenario).

III. Realism of Baseline Assumptions and Alternative Scenarios

3. **Realizing the potential growth rate assumed in the current projection has important implications for the debt adjustment path.** Portugal's growth forecast track record shows a relatively large median error compared with other countries with Fund-supported programs, especially during the pre-crisis period (Figure 2). The achievement of a growth rate of 1¼ 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 stalling or reversal of the reform effort—the rate of debt decline would significantly slow down, as also shown in Figures 4 and 5. Similarly, risks from a protracted period of negative inflation in Portugal could further impede the repair of already-weak private and public balance sheets, as highlighted by the customized deflation scenario in Figure 5.

4. **Given Portugal's sizable debt burden and financing needs, the primary balance is expected to exceed its debt-stabilizing threshold over the projection period.** Under staff's baseline scenario,[2] the fiscal primary balance is expected to stabilize at 1.5 percent of GDP over the medium term. As estimated in Figure 2, the 3-year change in the cyclically-adjusted primary balance identified for Portugal is in the top third of the fiscal adjustments observed in other countries with debt greater than 60 percent of GDP. However, due to the 3-year rolling nature of the estimate, this largely reflects the country's fiscal efforts already achieved over 2011–14. 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 2015–19 envisaged a reduction in public debt to 107.6 percent of GDP by 2019 (in line with the EU fiscal framework), however, neither the 2015 fiscal

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

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

outturn nor the 2016 budget are in line with the plans outlined in the SP. In addition, this target was based on considerably more optimistic growth assumptions than in staff's baseline scenario; including projected annual real GDP growth of 2.4 percent in 2017–19, as opposed to staff's baseline projection of average annual growth of 1.3 percent over the same period.

IV. Stress Tests

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

- Under a *growth shock* that lowers output by nearly 4.5 percentage points in 2016–17 (and in turn inflation by a cumulative 1 percentage point), debt would peak at about 138 percent of GDP in 2018, 11 percentage points higher than under the 2016 baseline. However, debt dynamics would be severely compromised under a *deflation scenario* where a sharper growth shock (that lowers output by 5½ percentage points in 2016–17) is associated with deflationary pressures (with inflation lower by cumulative 4 percentage points), in the context of a widening output gap and high unemployment. Under this scenario, debt would rise to 146 percent of GDP by 2018and remain close to this level over the medium-term.

- A sustained interest rate shock of 200 basis points throughout the projection period is not expected to have a large immediate effect, but it would slow down the rate of debt decline in the medium term, so that by 2020 the debt-to-GDP ratio is about 3 points higher compared with the baseline.

- Further materialization of contingent liabilities would also have implications for Portugal's debt dynamics. While the recent debt management operation for SOEs has significantly addressed fiscal risks from the transport and infrastructure sectors, staff's assessment suggests that, under a severe scenario, further contingent liabilities could potentially materialize for about 10 percent of GDP, due to financial sector risks, SOEs, PPPs, and State guarantees.[3] A contingent liabilities shock of this magnitude would push the 2017 debt ratio to 137 percent of GDP.

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

- 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 146 percent of GDP in 2018 and then remaining at this level over the medium term.

6. The authorities took note of the risks highlighted by staff, but also stressed the divergence of their medium-term outlook from staff's baseline scenario. The authorities were optimistic that reforms in recent years have laid the foundation for a structural transformation toward stronger export-oriented growth, which would underpin a larger improvement in medium-term debt dynamics than projected by staff. In addition, they remained confident that the 2016 fiscal deficit target will be achieved, resulting in a larger reduction of the debt-to-GDP ratio by the end of the year, and putting debt dynamics on a trajectory to improve at a faster pace than envisaged under staff's baseline scenario. Over the medium-term, the authorities reiterated their commitment to medium-term fiscal consolidation. In the near-term, they were optimistic that Portugal'srecent track record of fiscal adjustment and reform implementation under the adjustment program had strengthened their credibility with investors and the soundness of the economy, and would enable them to avoid any prolonged deterioration in market access.

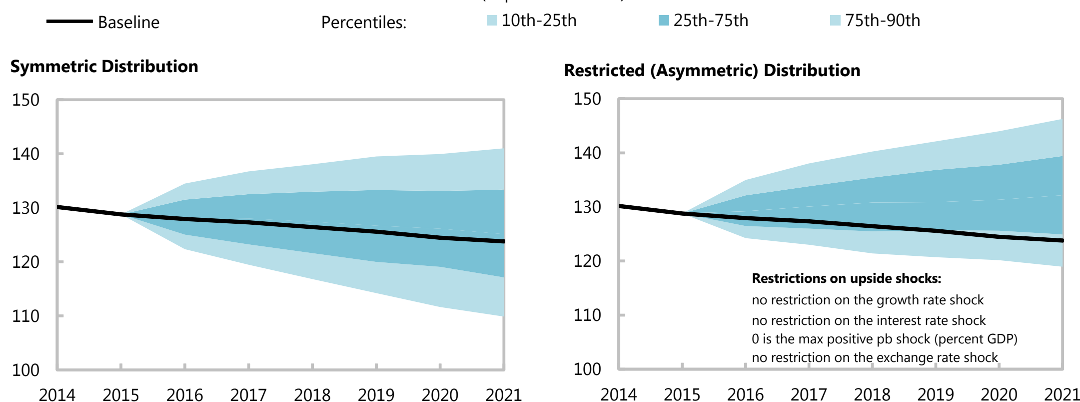
Figure 1. Portugal: Public DSA Risk Assessment, 2014–2021

Heat Map

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

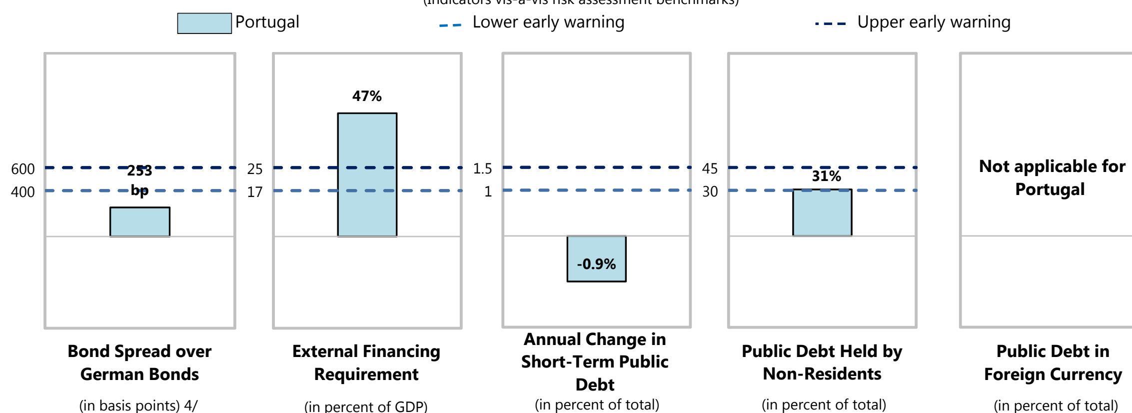
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)



Source: IMF staff estimates.

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

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

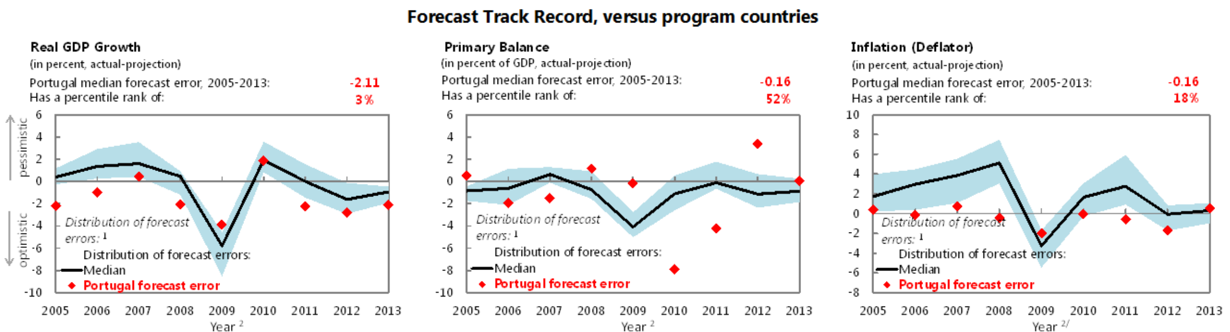
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant,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

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

4/ An average over the last 3 months, 10-Dec-15 through 09-Mar-16.

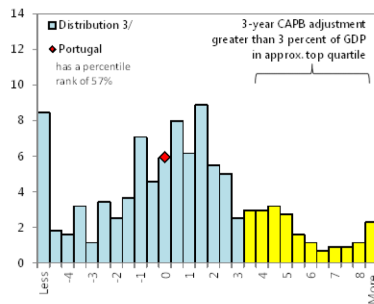
Figure 2. Portugal: Public DSA - Realism of Baseline Assumptions

Forecast Track Record, versus program countries

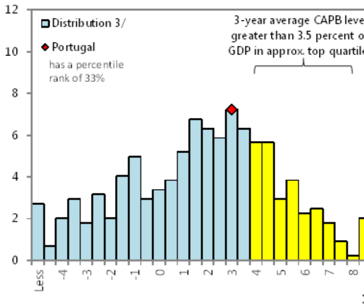


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Source: IMF staff estimates.

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

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

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

Figure 3. Portugal: Public Sector Debt Sustainability Analysis (DSA) Baseline Scenario, 2005–2021

(Percent of GDP, unless otherwise indicated)

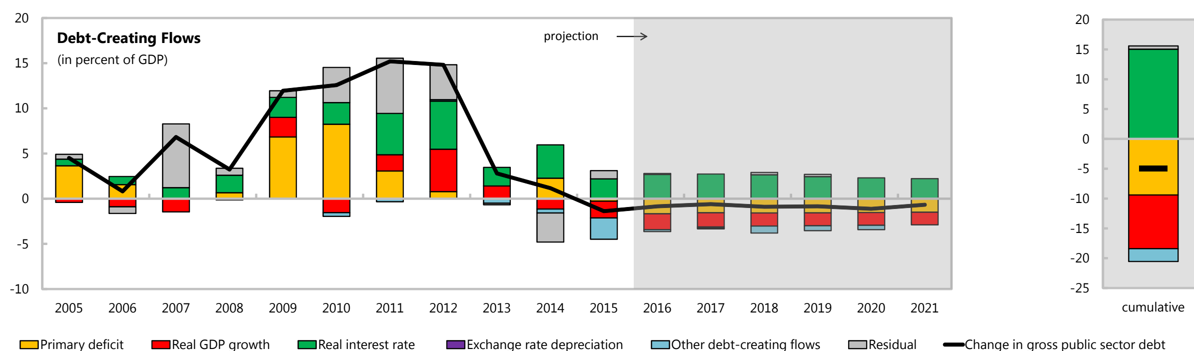
Debt, Economic and Market Indicators [1]

	Actual		Prel.	Projections					
	2005-2013 [2]	2014	2015	2016	2017	2018	2019	2020	2021
Nominal gross public debt	89.9	130.2	128.8	127.9	127.3	126.4	125.6	124.5	123.8
Public gross financing needs	...	30.9	22.4	19.9	15.2	13.5	16.3	16.9	20.2
Real GDP growth (in percent)	-0.3	0.9	1.5	1.4	1.3	1.2	1.2	1.2	1.2
Inflation (GDP deflator, in percent)	1.6	1.0	1.9	1.5	1.4	1.4	1.6	1.7	1.7
Nominal GDP growth (in percent)	1.3	1.9	3.4	2.9	2.7	2.6	2.7	2.8	2.9
Effective interest rate (in percent) [4]	4.4	3.9	3.7	3.7	3.6	3.6	3.6	3.6	3.6

As of March 09, 2016		
Sovereign Spreads		
Spread (bp) 3/		295
CDS (bp)		267
Ratings	Foreign	Local
Moody's	Ba1	Ba1
S&Ps	BB	BB
Fitch	BB+	BB+

Contribution to Changes in Public Debt

	Actual		Prel.	Projections							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	8.1	1.2	-1.4	-0.8	-0.6	-0.9	-0.8	-1.1	-0.7	-5.0	
Identified debt-creating flows	5.6	4.4	-2.3	-1.0	-0.5	-1.2	-1.1	-1.1	-0.7	-5.5	
Primary deficit	2.8	2.3	-0.3	-1.7	-1.6	-1.6	-1.6	-1.5	-1.5	-9.4	0.8
Primary (noninterest) revenue and grants	41.8	44.5	43.9	43.6	43.2	43.1	42.9	42.8	42.6	258.3	
Primary (noninterest) expenditure	44.5	46.8	43.6	41.9	41.6	41.5	41.4	41.3	41.1	248.8	
Automatic debt dynamics [5]	3.0	2.5	0.3	0.9	1.2	1.2	1.0	0.9	0.8	6.1	
Interest rate/growth differential [6]	3.0	2.5	0.3	0.9	1.2	1.2	1.0	0.9	0.8	6.1	
Of which: real interest rate	2.4	3.7	2.2	2.7	2.7	2.6	2.4	2.3	2.2	15.0	
Of which: real GDP growth	0.6	-1.1	-1.9	-1.7	-1.6	-1.4	-1.4	-1.4	-1.4	-9.0	
Exchange rate depreciation [7]	0.0	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	-0.1	-0.4	-2.4	-0.2	-0.1	-0.8	-0.6	-0.5	0.0	-2.2	
Privatization Revenue (negative)	-0.3	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Increase in deposits and other (- means drawn down of deposits)	0.2	-0.2	-2.4	-0.2	-0.1	-0.8	-0.6	-0.5	0.0	-2.2	
Residual, including asset changes [8]	2.4	-3.2	0.9	0.1	-0.1	0.3	0.3	0.0	0.0	0.5	



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, 2010–2021

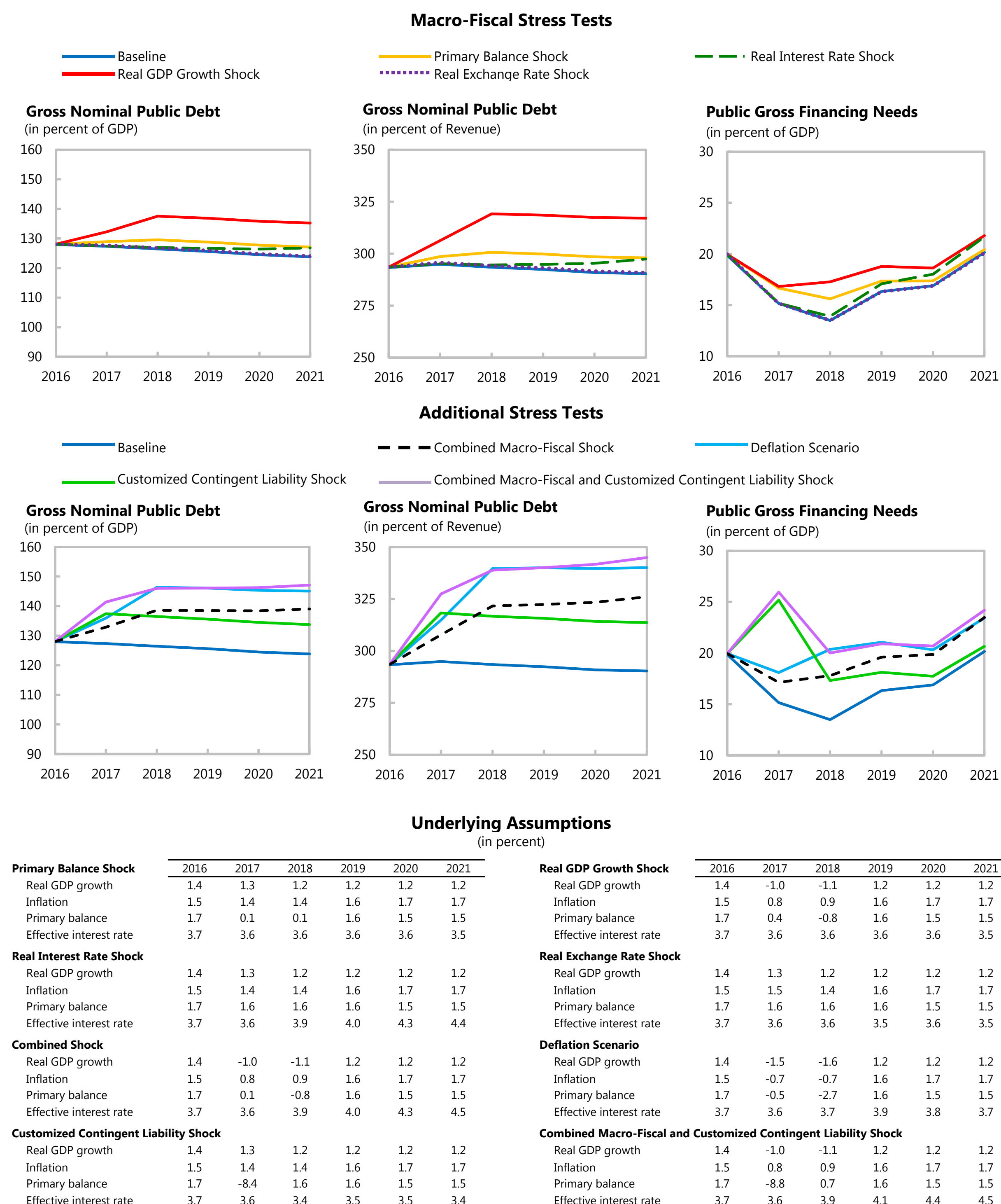
Underlying Assumptions
(in percent)

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

Historical Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	1.4	-0.1	-0.1	-0.1	-0.1	-0.1
Inflation	1.5	1.4	1.4	1.4	1.4	1.4
Primary Balance	1.7	-2.3	-2.3	-2.3	-2.3	-2.3
Effective interest rate	3.7	3.6	3.6	3.7	3.7	3.8

Source: IMF staff estimates.

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



Underlying Assumptions

(in percent)

Primary Balance Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	1.4	1.3	1.2	1.2	1.2	1.2
Inflation	1.5	1.4	1.4	1.6	1.7	1.7
Primary balance	1.7	0.1	0.1	1.6	1.5	1.5
Effective interest rate	3.7	3.6	3.6	3.6	3.6	3.5
Real Interest Rate Shock						
Real GDP growth	1.4	1.3	1.2	1.2	1.2	1.2
Inflation	1.5	1.4	1.4	1.6	1.7	1.7
Primary balance	1.7	1.6	1.6	1.6	1.5	1.5
Effective interest rate	3.7	3.6	3.9	4.0	4.3	4.4
Combined Shock						
Real GDP growth	1.4	-1.0	-1.1	1.2	1.2	1.2
Inflation	1.5	0.8	0.9	1.6	1.7	1.7
Primary balance	1.7	0.1	-0.8	1.6	1.5	1.5
Effective interest rate	3.7	3.6	3.9	4.0	4.3	4.5
Customized Contingent Liability Shock						
Real GDP growth	1.4	1.3	1.2	1.2	1.2	1.2
Inflation	1.5	1.4	1.4	1.6	1.7	1.7
Primary balance	1.7	-8.4	1.6	1.6	1.5	1.5
Effective interest rate	3.7	3.6	3.4	3.5	3.5	3.4

Real GDP Growth Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	1.4	-1.0	-1.1	1.2	1.2	1.2
Inflation	1.5	0.8	0.9	1.6	1.7	1.7
Primary balance	1.7	0.4	-0.8	1.6	1.5	1.5
Effective interest rate	3.7	3.6	3.6	3.6	3.6	3.5
Real Exchange Rate Shock						
Real GDP growth	1.4	1.3	1.2	1.2	1.2	1.2
Inflation	1.5	1.5	1.4	1.6	1.7	1.7
Primary balance	1.7	1.6	1.6	1.6	1.5	1.5
Effective interest rate	3.7	3.6	3.6	3.5	3.6	3.5
Deflation Scenario						
Real GDP growth	1.4	-1.5	-1.6	1.2	1.2	1.2
Inflation	1.5	-0.7	-0.7	1.6	1.7	1.7
Primary balance	1.7	-0.5	-2.7	1.6	1.5	1.5
Effective interest rate	3.7	3.6	3.7	3.9	3.8	3.7
Combined Macro-Fiscal and Customized Contingent Liability Shock						
Real GDP growth	1.4	-1.0	-1.1	1.2	1.2	1.2
Inflation	1.5	0.8	0.9	1.6	1.7	1.7
Primary balance	1.7	-8.8	0.7	1.6	1.5	1.5
Effective interest rate	3.7	3.6	3.9	4.1	4.4	4.5

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 loss of sole investment-grade rating: • Increase in sovereign bonds yields and reduction in foreign direct investment.	Medium	High Significant funding distress and loss of eligibility of sovereign debt as ECB collateral. Higher public and private borrowing costs.	**To minimize exposure:** Strengthen policy buffers and avoid backtracking on reforms. **If risk materializes:** Take steps to restore market access at favorable terms and ensure banks' access to liquidity is maintained. Take fiscal measures to ensure fiscal targets are being met.
Tighter or more volatile global financial conditions: • **Sharp asset price decline and decompression of credit spreads** as investors reassess underlying risk and respond to unanticipated changes in growth and financial fundamentals in large economies, Fed policy rate path, and increases in U.S. term premia, with poor market liquidity amplifying volatility.	Medium	High Given its high corporate and private debt levels, Portugal would be highly susceptible to financial contagion. The result would be a heightened financial stress in the Portuguese banking system, as balance sheet fragilities in both banking and corporate sectors are still significant.	**To minimize exposure:** Shore up liquidity and capital buffers; encourage private savings, and shrink private sector balance sheets. **If risk materializes:** ECB policy actions to ensure market liquidity, encourage lending to productive investment opportunities, and ensure orderly monetary transmission mechanisms, including expansion of asset purchase programs.
Sharper-than-expected global growth slowdown: • **Structurally weak growth in key advanced and emerging economies.** Weak demand and persistently low inflation from a failure to fully address crisis legacies and undertake structural reforms, leading to low medium-term growth and persisting financial imbalances in the Euro area and Japan (high likelihood). Easy global financial conditions coming to an end and insufficient reform progress undermine medium-term growth in emerging markets and suppress commodity prices (medium likelihood).	High/ Medium	High Low growth would imperil debt dynamics in all sectors, with the euro area accounting for 60 percent of total exports putting the current account balance and IIP at risk.	**To minimize exposure:** Step up structural reforms to improve competitiveness and reduce debt overhang. **If risk materializes:** Accelerate and deepen domestic structural reforms.

Annex II. Risk Assessment Matrix (Concluded)

Source of Risks	Relative Likelihood	Impact	Policy response
Dislocation in capital and labor flows: • **Reduced financial services by global/regional banks ("de-risking"):** Further loss of correspondent banking services significantly curtails cross-border payments, trade finance, and remittances in small economies.	Medium	**Medium** Weakening of the external position and further pressure on corporate balance sheets.	**To minimize exposure:** Step up structural reforms to improve competitiveness and reduce corporate debt.
Persistently lower energy prices, triggered by supply factors reversing only gradually.	High	**Medium** A low fuel import bill is potentially offset by greater difficulties in Angola, a key economic and financial partner.	**To minimize exposure:** Step up efforts to clean up corporate balance sheets, including the reduction of exposures to Angola.
Financial distress in one or more banks, requiring intervention.	Medium	**High** Loss of confidence in the banking system, resulting in potentially high fiscal costs.	**To minimize exposure:** Proactive bank supervision, a build-up of capital buffers in banks and of fiscal buffers. Strengthen oversight of banks' risk management practices. **If risk materializes:** Shore up the banks using the existing toolkit, while ensuring public debt dynamics are not compromised.

Statement by Mr. Carlo Cottarelli, Executive Director for Portugal

and Ms. Ines Lopes, Advisor to the Executive Director

March 30, 2016

I - Overview

The staff report of the 3rd Post-Program Monitoring mission provides an updated assessment of the recovering Portuguese economy and draws attention on challenges that remain to be addressed. However, we feel that a more balanced assessment—highlighting not only the remaining challenges but also some important results that were achieved in the most recent period—would have been more appropriate, especially with regard to fiscal prospects and the Government's policy actions in the area of structural reforms. A more balanced assessment, using fewer adjectives and adverbs, would also have conveyed better the constructive policy discussions that were held in Lisbon.

In particular, we would like to underscore the following positive developments:

- Growth in 2015 continued at a rate that compares relatively well with that of other countries in the euro area, supported not just by consumption but also higher private investment.
- The process of strengthening in the fiscal accounts is continuing, including in 2016: the relaxation highlighted in the staff report simply reflects assumptions on potential growth that is not observable and, in our view, underestimated by staff.
- Confidence indicators remain strong, something well depicted by figure 2, but not mentioned in the staff report.
- While spreads have increased somewhat, this has been caused by an increased risk aversion in international financial markets, rather than by weaker performance of the Portuguese economy. Actually, a very successful auction took place on March 23rd, with strong demand resulting in a yield of 3.36 percent on a 15 year maturity.
- Bank liquidity and profitability indicators have improved.

The Portuguese Government is fully committed to economic and fiscal policies that promote competitiveness, economic growth and social cohesion, while ensuring sound and sustainable public finances. This commitment has been welcomed by our European partners.

Also, the Portuguese authorities reaffirm their willingness to work in an open, frank and constructive way with the IMF, contributing to increase the staff's understanding of the Portuguese economic and social conditions.

II - Economic Activity

In 2015, economic activity in Portugal continued its gradual recovery, along with a mild improvement in the labor market and the adjustment of the external accounts. However, recent developments proved that the adjustment goals on unemployment, inequality and poverty require further measures to promote inclusive growth which require an effective answer from the Government as well as from partner international institutions.

Real GDP growth was 1.5 percent, in acceleration with respect to 2014. Internal demand had an important contribution, with GFCF growing 5.4 percent (2.8 percent in 2014) and private consumption by 2.7 percent (2.3 percent in 2014). The staff report could have highlighted that private investment increased by 3.5 percent, a further acceleration with respect to 2014.

Concerning the labor market, 2015 registered an increase of 1.2 percent of the employed population and a significant decrease of the unemployed population (-11.0 percent). The unemployment rate in 2015 stood at 12.2 percent, 1.4 percentage points lower than in the end of 2014.

The external accounts also improved with the current account rising from 0.1 percent of GDP in 2014 to 0.5 in 2015, being the goods component more dynamic than services one. Alongside, 2015 was marked by a continued depreciation of the real effective exchange rate, albeit at a rate lower than in the euro area.

After a 0.5 percent contraction of the measured labor productivity in 2014, the first nine months of 2015 were marked by an improvement in this indicator (0.3 percent). Looking ahead these positive trends are expected to continue, including by staff as the staff report projects growth in 2016 at the same level as in 2015, unemployment to further edge down and the current account surplus to rise. It is not clear why these actual and expected results (in the context of a decline of fiscal deficit and public debt even in the more pessimistic staff projections) are seen by staff as conducive to higher risk.

III - Fiscal Policy

The Portuguese Government reaffirms its full commitment to ensure the sustainability of public finances as well as the compliance with its national engagements and the EU fiscal framework, including, as a priority, exiting from Excessive Deficit Procedure in 2016.

The 2016 State Budget introduces a fiscal policy aimed at continuing the fiscal adjustment process, while fostering the recovery in households' disposable income, increased social cohesion and sustained economic growth. It projects a headline deficit of 2.2 percent of GDP (against a deficit that, based on new estimates that are now available, was of 3.0 percent of GDP in 2015, net of the one-off cost of support to BANIF). It should be noted that even under the most pessimistic staff projection of the 2016 deficit, there would be an improvement in headline terms. Rather, the staff report argues that there will be a fiscal relaxation on 0.5 percentage point of GDP. This is entirely due to the very low potential growth rate (0.2 percent in 2016) used for computing short-term potential output growth by staff (and other institutions), something we commented already in the past. We also project a primary balance of 2.3 percent of GDP, with a strong improvement vis-à-vis 2015. The Portuguese authorities are fully committed to achieving this ambitious target and will ensure a very tight budget execution to warrant it. Indeed, it should be stressed the success in the strict execution of the Budget in January and February 2016. This execution will continue to be closely monitored.

Regarding the General Government Gross Debt-to-GDP ratio, in 2016 it is expected a decrease by 1.1 percentage points. This conservative figure still includes a relative high cash buffer (of around 7.5 percent of GDP) and does not include the proceeds from the sale of Novo Banco nor the sale of assets received from BANIF resolution measure. Again, debt is projected to decline even in the more pessimistic staff projections.

IV - Structural reforms

The authorities are fully committed to address the structural bottlenecks that reduce the productivity and competitiveness of the economy. The 2016 State Budget guarantees fiscal stability and places the priority in simplifying regulations and reducing red tape costs. The staff report mentions the rolling back of some measures introduced during the Fund-supported program. There is no backtracking on the labor code. However in line with the provisions of the Memorandum of Understanding, as well as Constitutional requirements, only temporary measures such as the Personal Income Tax Extraordinary Surcharge and the Public Sector wage cuts are being gradually rolled back.

The Portuguese Government is analyzing ways to effectively tackle private sector indebtedness, a structural issue that was not adequately answered during the Fund-supported

program. A Mission Unit to explore solutions for firms' capitalization, especially SMEs, has also been established.

On pensions, it should be pointed out that in the 2016 State Budget pension expenditure is planned to decrease in percentage of GDP, despite the reduction of the Special Contribution for Solidarity and updating of minimum pensions (pensions below or equal to €628.82 will be adjusted by 0.4 percent). Also, the Government is committed to ensure that any future reforms of the pension system will be directed at reinforcing its sustainability, including through the diversification of revenue sources.

Regarding labor market reforms, the Government will reinforce life-long learning and redirect active market policies towards more vulnerable groups.

The Portuguese Government disagrees with the evaluation made by the staff report concerning privatizations. The EGF privatization process was not interrupted, CP Carga privatization was concluded and EID privatization was resumed. Public Sector concessions processes were hampered by legal aspects which were clearly explained to the staff during the PPM mission.

Additionally, the Portuguese Government has resumed the process of administrative modernization and associated reduction in red tape costs, which was abandoned during the Fund-supported program. In this regard the Government has revamped the 'Simplex Program' aiming at identifying constraints and opportunities in administrative modernization of public services. A framework for ensuring that new legislation does not involve excessive administrative costs also involving an ex ante analysis of costs and benefits is also being introduced.

These measures clearly show that the Government is committed to structural reforms. We trust that these initiatives, among others, will be adequately evaluated by the Fund staff and its results reported in future staff reports.

V - Financial Sector Policies

While some important challenges still remain and are shared by many other banking systems in Europe, the Portuguese banking sector is adjusting.

The liquidity of the Portuguese banking system continued to improve throughout 2015, with further improvements in a long lasting process that began in 2010 with a noticeable downward adjustment in the loan-to-deposit ratio. It should be highlighted that throughout the whole Economic and Financial Assistance Program period and, more recently, during the period of higher turbulence in financial markets, also associated with the resolution measures applied in Europe in December 2015, the deposit base of Portuguese banks showed resilience, a sign of confidence of the public on the system as a whole. Further, in 2015 the

access of Portuguese banks to the Eurosystem funding has declined, despite the stabilization that occurred at end year. It should also be highlighted that after four years of negative results, the banking sector as a whole achieved positive profitability levels in 2015. Finally, the capital ratios have also improved, when compared to 2014, mainly driven by the resolution measure applied to Banco Espírito Santo, completed in December 2015, and by the decrease in risk weighted assets.

However, the Portuguese banking system still faces significant challenges. Against the background of the current macroeconomic scenario—characterized by low growth, very low nominal interest rates and low inflation—and high non-performing loans, bank profitability remains under pressure. In fact, in 2015, even though most banks returned to profits after several years of losses, the level of profits has remained low and explained, in part, by non-recurring factors. On the positive side, deposit interest rates have declined, leading to a recovery in the net interest income, and administrative costs have been cut through restructuring efforts (albeit further efforts are needed—as banks continue to adapt to the current macroeconomic scenario characterized by low levels of demand for financial services, restructuring should involve further downsizing and reallocation of human resources).

Aggregate lending continues to decrease, contributing to the deleveraging of the economy, even though with significant heterogeneity among different sectors/debtors. In fact, credit to construction and real estate sectors continued to decline in 2015, while credit to manufacturing and exporting companies increased. In addition, credit is being channeled to those companies with the better credit quality, while there is evidence of price discrimination according to the risk profile of the debtor. In the same period, the stock of credit to households for house purchase continued the deleveraging path initiated in 2011.

The uncertainty of the global economic outlook represents an additional challenge for banks. In particular, the indirect exposure of Portuguese banks to emerging economies, as Angola, is significant and, as such, the evolution of non-performing loans (NPLs) is likely to be affected by the vulnerabilities observed in these economies. In fact, NPLs on banks' balance sheet continue to be a concern given the potential impact on the banks' solvency and on their ability and willingness to finance the economy. Although some progress is visible in terms of the reduction of new NPLs, the efforts to address the NPL stock must continue. In particular, given the existing constraints and the links between them, our comprehensive strategy, comprising measures on supervision, legal, judicial and fiscal levels, to address this issue must be reinforced.

VI – Conclusion

The authorities believe that some reforms implemented under the Fund-supported Program must be allowed time and stability to produce effects, whilst the unintended effects of the

adjustment, such as rising inequality and emigration, must be corrected. Economic growth, social cohesion and sound public finances are goals to be met in equilibrium.

The Portuguese authorities look forward for the forthcoming Article IV consultation and the 4th PPM mission, which will constitute a good opportunity to closely work with the Fund staff to deepen our dialogue and promote a closer mutual understanding.