INTERNATIONAL MONETARY FUND

IMF Country Report No. 22/203

PORTUGAL

June 2022

2022 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR PORTUGAL

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2022 Article IV consultation with Portugal, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its June 23 consideration of the staff report that concluded the Article IV consultation with Portugal.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 23, 2022, following discussions that ended on May 13, 2022, with the officials of Portugal on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 7, 2022.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Portugal.

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

Selected Issues

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

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Washington, D.C.

PRESS RELEASE

PR22/244

IMF Executive Board Concludes 2022 Article IV Consultation with Portugal

FOR IMMEDIATE RELEASE

Washington, DC – **June 30, 2022:** The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Portugal on Friday, June 23, 2022.

Growth in 2021 rebounded to 4.9 percent, driven by private consumption, investment, exports of goods, and gradually recovering tourism. The unemployment rate dropped to pre-pandemic levels on account of rising employment and participation rates. While growth strengthened in early 2022, the war in Ukraine is expected to dampen the recovery for the rest of the year through a significant deterioration in external demand, higher commodity prices, longer-lasting supply-side disruptions, lower confidence and tighter financial conditions. Growth in 2022 is projected to average 5.8 percent and 1.9 percent in 2023. Inflation has accelerated on the back of higher commodity prices and is projected to average 6.1 percent in 2022, before receding to 3.5 in 2023. The current account deficit is set to widen in 2022, before narrowing over the medium term as exports and tourism strengthen.

Despite the accommodative fiscal stance in 2021, the headline fiscal deficit dropped to 2.8 percent of GDP, reflecting buoyant tax revenues and some capital underspending. In 2022, the fiscal deficit is expected to narrow to 2.2 percent of GDP, reflecting the recovery and unwinding of remaining temporary Covid-19 economic support measures. On this basis, fiscal policy will remain suitably accommodative with measures to mitigate impacts of high energy prices and grant-financed investment supporting the recovery. Public debt is projected to steadily decline to below 100 percent of GDP over the medium term.

The corporate sector has withstood recent shocks well so far, although solvency gaps are estimated at more than 2 percent of GDP. Credit quality deterioration after the end of the relatively extensive loan moratoria has yet to fully materialize. Bank capital, profitability, and asset quality have steadily improved in 2021 but remain below EA averages. A few legacy domestic banks are still to complete their restructuring process. As in rest of EA, residential real estate prices have risen sharply, though attendant risks appear contained.

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

Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities' comprehensive policy response to the pandemic, including their successful vaccination campaign, which has supported the recovery. Noting that important downside risks remain, including the spillovers from the war in Ukraine and the protracted effects of the pandemic, Directors underscored the need to strike the right balance between supporting the recovery and rebuilding fiscal buffers and continuing with structural reforms that bolster stronger, more resilient, and private sector-led growth.

Directors agreed that near-term fiscal policy should remain accommodative and better targeted. In particular, the broad-based measures implemented in response to the energy shock should be kept temporary and preferably replaced with more targeted support. While emphasizing that fiscal policy should remain flexible this year, Directors also recommended greater savings should fiscal outcomes overperform. Recognizing the need to rebuild fiscal space for future shocks, address long-term ageing pressures, and mitigate public debt risks, Directors encouraged the authorities to pursue a gradual and growth-friendly fiscal consolidation starting from 2023. In particular, they called for reducing tax expenditures, enhancing pension sustainability, and strengthening public financial management.

Directors welcomed that the banking system has weathered the crisis well thus far and agreed that risks should be carefully monitored. They encouraged close vigilance of banks' asset quality and further strengthening banks' capital buffers. Directors also encouraged the authorities to continue monitoring risks from rising house prices. They welcomed the strengthening of corporate debt restructuring frameworks and called for further improvements in the insolvency regime. Directors recommended prompt private-led recapitalization of viable firms to mitigate corporate debt overhang risks, smooth resource reallocation, and limit scarring.

Directors welcomed the authorities' comprehensive structural reform and investment agenda anchored in the National Recovery and Resilience Plan (NRRP). They emphasized the need for efficient implementation and oversight to maintain strong investment absorption capacity and maintain the reform momentum. Directors underscored the potential of the NRRP to raise skill levels, digitalization, productivity, and living standards durably, and called for complementary reforms to address labor market duality and reduce youth unemployment. They commended the authorities' ambitious targets and policies to address climate change challenges. Directors saw merit in considering further increasing the carbon price—once the energy crisis subsides—while protecting the most vulnerable households.

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

Portugal: Selected Economic Indicators, 2020–23

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

	2020	2021	Projections 2022	Projections 2023
Real GDP	-8.4	4.9	5.8	1.9
Private consumption	-7.1	4.5	3.4	2.0
Public consumption	0.4	4.1	1.3	1.2
Gross fixed capital formation	-2.7	6.5	5.9	1.3
Exports	-18.6	13.1	7.2	2.5
Imports	-12.1	13.1	1.7	2.0
Contribution to growth (Percentage points)				
Total domestic demand	-5.5	5.2	3.5	1.7
Foreign balance	-2.9	-0.3	2.2	0.2
Resource utilization				
Employment	-1.8	1.9	1.2	0.8
Unemployment rate (Percent)	7.1	6.6	6.5	6.4
Prices				
GDP deflator	1.9	0.7	6.0	3.1
Consumer prices (Harmonized index)	-0.1	0.9	6.1	3.5
Fiscal indicators (Percent of GDP)				
General government balance	-5.8	-2.8	-2.2	-1.0
Primary government balance	-3.1	-0.5	-0.1	1.0
Structural primary balance (Percent of potential GDP)	1.7	1.6	1.2	1.2
General government debt	135.2	127.4	115.8	110.7
Current account balance (Percent of GDP)	-1.1	-1.1	-1.3	-0.5
Nominal GDP (Billions of euros)	200.1	211.3	237.1	249.3

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

INTERNATIONAL MONETARY FUND

PORTUGAL

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION

June 7, 2022

KEY ISSUES

Context: After a deeper pandemic-induced recession than the rest of the euro area in 2020, the Portuguese economy gained ground in 2021, and growth strengthened further in 2022:Q1. Employment reached pre-pandemic levels in 2021:H2 and GDP in 2022:Q1. Nonetheless output is expected to remain below pre-pandemic trend over the medium term. While growth in 2022:Q1 was supported by a strong bounce back in tourism and domestic demand, the recovery for the rest of the year is expected to be hampered by the war in Ukraine despite limited direct linkages with Russia and Ukraine, due to higher commodity prices, supply-side disruptions, and weaker confidence and external demand. The outlook is clouded by uncertainty relating to the war, new virus waves, and the ultimate effect of the pandemic on corporate, bank, and public sector balance sheets. While declining and with improved composition, public debt would remain high.

- **Policy Recommendations:** Policies need to balance short-term urgencies with a smooth transition to private-led growth, rebuilding fiscal space and advancing reforms for stronger growth and a more resilient economy.

- **Fiscal Policy:** The 2022 budget remains suitably accommodative, excluding the appropriate unwinding of Covid-19 measures. Broad-based measures in response to the energy price shock must be kept temporary and preferably replaced with more targeted measures to mitigate the impact on vulnerable households. Fiscal policy needs to be flexible for further support under severe adverse scenarios or more savings under fiscal overperformance. Starting from 2023, a growth-friendly fiscal consolidation, centered on reducing tax expenditures, achieving pension sustainability, and stronger financial management, would help rebuild fiscal room for much-needed investment after NGEU funds end and address ageing and health spending pressures while maintaining a firmly declining public debt path.

- **Financial Policy:** The Resilience and Capitalization Fund should be promptly mobilized for viability-based solvency support for the non-financial corporate sector (NFC). Priorities include heightened monitoring of banks' credit quality, adequate provisioning, and gradually strengthening capital buffers. Risks from rising house prices should be closely monitored.

- **Structural Policies:** A timely implementation of the National Recovery and Resilience Plan (NRRP) through efficient and transparent planning and budgeting, organization and oversight of the investments and reforms, coupled with reforms to reduce labor market duality and strengthen insolvency regimes would limit scarring, raise living standards, and build a more dynamic economy.

Approved By
Laura Papi (EUR) and Eugenio Cerutti (SPR)

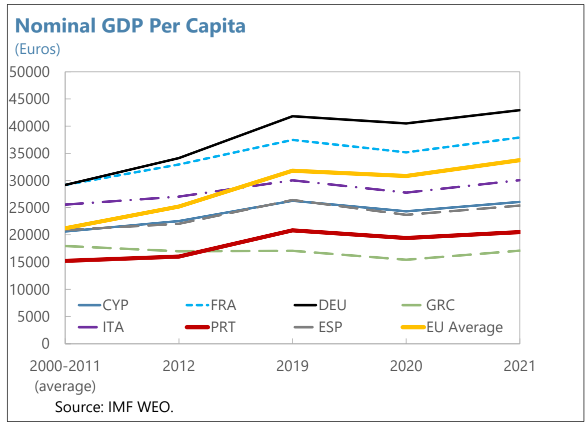
Discussions were held during October 21 to November 4, 2021 (virtual), and during May 9–13, 2022 (in-person). The mission team comprised Ms. Rupa Duttagupta (head), Mr. Kamil Dybczak, Ms. Magali Pinat, Mr. Andre Oliveira Santos, and Mr. Volodymyr Tulin (all EUR), and Mr. Antonio Pancorbo (MCM).
Ms. Ana Rita Mateus (OED) joined some of the mission meetings, Mr. Domenico Fanizza (OED) joined the concluding meetings.
Mr. Boyang Sun, Ms. Ritzy Dumo, and Ms. Erika Paola Espinoza (EUR) supported the mission from headquarters. The mission met with key interlocuters in Portugal—government agencies, Banco de Portugal, the private sector, and civil society—and the European Central Bank.

CONTENTS

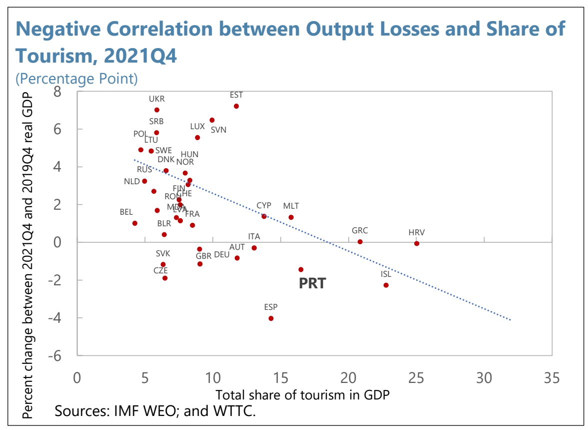
ANNEXES

CONTEXT

1. **Before the pandemic, the Portuguese economy had strengthened significantly, but productivity growth remained modest.** Growth averaged 3 percent in 2017–19 and unemployment fell to a 15-year low of 6.7 percent, supported by exports and tourism. Public and private debt were on a downward path, although still elevated. The banking system had achieved a steady reduction of impaired assets and improved capital positions. However, weak productivity growth reflected a low share of skilled labor, dominance of small and low-productivity firms, an ageing population, and structurally high youth unemployment. Per-capita income remained some 30 percent below the EU average.



2. **After being harder hit by the pandemic than the EA, the economy has been on a sustained recovery.** Reflecting its reliance on tourism, GDP fell 8.4 percent in 2020 (EA: -6.5 percent). Growth rebounded to 4.9 percent in 2021, helped by unprecedented policy support and an impressive vaccination drive (95 percent of the population is fully vaccinated). The effects of Omicron were relatively muted (Figure 1). Activity restrictions were lifted in early-2022 and the economy strengthened sharply in Q1.



3. **The war in Ukraine poses new headwinds.** Direct exposures to Russia and Ukraine are limited, and Russian energy imports comprise less than 10 percent of total energy supply (Figure 2). However, Portugal will be hit by sharp increases in energy and food prices (oil and gas account for 70 percent of energy use), and lower European trading partners' demand. Refugee inflows from Ukraine have increased steadily since the start of the war, exceeding 36 thousand in early May.

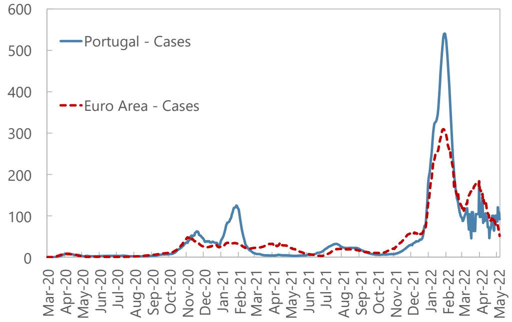
4. **The center left socialist party that led a minority government during 2015–2021 emerged with an outright majority in the January 2022 elections.** The new government has recommitted to a timely implementation of the NRRP financed by the Next Generation EU (NGEU) funds, public debt reduction, and structural reforms, which featured prominently in previous Article IV recommendations (Annex I).

Figure 1. Portugal: Covid-19 Developments, March 2020–May 2022

Daily cases in Portugal picked up sharply due to Omicron...

COVID-19 Daily Cases

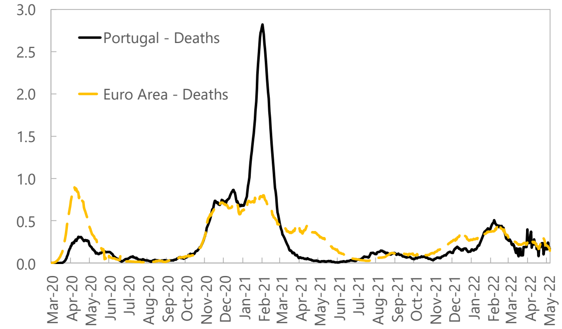
(7-days moving average per 100K people)



... although mortality rates were significantly lower than in previous peaks.

COVID-19 Reported Deaths

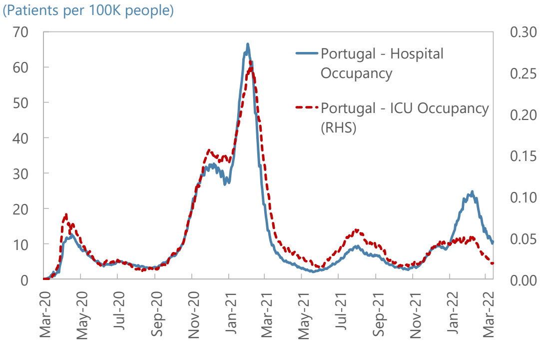
(7-days moving average per 100K people)



Covid-related hospitalizations rose slightly after the spread of Omicron...

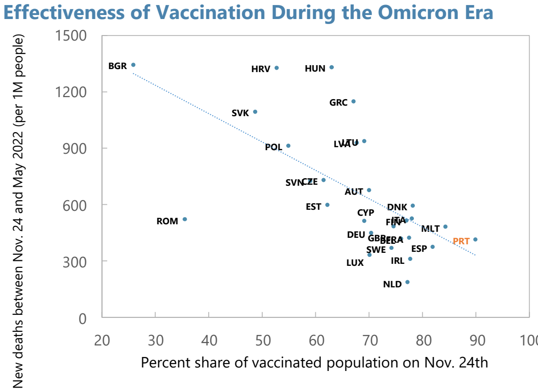
Hospitalization and ICU Occupancy by Covid Patients

(Patients per 100K people)



... while vaccinations have proved to be highly effective in containing the mortality rate.

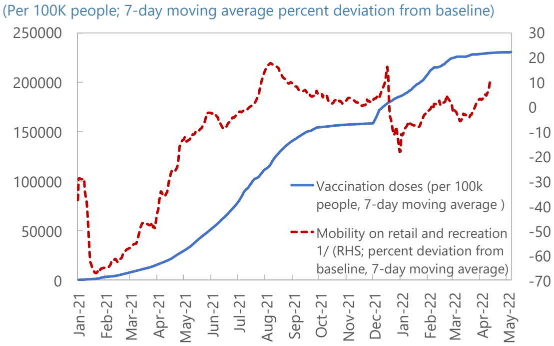
Effectiveness of Vaccination During the Omicron Era



Mobility improved in 2022, with an impressive vaccination drive and limited activity restrictions...

Vaccination Doses and Mobility Index

(Per 100K people; 7-day moving average percent deviation from baseline)

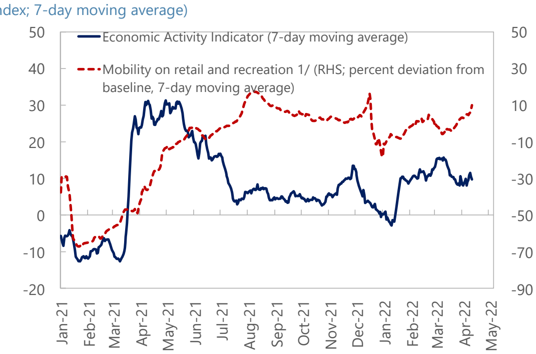


1/ The baseline is the median value during the period Jan 3–Feb 6, 2020.

... and higher mobility led to the recovery of economic activity.

Mobility Index and Activity Indicator

(Index; 7-day moving average)



1/ The baseline is the median value during the period Jan 3–Feb 6, 2020.

Sources: Bloomberg; Google Mobility: European Centre for Disease Prevention and Control; Banco de Portugal; and Our World in Data.

Figure 2. Portugal: Exposure to Spillovers from the War in Ukraine

Portugal's direct trade exposure to Russia and Ukraine is limited.

Portugal: Bilateral Trade Exposures to Russia and Ukraine

(Percent of total, latest year available)

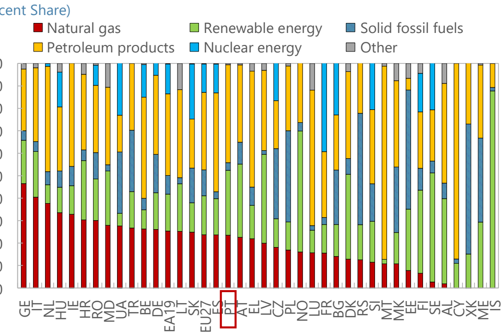
Exports of Goods & Services to Russia	0.3%
Exports of Goods & Services to Ukraine	0.1%
Imports of Goods & Services from Russia	0.7%
Imports of Goods & Services from Ukraine	0.3%
Tourist Arrivals from Russia	0.7%
Tourist Arrivals from Ukraine	0.2%
Main Goods Exports to Russia: Cork, Nuclear React/Boilers/Machinery, Animal Ori.	
Main Goods Exports to Ukraine: Animal Origin, Cork, Beverages	
Main Goods Imports from Russia: Mineral Fuels/Oils/Waxes, Iron & Steel, Fish	
Main Goods Imports from Ukraine: Iron & Steel, Elec Machinery/Sound/TV, Wood	

Sources: IMF WEO; Eurostat; and INE.

While dependence on fossil fuels is high…

Energy Products in Gross Available Energy

(Percent Share)

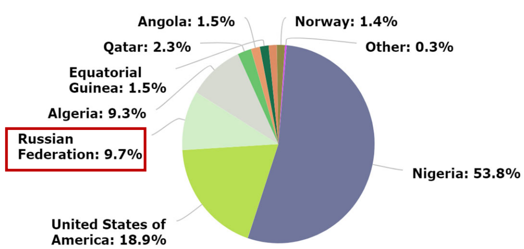


Source: Eurostat.

… direct import of gas from Russia is contained.

Portugal: Imports of Natural Gas, 2020

(Percent)

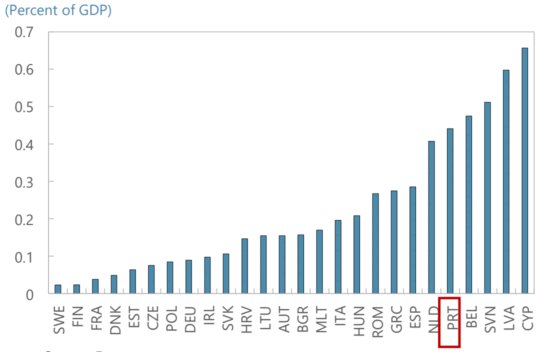


Source: Eurostat.

Reliance on cereal imports is sizeable.

Cereal Imports, 2021

(Percent of GDP)



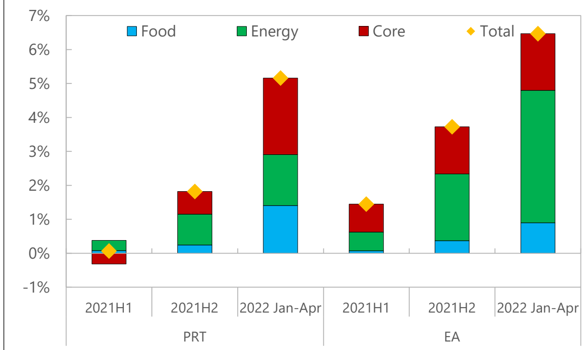
Source: Eurostat.

RECENT DEVELOPMENTS

5. **A gradual, but uneven, recovery continued through early 2022** (Figures 4–5). Growth rebounded to 4.9 percent (y/y) in 2021, reflecting strong private consumption and NGEU investment, while tourism improved faster from 2021:H2. Private consumption growth eased with the Omicron wave and supply-chain bottlenecks hampered manufacturing activity starting in late 2021. However, the recovery regained momentum in 2022:Q1, when GDP rose by 2.6 percent q/q (one of the highest in the EA) and surpassed the pre-pandemic level.

6. Inflation pressures, induced by commodity prices, have become broad-based (Figure 6). The Harmonized Index of Consumer Prices (HICP) inflation stood at 7.4 percent (y/y) in April 2022 (EA: 7.4 percent), mostly due to fuel, transport, and food prices. Core inflation (HICP excluding energy and unprocessed food) has also risen to 5.3 percent (y/y) in April 2022 (EA: 3.9 percent) reflecting broadening inflation pressures into other components, specifically, housing and utilities, transportation, and hotels and restaurants. Energy prices increased by 27 percent (y/y) in April (EA: 38 percent) reflecting policies that allow a slower passthrough to retail prices.[1] However, wage inflation—measured by growth in compensation per employee—(2.9 percent (y/y) 2021:Q4) is still contained and below the EA average (3.5 percent (y/y) 2021:Q4).[2]

Portugal and Euro Area: Contribution to Inflation
(Percent)



Source: Eurostat.

7. The policy response to the pandemic was timely and comprehensive (Figure 7, Annex II):

- **Above the line cumulative measures** in 2020–21 included discretionary measures (6.1 percent of GDP) and automatic stabilizers (2¾ percent of GDP). This included higher health spending, job retention and wage subsidy programs and expanded social safety nets.

- **Below the line and other measures** comprised 4.5 percent of GDP in 2020–21 to contain NFCs' liquidity stress mainly via state-guaranteed credit lines for the most-affected firms (covering 12 percent of NFC loans at end-September 2021).

- **A large public moratorium was extended several times until September 2021**,

Discretionary Fiscal Support Measures
(In Percent of GDP)

	2020	2021
Above the line (national accounts)	**2.5**	**3.6**
Revenue, foregone 1/	**0.3**	**0.2**
SS contribution exemption	0.3	0.1
Other	0.0	0.1
Expenditure	**2.2**	**3.3**
Health sector	0.4	0.8
Employment support schemes	0.6	0.6
"*Simplified layoff*" 2/	0.4	0.2
Support for progressive resumption of activity	0.1	0.3
Wage subsidy (normalization of activity)	0.1	0.2
Support to households	0.3	0.4
Unemployment extension	0.2	0.2
Support for the self-employed	0.1	0.2
Unemployment extension	0.1	0.0
Social benefits and transfer	0.1	0.2
ALMPs (Program ATIVAR)		
Support to firms	0.7	1.1
Micro and SME grants (program Apoiar)	0.0	0.5
Other support to firms (transport, tourism, etc)		0.2
Airlines	0.7	0.4
Other support	0.2	0.3

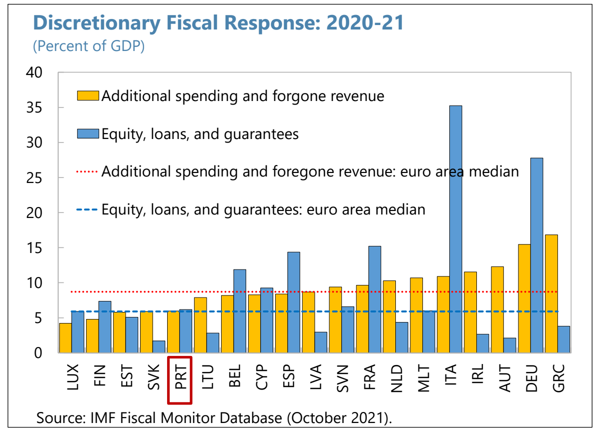
Source: Portuguese authorities and IMF staff estimates.
1/ Excludes tax deferrals.
2/ Scheme for the temporary interruption of work.

[1] About 12 percent of Portuguese households benefit from means-tested social tariffs for electricity (33.8 percent discount). Also, regulated tariff regime covers about 11 percent of low-voltage consumption, and consumers are allowed to switch. The regulated market tariff reduces volatility and helps guide the liberalized market price. The price of electricity for households on the regulated market increased on April 1, 2022, by an average of 3.0 percent following quarterly regulatory review. The surge in the wholesale Iberian Electricity Market price (MIBEL) will be mitigated by (i) the lower payment to renewables, which in 2022 is expected to provide a figure in the order of 0.8billion euros in consumers' favor, (ii) lower network tariffs (508 million euros, such as from EU-ETS revenues transfer), particularly for the Very High, High and Medium Voltage consumers, (iii) further EU-ETS revenue transfer (150 million euros) towards network tariff reduction, and (iv) temporary gas price cap in the wholesale electricity market.

[2] Gross monthly earnings per employee, which grew by 3.4 percent in 2021, decelerated to 2.2 percent in 2022:Q1.

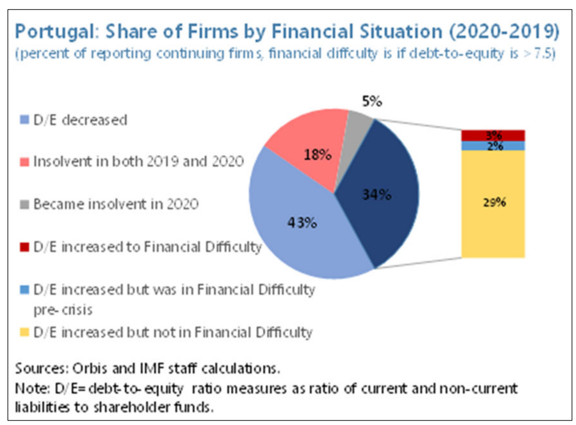
covered 18.7 percent of total loans at the peak (September 2020) but falling under 0.1 percent at end-2021.[3] Bankruptcy filing obligations remain suspended.

- **The EU's NGEU (mainly RRF and REACT-EU) of 8 percent of GDP in grants over 2021–26** provides sizeable funding for economic transformation. The government intends to use only some 1½ percent of GDP in loans (out of 7 percent of 2020 GDP available). SURE loans provided 2.9 percent of GDP against unemployment risk.



- **Fiscal room was boosted by ECB policies.** The Eurosystem holdings rose from 18 percent of sovereign debt in 2019 to 29½ percent in 2021. Despite high public debt (127.4 percent of GDP in 2021), sovereign spreads remain compressed. While long-term bond yields have risen by 125 basis points (bp) since mid-2021, spreads to German bunds have risen by much less (40 bp).

8. Pandemic policy support is estimated to have saved about one-third of jobs and one-fifth of NFC output (Selected Issues Paper, SIP I). During 2020, about 40 percent of Portuguese firms experienced an increase in leverage, while the share of firms in financial difficulty (with leverage ratio above 7.5) rose from 20 to 28 percent. A Resilience and Capitalization Fund was created (¾ percent of GDP) to support debt reduction and recapitalization of viable corporates with equity and quasi-equity instruments. The authorities also launched a program to incentivize distressed but viable firms to restructure bank loans supported with a partial government guarantee, but received limited take up, partly reflecting difficult-to-meet qualifications criteria, and perceived better alternatives, including an European Investment Bank (EIB) Group credit guarantee operations.



9. Several measures have been taken in response to surging energy prices. Support (0.6 percent of GDP) extends October 2021 measures (reduction in excise duties on oil products, monthly subsidies for fuel prices at the pump) until at least June 2022 and introduces new temporary measures for this year (freezing carbon taxes, oil tax reduction for agriculture, augmentation of subsidies to firms, flexibility in tax payments' regime, spending on refugees). Liquidity support has been granted to the hardest-hit sectors (transport, agriculture).

[3] Public moratoria were also matched by private moratoria offered by financial institutions to HHs and NFCs with loans that were not eligible under the public moratoria for a shorter period, most of which expired in March 2021. With the amendment to the public moratoria in March 2021, private moratoria beneficiaries were also eligible for a six-month extension under the public moratoria.

Portugal and Spain were granted an exception by the European Commission to set maximum price ceilings for gas in the Iberian market to control electricity inflation. The authorities are also awaiting the EC's approval for a temporary lowering of fuel VAT rates, and pending this decision, have temporarily reduced oil taxes (equivalent to a 10-pp cut on fuel VAT).

Fiscal Measures to Mitigate the Impact of the War in Ukraine

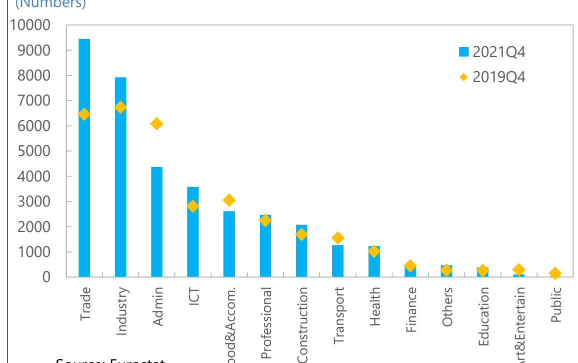
	Targeting	Quantification, EUR mln 2021	2022 Est.
Above the line measures			
Tax Measures		**200**	**775**
Oil tax unit rate reduction (ISP): Oct 2021- Feb 2022: €0.02/ L in gasoline and €0.01/ L in diesel; Mar 2022-Jul 2022: weekly adjustment of oil tax to neutralize tax burden impact of price spikes on VAT charged on fuel	All consumers of unleaded gasoline and road diesel	90	180
Agriculture/fisheries measures: Oil tax unit rate reduction (ISP) for diesel, €0.034/L; electricity subsidy up to 20% cost; VAT suspension on fertilizer and feed, Mar - Dec 2022	Agriculture		65
Oil tax unit rate reduction (ISP) equivalent to a 10pps cut in VAT on fuel: May-June, 2022	All consumers of unleaded gasoline and road diesel		170
Temporary suspension of an increase in Carbon Tax (retail fuel impact of €0.05/L): Nov 2021- 2022	All consumers of unleaded gasoline and road diesel	95	360
Temporary 50% reduction in circulation vehicle tax for heavy goods vehicles	Transport	15	
Under considerations or pending approval			
A temporary reduction in the standard VAT rate for energy from 23% to 13% (pending EC's and parliament's approval)			...
Spending Measures		**133**	**668**
Temporary monthly subsidy for the purchase of fuels by public buses and heavy goods carries (€0.3/L for vehicle under 35 tonnes, and €0.2/L for vehicle over 35 tonnes,€0.2/L for AdBLue additive), Oct 2021 - June 2022	Transport companies and social sector (non-profit institutions)		75
Rebate on VAT spending on refined oil products for retail consumers (Autovoucher): Nov 2021-March 2022: Devolution of €0.1/L up to a max of 50L per month. March-April 2022: increase in the max devolution amount from €5 to €20 per month	Retail consumers of refined petroleum products	133	133
Subsidy to support energy-intensive companies suffering due to the increase in gas prices. (30% of the increase in the costs of gas, up to a limit of €400,000 per company), Apr-Dec 2022	Companies with cost of gas in 2021 above 2% of annual turnover (~3,000 companies).		160
Extraordinary EUR 60 support to all households that benefit from the social electricity tariff or receive minimum social benefits to offset the impact of rising food prices (once for 3 months)	About 800 thousand households		46
Bottled LPG subsidy of 10 EUR (once for 3 months)	Beneficiaries of the social electricity tariff or that receive minimum social benefits (800 thousand households)		8
Support refugees (mobilization of European funds for expenditure host, e.g. accommodation), from April-2022.	Refugees		50
Reduction of electricity network access tariffs funded by transfer from the Environmental Fund (requires parliamentary approval), 2022H2	Electricity customers in the regulated and the unregulated markets		150
Subsidy for photovoltaic installation. Up to €200,000 per company. Duration: permanent (reinforced in Apr 2022). In addition to the decrease in VAT to 6%	Agriculture		46
TOTAL Above the line		**333**	**1,443**
as percent of GDP		**0.2**	**0.6**
Liquidity and below the line			**459**
Credit line ("Production Support") for companies that are more dependent on energy and are facing liquidity problems	Manufacturing and transport		400
Credit line ("agriculture")	Agriculture		59
Tax payment deferrals, 2022H1	Transport companies		...

Source: Portuguese authorities and IMF staff estimates.

10. The unemployment rate rose only ½ percentage point (pp) and has since recovered, while mirroring the divergence in output recovery. Employment and labor force participation in 2021 already surpassed the 2019 level and unemployment reached 5.9 percent by March 2022. Total hours worked in 2022:Q1 stood around 1 per cent above the 2019 level, but employment indicators lag for contact-intensive sectors (Figure 5). The young, low-skilled, and workers with temporary contracts—disproportionately hired in the contact-intensive sector—were worse affected. At the same

Portugal: Unfilled Job Vacancies by Sector

(Numbers)

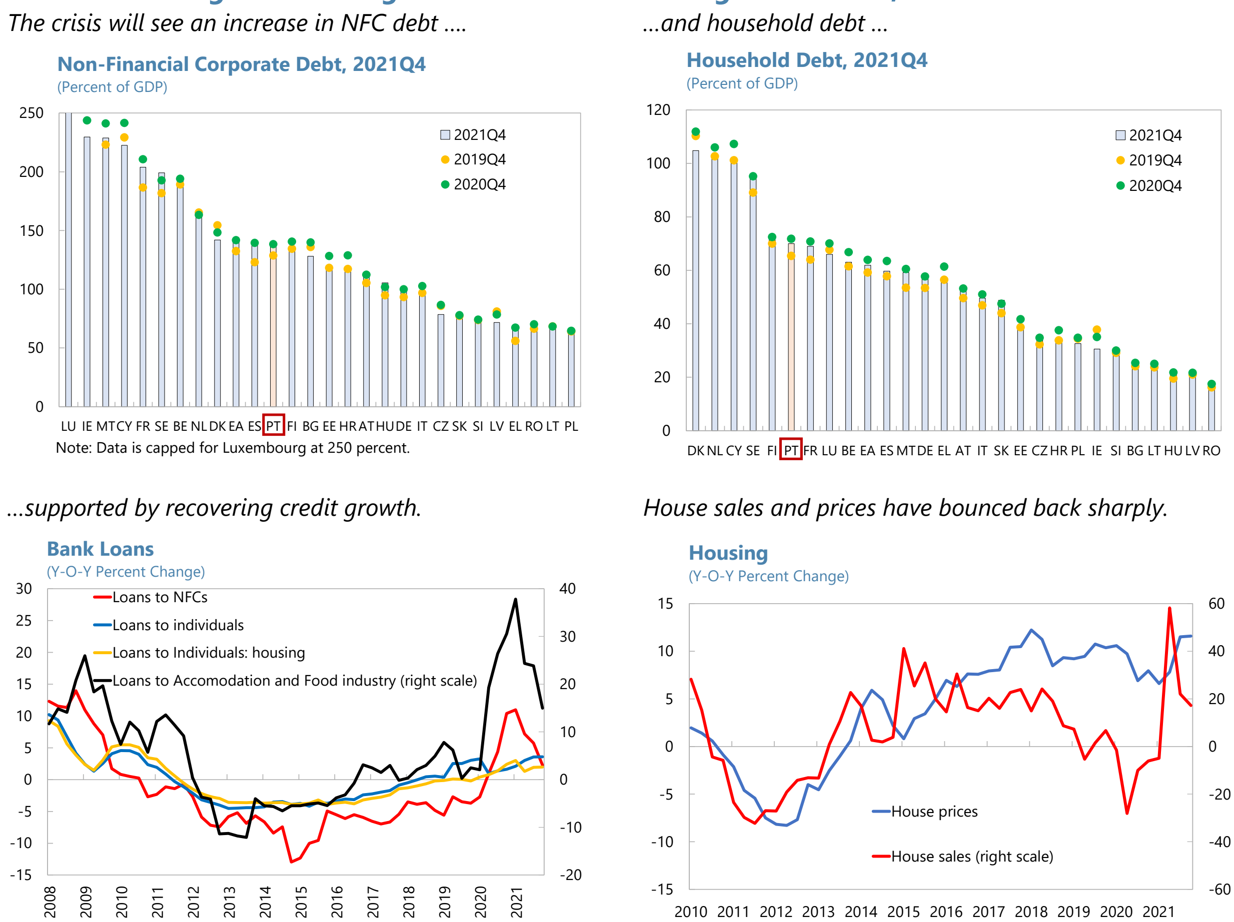


Source: Eurostat.

time, many sectors are faced with labor shortages (in high and low skills), partly reflecting early retirement during the pandemic and lower foreign workers inflow

11. In contrast to previous crises, private credit held up and residential real estate prices surged (Figure 3). As in other EA countries, residential real estate prices have increased sharply, gaining 20 pp in real terms and relative to rents, and suggesting overvaluation of 8–17 percent (Annex III). While housing credit was not a factor behind the rise in house prices and has picked up only recently (averaging 4 percent y/y growth in 2021:H2–2022:Q1),[4] the stock of housing credit has been rising. Housing affordability concerns have also risen.

Figure 3. Portugal: Private Sector Leverage and Credit, 2008–2021

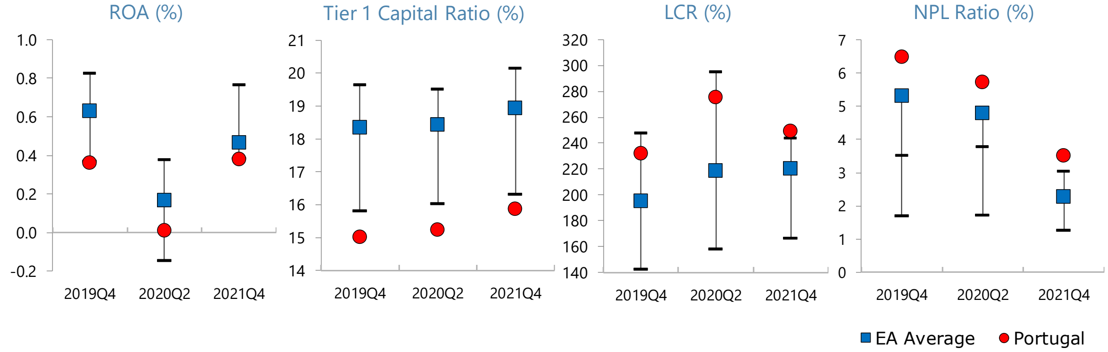


Sources: Eurostat and Haver Analytics.

[4] The share of residential real estate transactions financed by domestic credit, at 55 percent, is still some 20 p.p. lower than prior to the sovereign debt crisis. Nonresidents have reportedly played an increasing role in the housing market. More generally, the tightening of macroprudential measures by the BdP in 2018 is assessed to have reduced the probability of default of this market segment during the pandemic (see *Macroprudential Recommendation on new credit agreements for consumers – progress report*, *Banco de Portugal,* March 2021).

12. The banking sector has been resilient so far, but a potential credit deterioration has yet to fully materialize.[5] Financial health improved in 2021 though capital and asset quality remained weaker than EA averages. The drop in NPLs reflected policy support, NPL sales to investors, and write-offs. While staff estimates suggest that the banking system, on average, should be fairly resilient to adverse shocks, including from the war impacts, there is considerable variation across banks.[6] A few legacy domestic banks are still to complete their restructuring process. Moreover, the share of stage 2 loans is 13 percent in total loans (Figure 8).

Banking Sector: Profitability, Capitalization, Liquidity and Nonperforming Loans



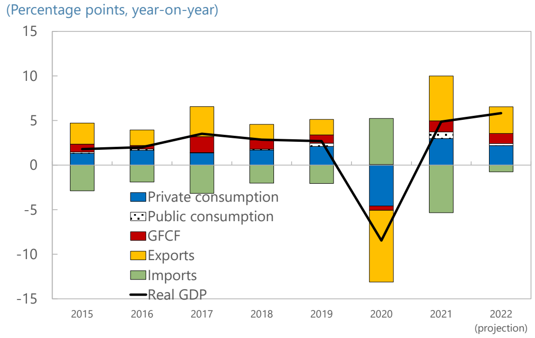
Sources: EBA Risk Dashboard; and IMF staff calculations.
Note: The whiskers correspond to the 25th and 75th percentiles. Sample comprises EBA-reporting institutions.

13. The 2021 external position is assessed to be broadly in line with medium-term fundamentals and desirable policies (Annex IV). As tourism receipts collapsed at the onset of the pandemic, the current account recorded its first deficit since 2011 at -1.1 percent of GDP in 2020 (Figure 9). The deficit remained broadly similar in 2021, as higher imports—reflecting rebounding consumption and investment and worsening terms-of-trade—offset improving exports, the latter limited by supply-chain bottlenecks and slower tourism recovery.

OUTLOOK AND RISKS

14. Growth is projected to average 5.8 percent in 2022 and 1.9 percent in 2023. The pickup in 2022 growth reflects the strong bounce-back in tourism and domestic demand in Q1. However, activity in the rest of the year is expected to be impacted by negative spillovers from trading partners' demand, adverse terms-of-trade, higher energy and materials costs, and lower confidence. Factoring in the Q1 growth

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



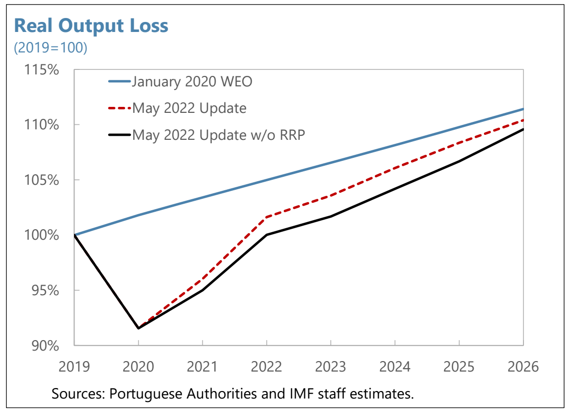
Sources: IMF WEO; and IMF Staff Forecasts.

[5] There is considerable heterogeneity in the six largest banking groups; however, with a few relatively weaker banks. The non-bank financial sector is relatively much smaller and growing moderately.

[6] See S. Aiyar, M. Chi Dao, A. Jobst, A. Mineshima, S. Mitra, M. Pradhan (2021). The June 2021 EBA/SSM stress tests, which cover only three of the larger domestic banks, highlights somewhat higher risks for these banks. Banks' direct linkages to Russian banks, based on BIS data, total around 0.1 percent of banking system assets).

outturn, this entails a 2022 GDP downgrade of some 1–1½ percent relative to pre-war.[7] The baseline projections assume: no escalation of the war; softening in commodity price growth in 2023; gradually rising interest rates; and fiscal policy supportive in 2022 and neutral in 2023. Growth will be driven by private consumption—as household saving rates fall to pre-pandemic levels faster—net exports, and NGEU-backed investment. Tourism is expected to reach its 2019 level in 2023 (SIP II).

15. Medium-term growth is expected to converge to below 2 percent with some scarring. NRRP investments and reforms are expected to raise output by 2 percent over the medium term (Annex V), without which scarring would be higher. Staff estimates suggest that the share of tourism in GVA could stay some ½-2 percentage points below its pre-pandemic trend, offset by higher shares of sectors such as ICT (SIP II). However, if risks from heightened NFC leverage and zombification are unresolved, or get amplified further by war-related shocks, medium-term TFP growth could be weakened materially due to allocative efficiency and productivity losses (SIP I). The output gap is expected to close gradually over the medium term and GDP to remain some ½ percent below the pre-pandemic trend.



Sources: Portuguese Authorities and IMF staff estimates.

16. Inflation is projected to average 6.1 percent in 2022 and start receding in 2023 as energy price growth softens and supply-side disruptions ease (Figure 6). Core inflation is expected to average 4.5 percent in 2022 and decline slowly over the forecast horizon, reflecting the broad-based nature of inflation pressures. However, second-round effects are expected to remain broadly contained and inflation expectations anchored, allowing inflation to decelerate towards 2 percent in the medium term.

17. The current account deficit is expected to widen significantly in 2022, before narrowing over the medium term, as terms-of-trade normalize, and exports and tourism receipts recover. Similarly, the negative NIIP position is projected to decline over the medium term as the current account deficit narrows and the fiscal balance improves.[8]

18. Risks remain tilted to the downside amid high uncertainty (Annex VI). Besides potentially new virus waves, the main risk stems from the war in Ukraine. A faster normalization of ECB monetary policy and tighter financial conditions could hurt growth and the fiscal position. The end of loan moratoria could eventually expose higher insolvencies, lowering investment and bank capital. Slower use of NGEU funds could weaken the recovery. Moreover, despite its projected decline, public debt will remain high and vulnerable to downside risks, potentially aggravated by sovereign-bank-corporate linkages, while rising real estate prices pose additional risks. More

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[7] As a member of the European Union, Portugal joined the sanctions adopted at the EU level in response to Russia's invasion of Ukraine.

[8] The SDR allocation amounted to about 1.1 percent of GDP. A possible voluntary channeling is under consideration.

protracted supply-side bottlenecks, higher commodity prices, and wage pressures could lead to persistently higher inflation and weaken prospects further. On the upside, a stronger tourism recovery, continued strength in pent-up demand and higher payoffs from NGEU investments would brighten the outlook.

Authorities' Views

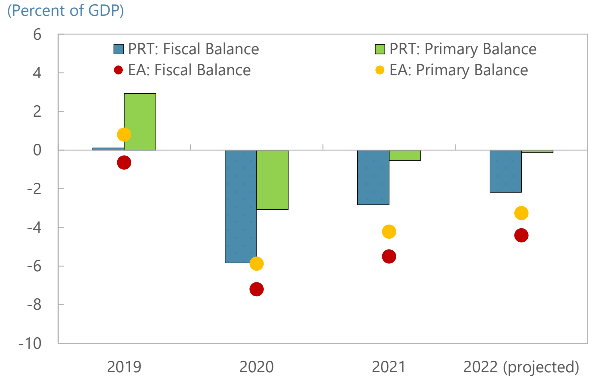
19. The authorities broadly agreed with staff's assessment of the outlook and risks but expected annual growth in 2022 to be stronger, reflecting carryover effects from 2022:Q1. They noted that labor market employment and participation rates were already above pre-pandemic levels. They agreed that inflation will likely peak this year, although the broad-based nature in inflation and likely persistence may imply inflation converging to a slightly higher than pre-pandemic level. The views on risks were broadly aligned, although the authorities noted that a stronger bounce-back in tourism and manufacturing exports presented important upsides. They concurred with staff's external sector assessment and that a significant reduction of the NIIP to more prudent levels would require a sustained current account surplus over the medium term.

POLICY DISCUSSIONS

A. Fiscal Policy

20. The fiscal deficit fell to 2.8 percent of GDP in 2021, beating budget projections. VAT and PIT overperformed and capital allocations were underspent. The overall fiscal position was appropriately supportive. However, some 2 percent of GDP of the 2020–21 fiscal measures relative to 2019 are expected to be permanent—¾ of the 1 percent GDP increase in wage bill reflected trend increases in public wage and employment growth; reference increases in pensions and other social spending will also add to recurrent spending.

Fiscal Balance and Primary Balance
(Percent of GDP)



Source: IMF WEO.

21. The 2022 fiscal position is expected to remain suitably accommodative with a structural primary balance broadly similar to 2021.[9] The fiscal deficit is expected to narrow to 2.2 percent of GDP, largely reflecting the boost from the recovery and unwinding of the remaining temporary Covid-19 measures, despite additional measures in response to higher energy prices. NGEU grant-financed spending will provide additional support (1.5 percentage points).

[9] The structural primary balance corresponds to cyclically adjusted primary balance excluding one-off and temporary measures, and hence is subject to uncertainty associated with cyclical assessment, stability of the output gap elasticities, and judgement involved in treatment of Covid-19 discretionary policy measures as temporary.

22. However, some fiscal measures should be better targeted. The planned outlays on expanding ALMPs, social housing, education and public sector digitalization, and NFC solvency support are welcome. However, plans for general tax relief, including for the youth, and expanded family support allowance should be better targeted. The projected expansion in current spending should be offset with equal measures over time. Similarly, the broad-based measures on energy price relief, caps on wholesale electricity prices, and energy tax cuts should preferably be replaced with more targeted and temporary support for vulnerable households and the most affected and viable firms, while preserving price signals for most users to facilitate energy savings.

23. Contingency measures may be needed under severe downside risks. Automatic stabilizers should be fully deployed if growth disappoints. For potentially new pandemic waves that entail extensive activity restrictions and severe downturns, extension of existing short-term work schemes, social benefits, and turnover loss compensation grants could be considered, balancing cautiously near-term macro-stabilization with medium-term debt sustainability priorities.

24. Starting 2023, a gradual and steady growth-friendly fiscal adjustment is needed to rebuild policy space, improve expenditure composition, address longer-term fiscal pressures and alleviate public debt risks.

Motivation. Under the baseline assumption of unchanged policies, public debt is projected to steadily decline to below 100 percent of GDP, driven by favorable (r-g) dynamics, but remain high and more market-reliant as ECB support normalizes. Despite rising nominal yields, the extended maturity profile—with maturing debt being rolled over at lower rates than rates at which they were originally contracted—and low effective interest rates over the medium term offer comfort. Nevertheless, risk perceptions may change abruptly. Portugal remains susceptible to a faster-than-projected normalization of ECB monetary policy and spillovers from negative events in the rest of the EA, through co-movement of market risk perceptions (2019 Article IV staff report). [10] Contingent liabilities related to the credit guarantees and a potentially larger-than-expected impact of the end of moratoria on firms and banks as well worsening financial health of SOEs since the pandemic also add risks (Annex VII). RRF-backed spending provides a window to rationalize current spending, rebuild room for ageing-related spending and avoid cliff effects on public investment at the end of the RRF. Early identification and announcement of fiscal measures would anchor the fiscal path.

Pace. A sustained and gradual discretionary consolidation—averaging annually 0.5 percent of GDP in the structural fiscal balance during 2023–26 is advisable (relative to the authorities Stability Program, which assumes no policy change), with flexibility to respond to shocks. The pace of consolidation should be data dependent, with more ambitious fiscal savings under fiscal overperformance, and full operation of automatic stabilizers under downside scenarios.

Measures. The following measures provide scope for the recommended consolidation.

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[10] While holdings of EA public debt by the Portuguese banking sector also induces financial sector risks, bank holdings of Portuguese government debt declined from 8 percent of total bank assets during 2019–20 to 7 percent in 2021 and holdings of other EA sovereign debt is also limited (see Banco de Portugal, Financial Stability Report, December 2021).

- **Tax reforms** should aim at greater efficiency, remove distortions, and broaden the tax base. There is scope for institutional reform to strengthen tax policy and tax expenditure analysis, reduce proliferation of tax incentives, and revisit reduced VAT rates.[11, 12] Increasing property taxes would also raise revenue and improve the tax mix.[13, 14]

Potential Revenue Measures

(In percent of GDP)

	Yield per year
1. Lowering tax expenditure policy gap to euro area average 1/	**0.8 - 1.5**
2. Reducing VAT compliance losses 2/	**0.2 - 0.4**

Source: GTAP, European Commission, and IMF staff estimates.

1/ Direct cross-country comparisons of the value of tax expenditures need to be interpreted with caution. Tax expenditures are departures from country-specific benchmark tax systems and their aggregation can result in over- or underestimation.

2/ Revenue lost to VAT fraud and evasion, VAT avoidance and optimisation practices, bankruptcies and financial insolvencies, as well as miscalculations and administrative errors.

- **Rationalizing current spending.** The estimated increase in ageing-related fiscal outlays of ¾ percent of GDP is a key medium-term headwind. Spending reforms should include bolstering pension sustainability. Key reforms include simplification of non-contributory benefits regimes, including eliminating duplication, strengthening contributory working period incentives of minimum pensions, extending the link between increases in the retirement age and life expectancy gains to the minimum age of early retirement, and abolishing special (early) retirement ages for specific subgroups,[15] (see 2019 IMF Staff Report and OECD Pensions report 2021); strengthening financial management and spending rationalization in the NHS; improving social benefits targeting, spending reviews; and improving SOEs' financial sustainability and governance. Containing the public wage bill over the medium term will require a comprehensive review of the public employment and compensation structure.

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[11] The MoF has a fiscal policy department, but no tax policy division. Tax policy is currently developed through informal collaboration of relevant parties such as the group of advisers in the Cabinet of the Secretary of State of Tax Affairs in the MoF.

[12] A 2021 Fund technical assistance mission estimated that tax expenditure has been on the rise, reaching more than 7 percent of GDP in 2020. Moreover, the number of tax deviations has increased by 40 percent over the past decade. The single most important item among current expenditures is the set of reduced rates for the VAT, which accounts for 52 percent of total estimated revenue forgone. In addition, the investment law offers some of the most generous incentives, including the non-regular resident scheme (a reduced PIT rate of 20 percent, for a period of 10 years, for a set of high value-added activities, costing about 0.4 percent of GDP annually).

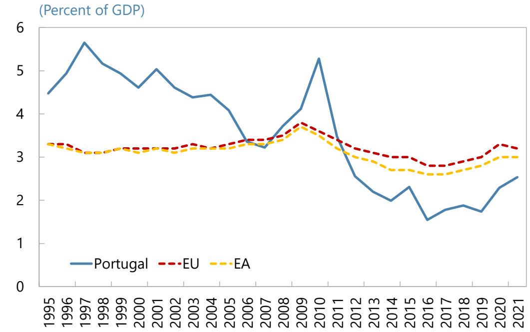
[13] Property tax revenues and rates, ranging from 0.3 percent to 0.45 percent for urban areas, are below OECD peers.

[14] Efficiencies could also be gained by leveraging the anti-money laundering framework to enhance tax compliance and better tackle tax evasion.

[15] Portugal has one of the most generous pension systems in the OECD (net pension replacement rate for average wage workers at 90 percent of pre-retirement earnings). In line with past IMF advice, authorities should make further efforts over the medium term to enhance the equity of the pension system by reducing accrual rates for the largest earning brackets to make average gross replacement rates in the public pension schemes gradually converge to EU average levels.

- **Composition.** Over the last decade, public investment has fallen from high levels to below EU peers. The NRRP can reverse this trend, with significant investment in R&D spending, digital and climate transitions. Transparent planning and budgeting, implementation, and oversight will be key for timely and effective absorption of the EU funds.

Public Gross Fixed Capital Formation
(Percent of GDP)



Source: Eurostat.

25. Addressing growing distributional challenges will also be key. The Covid-19 crisis reinforced existing social challenges in regional inequality of opportunity, poverty, social exclusion and housing affordability. Some 21.1 percent of the population was still at risk of poverty or social exclusion in 2019. While this has steadily fallen in recent years, workers with short-term contracts, rural areas residents, and children remain at risk. Strengthening social assistance will require streamlining complex regulations and requirements that determine entitlement (OECD, 2021).

26. Completing ongoing structural fiscal reforms would strengthen fiscal sustainability. Efforts to centralize integrated reporting of Covid-19 spending and the RRP implementation on the national Transparency Portal seek to improve accountability and transparency of public expenditure. Amendments to the Budgetary Framework Law approved in April will strengthen the ex-post evaluation of macroeconomic forecasts, and the role of the Public Finance Council but further reforms are needed to: (i) fully implement the 2015 Budgetary Framework Law (BFL) to upgrade budgetary processes and integration of annual budgets within a medium-term budgetary framework, expenditure controls, and cost efficiency; (ii) reinvigorate NHS reforms to enhance governance, resolve planning and management control weaknesses, and do away with the recurrent arrears; and (iii) timely, transparent, and comprehensive monitoring of the financial situation and performance (enhanced management contracts, strategic management plans) of state-owned enterprises (SOEs), and structural reforms to improve pension sustainability (OECD, 2021, IMF Staff Report 2019).

Authorities' Views

27. The authorities were confident that fiscal performance would improve significantly in 2022, despite the new energy crisis measures. The strong recovery was boding well for the revenue outlook. Also, unwinding of Covid-19 emergency measures would more than compensate discretionary energy-related expenditure. These factors would allow the headline deficit to fall to 1.9 percent of GDP. On the economic fallout from the war in Ukraine, they noted that the new measures focused on ameliorating the effects of heightened energy prices on overall inflation, vulnerable households, and energy-intensive sectors. They cautioned that downside risks may require some measures to be maintained for longer and stressed the importance of the prompt adoption of a joint European strategy for coping with these challenges.

28. The authorities reiterated commitment to fiscal discipline, underscoring their strong track record of fiscal overperformance. They stressed that political stability in the parliament was conducive for policy continuity and thereby implementing the RRP, promoting potential growth while maintaining sound public finances. They noted that past pension reforms had mitigated the fiscal effects of an ageing population, but more effort would be needed in the coming years. They plan to create a working group to explore options to strengthen pension system sustainability. They highlighted the April-2022 amendments to the Budgetary Framework Law strengthened fiscal policy evaluation and oversight. In parallel, efforts will continue on improving efficiency of public investment and strengthening governance and financial performance of SOEs.

B. Corporate and Financial Policies

29. Despite policy support, NFCs' solvency needs are estimated to have increased by some 2¼ percent of GDP (SIP I).[16] Firms impacted include both, the micro and small firms, with lower capital needs but higher employment base, and medium and large firms, particularly in the transport sector, with systemic economic presence. Moreover, the share of zombie or low-productivity firms is expected to rise, which would depress productivity and investment, unless addressed promptly. Additional vulnerabilities due to the war in Ukraine, cost-push pressures, supply-chain disruptions and higher interest rates could elevate insolvency risks.

30. Leveraging banking sector technical expertise for NFC viability assessments is essential in providing timely support to viable firms. Prompt recapitalization will also help viable firms better handle the energy crisis. Relatedly, the newly established state-owned development bank, Banco Portugues de Fomento (BPF), is managing the capitalization fund. The two solvency support programs—Strategic Recapitalization Program and Consolidar—have efficient features such as viability requirements but may need (size and instrument) augmentation. The BPF should draw on commercial banks' expertise in assessing borrowers' viability. The BPF's mandate should be clearly defined to increase accountability and its activities, not introduce market distortions.

31. Strong restructuring and insolvency regimes would facilitate effective reorganization and exit of businesses and optimizing resource reallocation without overwhelming the financial system. Clear communication and a short deadline on the lifting of the duty to file for insolvency will allow corporate debtors to prepare for the reintroduction of the rule. Moreover, the low uptake of the November 2020 pandemic insolvency reforms points to need for further steps to simplify and strengthen the effectiveness of the restructuring and insolvency law, and establishing clear guidelines for the participation of public creditors (tax, social security and other public administrations) in all procedures (2018 Staff Report and Selected Issues Paper); and streamlining liquidation procedures by addressing bottlenecks in the verification of claims and asset sales. Building on recent efforts to strengthen insolvency statistics would enable better analysis of the effectiveness and efficiency of current insolvency systems (see Garrido and others, 2019). Also, while

[16] The change in equity gap is for continuing firms (balance sheets data available in both 2019 and 2020), and hence is lower than change in aggregate solvency gap (1 percent of GDP) due to survivorship bias (non-reporting of 2020 balance sheets by firms with solvency gap in 2019).

the recent implementation of the EU Restructuring Directive is welcome, a broader reform that rationalizes the insolvency regime, effectively coordinating all procedures, should be considered.[17]

32. Close monitoring of banks' credit quality after the end of the moratoria and in light of new risks from the housing market continues to be essential (Figure 9). Bank capital buffers and asset quality have steadily improved but remain below EA averages (see ¶9). Forward-looking assessments of bank financial soundness should be a priority, given the uncertain effects of the two overlapping exogenous shocks in the context of sovereign-bank-corporate-housing market linkages.

- Banks should continue to apply well-defined strategies for adequate loan classification, managing NPLs, and maintaining adequate provisioning levels, in order to mitigate the potential increase in NPLs over time. Continued strong supervisory pressure by prudential authorities should ensure banks act preventatively against credit quality deterioration. Where needed, particularly in a few relatively weaker domestic banks, capital buffers should be gradually rebuilt. Given uncertainties on banks' capital needs, and in light of the new economic shocks, caution is needed in dividend distributions and share buybacks.

- Banks should value their exposures to restructuring funds at market or fair values and their deferred tax assets should follow prudent valuations.

- Risks from rising real estate prices remain contained (Annex II and ESRB 2021). Macroprudential policy measures are already relatively tight and have helped in containing leverage ratios (Banco de Portugal, December 2021 Financial Stability Report). Additional guidance was issued in April 2022 to reduce the average maturity of housing loans. However, given the dominant share of variable rate mortgages (three-quarters with rate fixation of up to one year, with an average interest rate of 0.8 percent on all outstanding mortgages) and long maturity (average 35 years), these risks should be closely monitored. For instance, an interest rate increase of 100bps would raise the average per-capita interest burden from 3¼ to 7¼ percent of gross disposable incomes. Once the recovery is well established, the BdP could consider introducing a positive rated CCyB or a sectoral systemic risk buffer (SRyB), in line with the CRDV and following EBA Guidelines, to contain macro-financial risks from banks' real-estate exposures. Such buffers would bolster banking system strength gradually, increasing resilience to housing market risks while avoiding the distributional costs of tighter macroprudential measures.[18]

[17] Portuguese law includes several restructuring procedures (PER and RERE). In addition, PEVE was introduced as a provisional hybrid restructuring procedure to address the impact of the pandemic, but it expired by end 2021. PER is the generally applicable restructuring procedure. RERE is an out-of-court restructuring procedure designed for illiquid but solvent companies, with viability prospects. Differences in treatment may lead debtors to choose one procedure over another. Previous Fund work also calls for improvements in Portugal's legal framework to facilitate in-court and out-of-court proceedings, debt recovery processes and collateral enforcement and to eliminate tax disincentives to impairment and write-offs.

[18] More broadly, longer-term imbalances in the housing market may need to be addressed through stronger property taxes (see section on Fiscal Policy). The Golden Visa provides salient tax incentives. However, the program was terminated in three key areas—Lisbon, Porto and Algarve—in December 2021.

33. Policies to address potential money laundering risks should be focused on their cross-border dimension. Portugal is a transit country for financial flows and provides incentives to attract foreign investment through the Golden Visa Program and the Madeira Free Trade Zone (FTZ) with a potential impact on non-resident banking-sector deposits and house prices. Close monitoring of cross-border flows and accounting for the relevant transnational money laundering (ML) and terrorist financing (TF) threats is essential in Portugal's national risk assessments and AML/CFT policy priorities. Portugal's Financial Intelligence Unit's priorities should be aimed at collecting and disseminating financial intelligence related to suspicious cross border flows. AML/CFT risk-based supervision of banks and real estate agents could also be strengthened commensurate with these risks. The establishment of the Central Registry of Beneficial Ownership (RCBE), which applies to legal entities including foreign trusts authorized to trade in the Madeira FTZ, is welcome, and next steps would be to ensure that the RCBE contains complete, accurate and up-to-date data on all relevant legal entities, including foreign trusts operating in the Madeira FTZ. Portugal should ensure that its AML/CFT framework provides for regulation of virtual assets sector in line with international standards.

Authorities' Views

34. The authorities noted that while the corporate sector had handled the pandemic well, solvency risks may take time to materialize. They assessed that even sectors that were disproportionately affected by both overlapping shocks (Covid-19, energy price increase) had held up well so far, but the situation warranted continued close monitoring. They agreed with the mission on the importance of a prompt recapitalization of viable firms. They shared the importance to resume the duty to file for insolvency to support market forces to allow a smooth exit of non-viable firms and normalization in corporate sector activity.

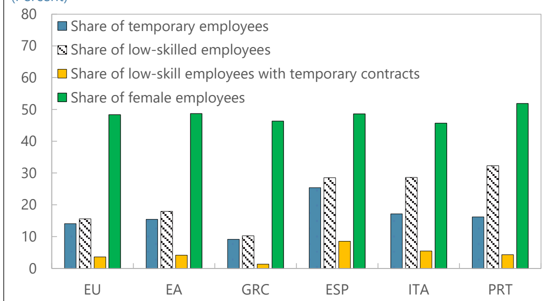
35. The authorities broadly agreed with the mission's recommended priorities for the financial sector. They continue to closely monitor banks' credit quality and adequacy of loan loss provisions, especially for NFC exposures that benefited from credit moratoria and that show higher deterioration than average. Supervisory efforts have focused on strengthening bank capitalization, particularly for institutions with weaker-than-average capitalization and profitability. While the authorities also concurred with the mission's diagnosis that housing market risks were increasing, they noted that important risk mitigants are in place, notably those related to the borrower-based macroprudential measure, which had been effective in lowering the risk level of new mortgages, the borrowers' leverage ratios and related macro-financial risks. Targeted measures to build banks' systemic resilience could be assessed in due course when risks for economic recovery subside. On AML/CFT, the authorities noted that they continue to integrate the cross-border dimension into their AML/CFT supervisory risk assessment and that the risk factors remain relatively stable. Risks related to exposures to the Madeira FTZ were not considered material and those related to the Golden Visa Program were strictly monitored.

C. Structural Reforms

36. The NRRP focuses on key long-term challenges of the Portuguese economy (Annex IV). The structural reforms to raise skill levels and increase competitiveness, steps to strengthen NFC health, and measures for a greener and more digitized economy would underpin stronger medium-term saving and investment rates and growth without generating external imbalances.

37. The lack of skilled labor remains a long-standing obstacle to productivity although the situation is set to improve gradually. The share of low-skilled workers is still among the highest (35 percent versus 18 percent for EA average), which in turn is rooted in long-standing issues in the Portuguese education system. However, earlier reforms have begun to bear fruit, helping reduce the share of young low-skilled to 20 percent of all employees. Also, the NRRP presents reforms to (i) reinforce vocational and educational training; (ii) strengthen cooperation between higher education, public administration and enterprises; (iii) strengthen teachers' digital skills; and (iv) improve the digital infrastructure of schools. If implemented well, these reforms should address skill shortages and labor supply over time.

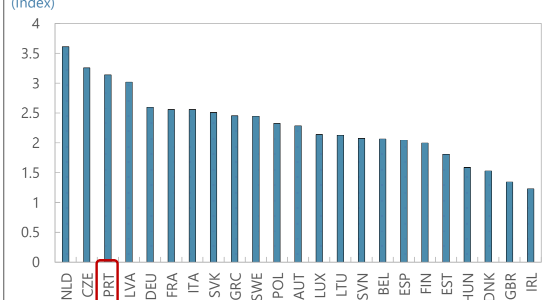
Worker Characteristics: Temporary and Low-skilled Employment, 2021Q4
(Percent)



Source: Eurostat.

38. High youth unemployment and labor market duality also need to be tackled. Further efforts at improving vocational and on-the-job training—including for the older cohorts—steps to ease immigration, and training incentives will be important (OECD, 2022). Measures to alleviate costs from employment protection for permanent contracts will also be essential to reduce labor duality. Indeed, some 17 percent of all workers —predominantly young—are employed on a temporary basis (3–4 percentage points above the EA-EU averages) with lower access to training opportunities and higher job insecurity. Allowing permanent contracts to be more flexible, combined with ALMPs (as planned under the RRP) and a stronger social safety net will increase labor market efficiency while limiting adverse distributional effects.

Strictness of Employment Protection – Individual and Collective Dismissals, 2019
(Index)



Source: OECD.

39. The NRRP includes ambitious milestones to reduce digital skill gaps which will contribute to raising productivity. In 2021, some 51 percent (60 percent EA/EU average) of Portuguese companies had basic digital intensity. Low digitalization of SMEs and low investment in human capital are key factors behind sluggish productivity growth. The national priority to advance digital transformation is welcome. Under its *Digital Transition* pillar, the NRRP envisages several measures to improve Portugal's digital position including: (i) tax credits for companies' digital transition; (ii) digitalization of public administration, including the judicial system; and the educational system; and (iii) digital skill training to SMEs to help a holistic digital transition of the economy.

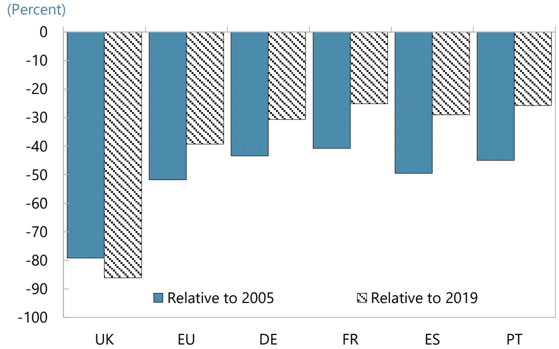
Authorities' Views

40. The authorities highlighted that the broad set of growth-enhancing reforms and investment goals in the NRRP with focus on climate transition, digitalization, education, and governance were conducive to raising growth potential durably. They stressed that Portugal was among the first countries to receive pre-financing and the first regular payment under the NRRP. Introduction of simplified procedures for recruitment and public spending processes would allow smooth implementation of the NRRP. On labor market duality, the draft Decent Work agenda being discussed with social partners aims to improve prospects for young, long-term unemployed, and inactive labor. They stressed the importance of permanent job contracts in improving job stability, and higher statutory minimum wages in raising living standards. They agreed with the importance of ALMPs and reforming the vocational training system to reduce structural unemployment and facilitate sectoral reallocation.

Transition Towards Carbon Neutrality

41. The authorities have set ambitious targets and policies to address climate change challenges. With per capita GHG emissions below EU average, Portugal's contribution to global emissions remains limited. In 2016, Portugal was among the first to announce its target to become carbon neutral by 2050, implying a reduction of emissions of 85–90 percent relative to 2005. The long-term strategy for low GHG emissions were formulated in a Roadmap for Carbon Neutrality 2050 (RCN) and set out in the National Energy and Climate Plan (NECP). The authorities are committed to an overall investment of 3 percent of GDP by 2030 to support climate-related research and innovation. The NRRP also proposes relevant reforms for energy transition with funding for sustainable mobility, energy efficiency, renewables, decarbonization and the bioeconomy. Tackling energy poverty—with some 15 percent of the population without proper access to heating—is also a key national objective.

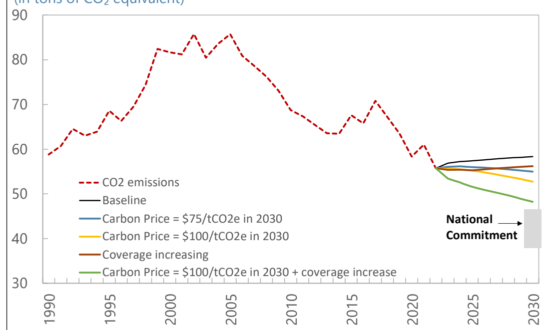
Target Emission Reduction by 2030
(Percent)



Sources: Eurostat/UNFCCC, and IMF staff calculations.

42. More effort would be required for Portugal to achieve carbon neutrality by 2050 (SIP, III). Driven by improvements in energy efficiency, total GHG emissions—which peaked in 2005—are now close to 1990 level. With some three-quarters of total electricity supply from renewable sources and the last coal-based power plant closed in 2021, emissions from electricity generation are expected to decline further. Nonetheless, under unchanged current policies, staff estimate GHG emissions to increase by about 5 percent between 2022 and 2030. A gradual increase of carbon price to $100 per ton of CO2e, accompanied with the elimination of energy subsidies and a broader coverage of the carbon tax could reduce GHG emissions by about 15 percent by 2030—on a path towards reaching carbon neutrality by 2050—while also gradually raising revenues. Nonetheless, to achieve carbon neutrality in 2050, other measures outlined in NECP and RNC, such as: (i) investment in public transportation infrastructure and urban planning; (ii) renewable-based power generation; (iii) introducing or raising efficiency standards; (iv) water, land and forest management; and (v) investment in R&D initiatives will be critically important.

Portugal: GHG Emissions Over Time, 1990-2030
(in tons of CO_2 equivalent)



Source: UNFCCC GHG Data Interface and IMF staff calculations.

43. However, carbon pricing would weigh on vulnerable households. Reforms will need to be complemented with transfers to offset the regressive nature of the carbon tax on the most vulnerable households. Measures to promote sustainable mobility, energy efficiency, higher share of renewable energy sources, and low-carbon products and services—including developing financial devices to reduce the risk-weighted capital costs of low-carbon technologies and projects will also be needed. To address the impact of extreme weather events (floods, coastal erosion, droughts, heat waves, and forest fires) investments in risk prevention and preparedness, and climate change adaptation may also be needed (SIP III).

Authorities' Views

44. The authorities highlighted that the energy crisis is an opportunity and a call for Portugal to accelerate energy transition. They noted that the country is well positioned to comply with the Fit for 55 targets. A revised NECP, which will be submitted to the EC in July 2023, will include plans to contain the impact from the current energy crisis and strengthen energy risk preparedness. The ultimate goal over the long term is to tax all carbon production, but given present circumstances, it is difficult to ascertain the timing of such a move. They noted that the energy transition could be further accelerated thanks to Portugal's strong legal framework and regulatory environment and strengthened by available EU funding. They also noted that a National Strategy to Tackle Energy Poverty focusing on strengthening access to energy, reduction of energy costs, and improving energy performance of households is expected to be approved soon.

STAFF APPRAISAL

45. The recovery is expected to continue despite adverse spillovers from the war in Ukraine. Near-term growth, while remaining strong, is expected to be affected by second-round effects from the war in Ukraine. The effects of two consecutive shocks will likely result in scarring. Inflation is expected to increase in 2022 before receding in 2023, reflecting surging energy prices, but also broader pressures.

46. Risks are to the downside. Key risks stem from the war and the pandemic. Furthermore, tighter financial conditions could hurt growth and the fiscal position. The end of loan moratoria could expose higher insolvencies, lowering investment and bank capital, and amplifying fiscal strains. On the upside, a stronger tourism recovery, pickup in pent-up demand and higher-than-projected payoffs from the NRRP would brighten the outlook.

47. Fiscal policy should remain appropriately accommodative in the near term, with support measures carefully designed to be temporary and well-targeted. Broad-based tax cuts and price measures to alleviate the energy shock could be preferably replaced with more targeted support for vulnerable households and the most affected and viable firms. Policies need to be flexible to provide more support should severe downside risks materialize. Fiscal overperformance should be saved.

48. A growth-friendly fiscal consolidation from 2023 is key to rebuilding fiscal space, preparing for long-term fiscal pressures, and alleviating risks from high public debt. While public debt is projected to remain on a solid downward trajectory, it will remain exposed to shocks. A stronger consolidation path—centered on reducing tax expenditures, bolstering pension sustainability, and stronger financial management—would rebuild fiscal space for much-needed investment even after NGEU funds end, while helping offset longer-term ageing and health spending pressures.

49. Timely adjustments in the corporate sector are key to a smooth reallocation of resources. The ultimate effect of the pandemic on corporate, bank, and public sector balance sheets remains uncertain, potentially amplified by war-related strains. Prompt recapitalization of viable firms to leverage private funds and expertise will help mitigate debt overhang, productivity losses, and better handle the energy crisis. Further improvements in the insolvency regime with active labor market policies are needed to smooth exit for unviable businesses, reallocation, and limit scarring.

50. Vigilance on financial sector health with continued efforts to rebuild weak balance sheets is critical in the context of the roll back of Covid-19 measures. The banking system has held up well so far, and, on average, should be resilient to adverse shocks. Nonetheless, capital and asset quality still lag behind the EA and a few domestic banks are yet to complete their restructuring. Continued close monitoring of banks' credit quality is essential given downside risks to the outlook.

51. Advancing structural reforms on multiple fronts—anchored by the NRRP—are essential to raise growth potential durably. The NRRP reforms and investments appropriately focus on addressing Portugal's structural challenges and facilitating the climate and digital transition. Efficient planning, budgeting, implementation, and oversight will be key to maintain strong investment absorption capacity. Reforms to strengthen insolvency regimes and reduce labor market fragmentation are also important. To achieve Portugal's ambitious climate targets, the authorities may consider further adjustment of the carbon price when uncertainty surrounding the energy crisis subsides, combined with measures further improving energy efficiency and offsetting the impact on the most vulnerable households.

52. It is proposed that the next Article IV consultation takes place on the standard 12- month cycle.

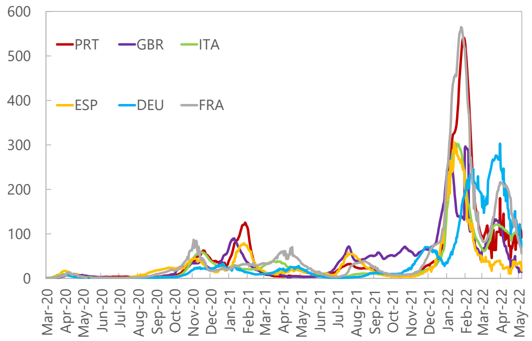
Figure 4. Portugal: Covid-19 Pandemic and its Economic Impact, 2020–2022

After being buffeted by recurring waves of the pandemic, which particularly affected the tourism sector, the economy gained ground, although more slowly for the tourism sector.

Portugal was hit by several waves of Covid-19…

COVID-19 Daily Cases

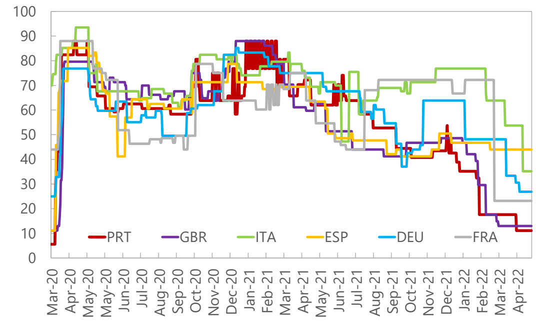
(7-days moving average per 100K people)



…which necessitated several rounds of mobility restrictions to contain the spread of the virus…

Oxford Stringency Index, Mar.2020–May.2022

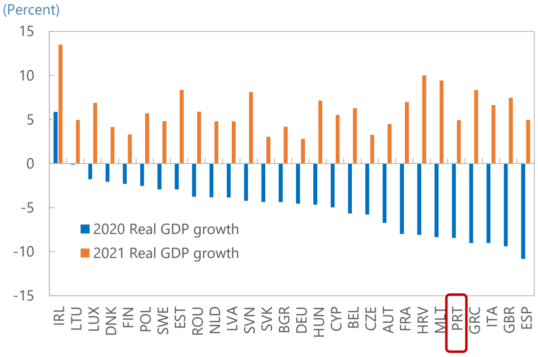
(Index, 0-100)



…and induced a severe recession in 2020…

Real GDP Growth in EU Countries, 2020 and 2021

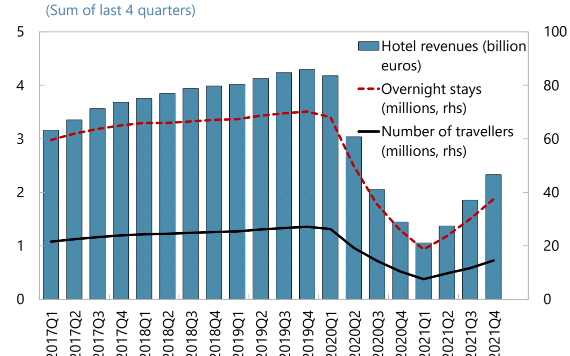
(Percent)



…primarily reflecting a sharp decline in tourism.

Tourism Developments

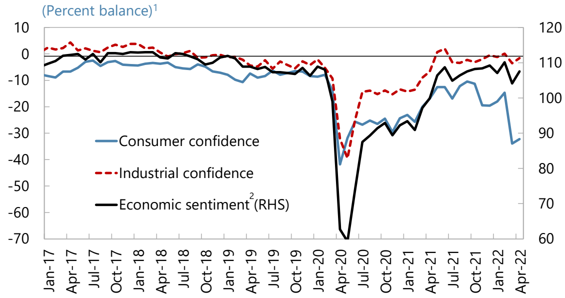
(Sum of last 4 quarters)



Confidence indicators have improved despite a recent soft patch.

Confidence Indicators

(Percent balance)[1]

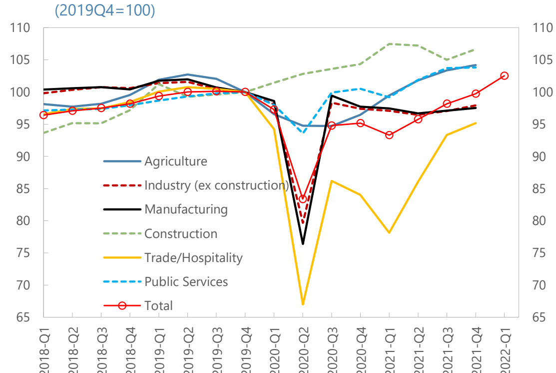


[1]Percent balance equals percent of respondents reporting an increase minus the percent of respondents reporting a decrease.
[2]Long-term average = 100.

And output recovery has been strong, although divergent across sectors.

Sectoral Gross Value Added

(2019Q4=100)



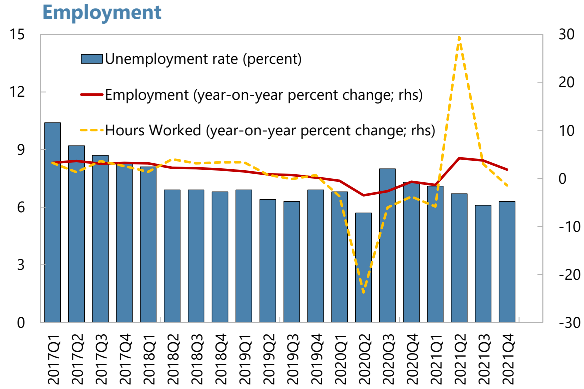
Sources: IMF WEO; Eurostat; Bloomberg; Oxford University; and Banco de Portugal.

Figure 5. Portugal: Labor Market Indicators, 2017–2021

The employment recovery has been strong, but also divergent across sectors and different demographic groups.

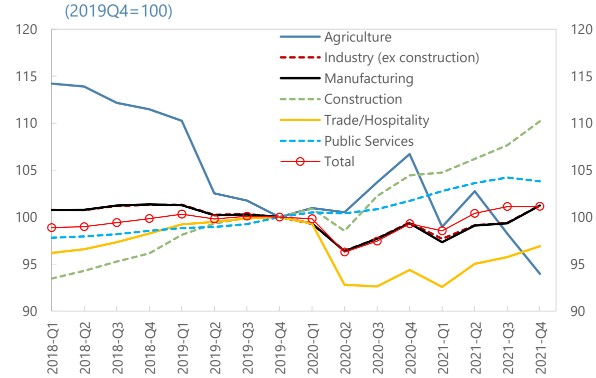
Employment indicators have recovered well and reached pre-pandemic levels...

Employment



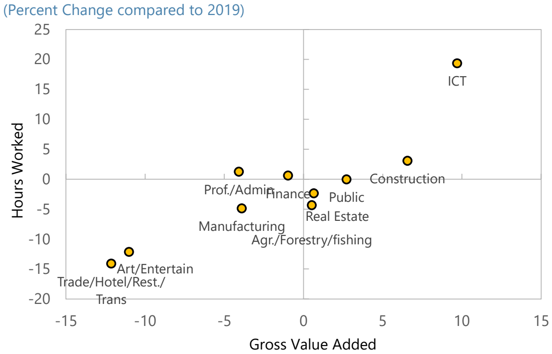
... but sectoral job growth has been slower for tourism.

Sectoral Employment
(2019Q4=100)



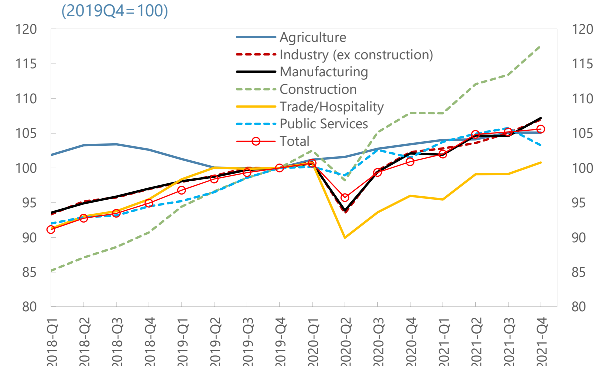
Hours worked are also divergent across sectors....

Gross Value Added and Hours Worked, 2021
(Percent Change compared to 2019)



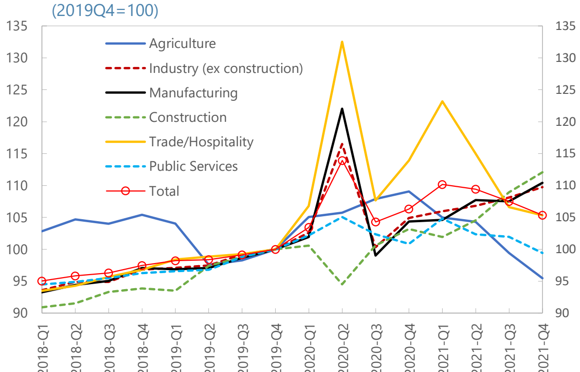
... and wage recovery is weaker in affected sectors.

Sectoral Compensation of Employees
(2019Q4=100)



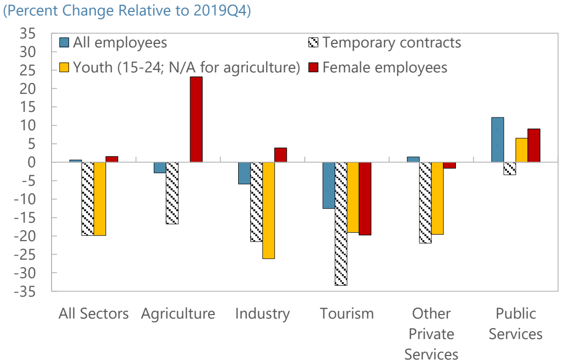
Unit labor costs have risen in construction, industry and manufacturing reflecting higher energy and material costs.

Unit Labor Costs
(2019Q4=100)



Labor market duality remains a key challenge.

Portugal: Employment Growth, 2021Q4
(Percent Change Relative to 2019Q4)



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

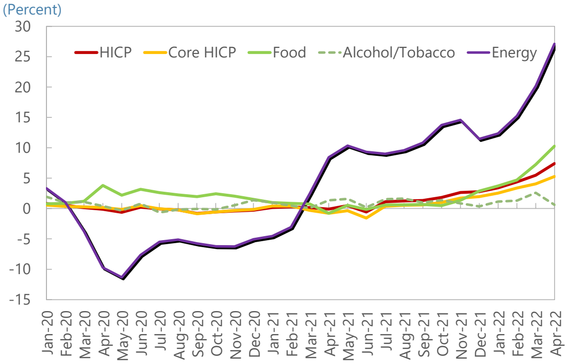
Figure 6. Portugal: Inflation Developments, 2020–2022

Inflation has picked up on higher energy prices, and has broadened more recently though second-round effects through wages are limited so far

Inflation has risen sharply relative to the recent past…

Portugal: HICP Inflation

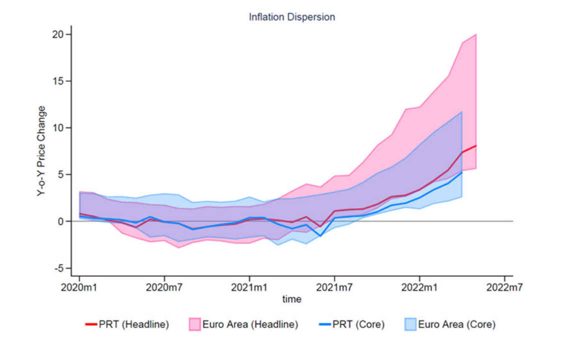
(Percent)



…but has remained below the EA average…

Portugal: Inflation Dispersion

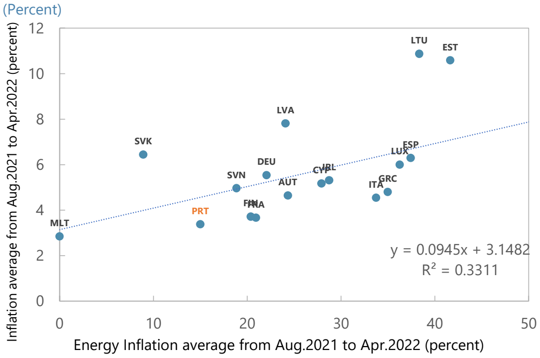
(Y-O-Y Percent Change)



…reflecting the more limited increase in domestic energy prices relative to other EA countries.

Headline Inflation and Energy Inflation

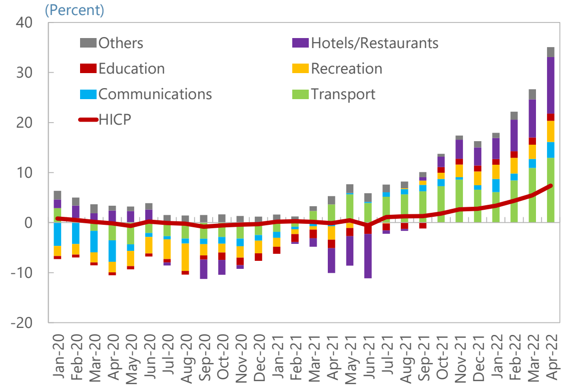
(Percent)



Among sectors, transport and hospitality have been harder hit.

Portugal: HICP Inflation

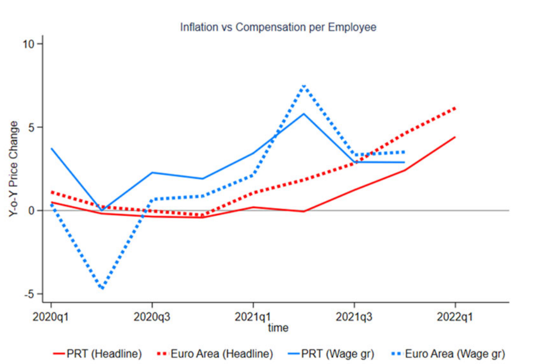
(Percent)



Overall wage pressures have remained limited so far…

Portugal: Inflation VS Compensation Per Employee

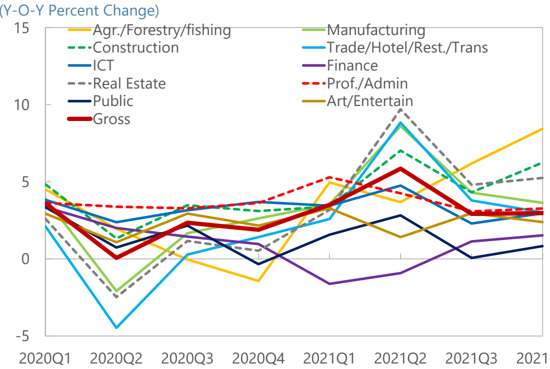
(Y-O-Y Percent Change)



…although there are sectoral differences.

Portugal: Growth of Compensation Per Employee

(Y-O-Y Percent Change)



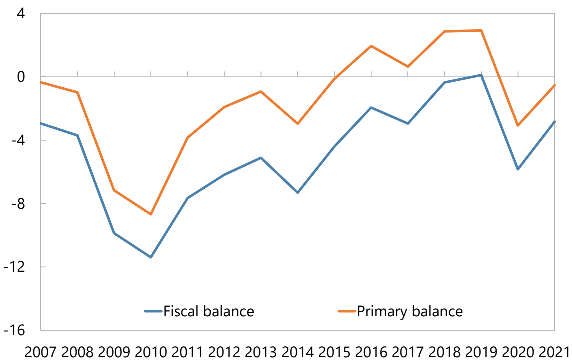
Sources: Eurostat; Haver Analytics; and IMF Staff Calculations.

Figure 7. Portugal: Fiscal Sector Indicators

A timely fiscal response to the pandemic, helped by accommodative funding conditions, widened the deficit. Over the medium term, containing expenditure, particularly relating to ageing, and improving revenue efficiency will be key

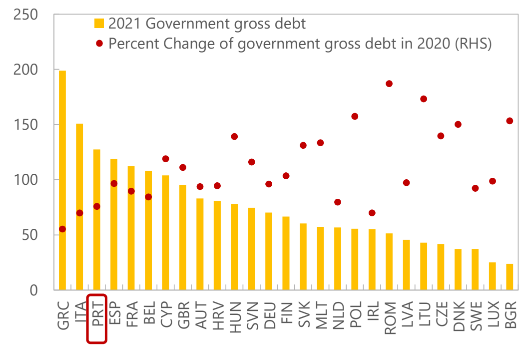
The fiscal balance fell sharply as prompt fiscal support was deployed in response to the pandemic…

Fiscal Balance
(Percent of fiscal year GDP)



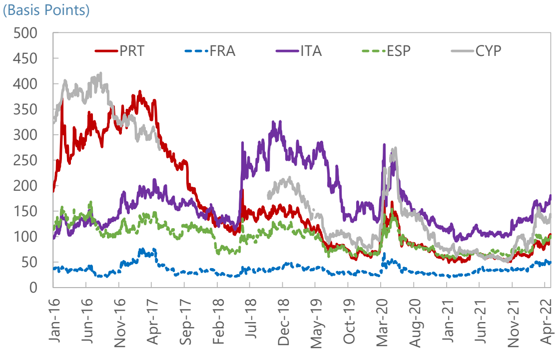
…causing public debt to rise significantly.

Government Gross Debt, 2021
(Percent of GDP)



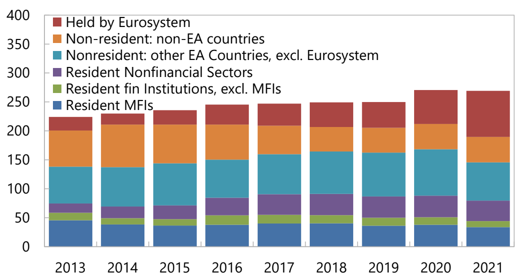
However, low interest rates, including low sovereign bond yields…

10-Year Govt Bond Spreads Relative to German Bunds
(Basis Points)



…and the ECB's asset purchase programs have provided ample funding.

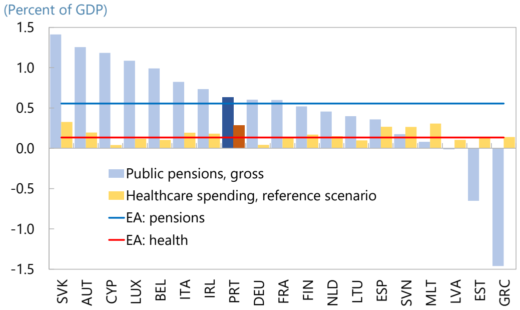
General Government Debt Holdings
(Billion euros)



Source: ECB and IMF staff calculations.
Note: the Eurosystem comprises the ECB and the national central banks of those countries that have adopted the euro.

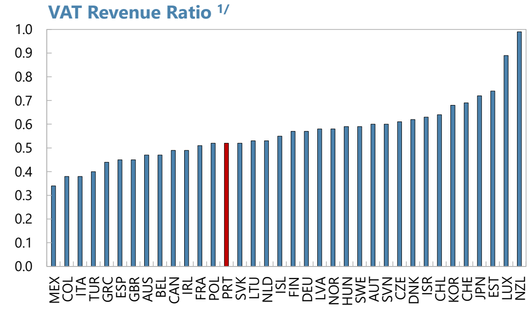
In the medium term, containing expenditure growth …

Ageing: Change in fiscal outlays on pensions and health: 2019-2025
(Percent of GDP)



…and improving revenue performance will be key.

VAT Revenue Ratio [1/]



[1/] Ratio between the actual value-added tax revenue collected and the revenue that would theoretically be raised if VAT was applied at the standard rate to all final consumption. Data is for 2018.

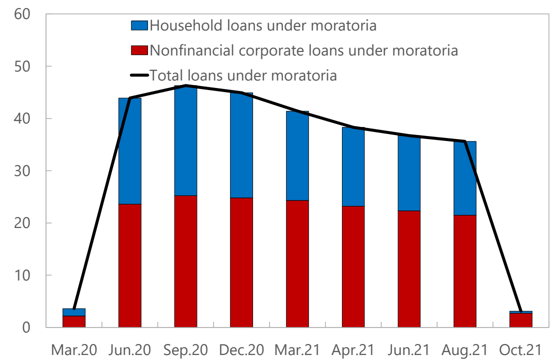
Sources: IMF WEO; Haver Analytics; ECB; OECD; European Commission; and IMF staff calculations.

Figure 8. Portugal: Bank Loans Under Moratoria

The end of loan moratoria presents a key uncertainty for the health of the financial system over the medium term.

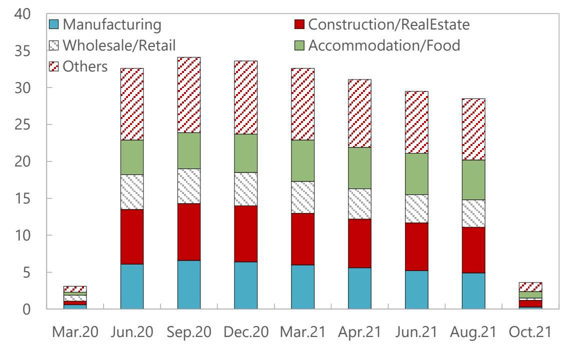
Loans under moratoria peaked in September 2020 and have been declining since the end of moratoria.

Portugal: Bank Loans under Moratoria
(Billions of Euros)



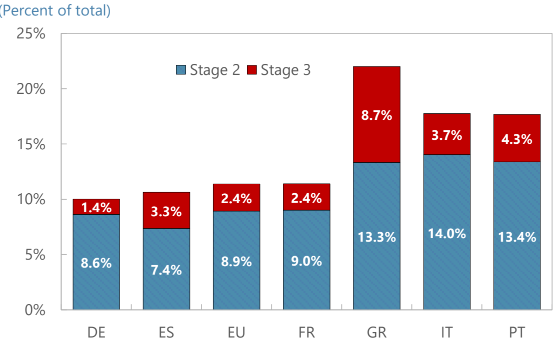
All non-financial sectors of the economy benefited from moratoria.

Portugal: Loans to NFCs under moratoria
(Percent of total loans to NFC)



The share of stage 2 and 3 loans in total loans is relatively high...

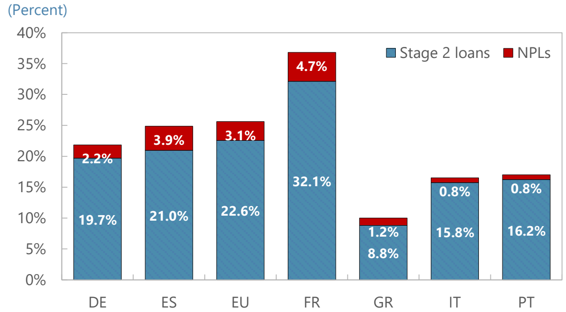
Bank Loans by IFRS9 Stage, 2021Q4
(Percent of total)



Note: Sample comprises EBA-reporting institutions.

... although this share in government-guaranteed loans (about 4 percent of total loans) is relatively low.

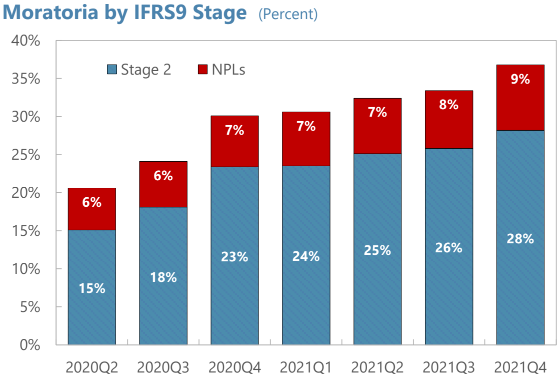
Bank Loans Subject to Public Guarantee Schemes by IFRS9 Stage, 2021Q4
(Percent)



Note: Sample comprises EBA-reporting institutions.

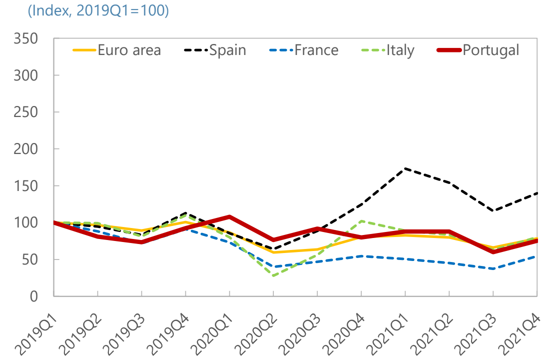
The credit quality has fallen for loans that were under moratoria.

Portugal: Bank Loans with Expired and Unexpired Moratoria by IFRS9 Stage (Percent)



Bankruptcies still remain low, partly reflecting the continued suspension on duty to file for bankruptcies.

Bankruptcy Declarations, Total Industry
(Index, 2019Q1=100)



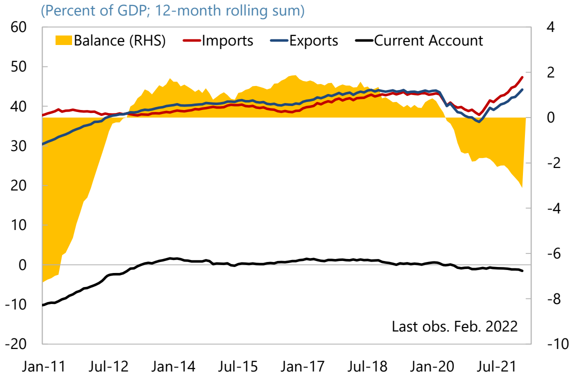
Sources: Eurostat; Banco de Portugal; and European Banking Authority.

Figure 9. Portugal: External Sector Indicators

The current account position suffered a sharp decline during the pandemic, mainly due to tourism.

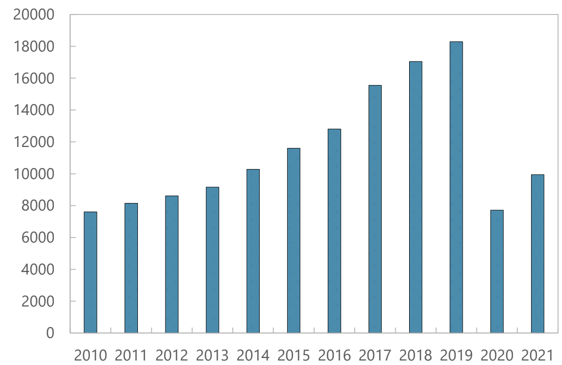
The current account turned negative with a sharper decline of exports relative to imports …

Trade in Goods and Services
(Percent of GDP; 12-month rolling sum)



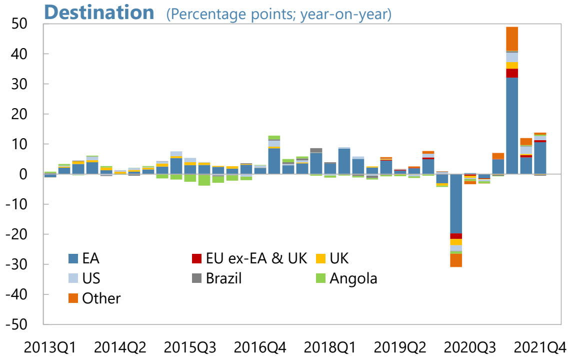
…reflecting a collapse of international tourism receipts, that partially recovered in 2021.

Travel Services Export
(Million Euros)



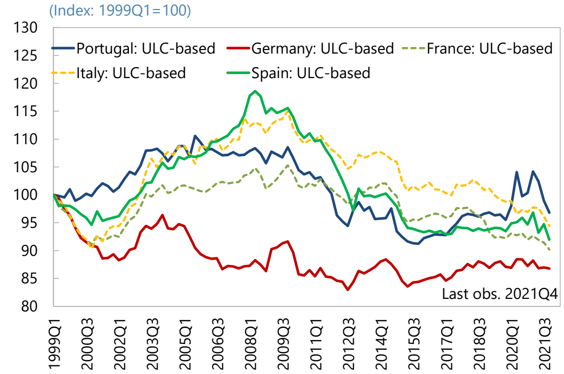
Goods exports have recovered with a simultaneous rebound in the rest of the euro area.

Contribution to Growth in Exports of Goods, by Destination
(Percentage points; year-on-year)



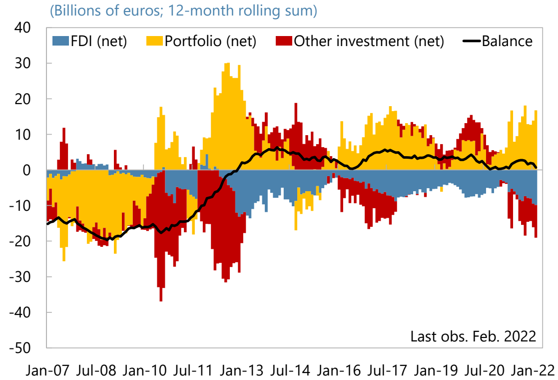
The ULC-based REER appreciated slightly reflecting support measures to employment.

Real Effective Exchange Rate
(Index: 1999Q1=100)



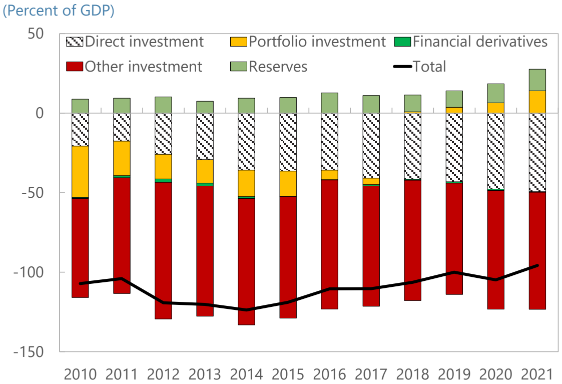
The financial account strengthened in 2021 as net liabilities fell, driven by a reduction of Portuguese long-term public debt held by non-residents.

Financial Account
(Billions of euros; 12-month rolling sum)



The NIIP deteriorated in 2020, worsening an already high negative balance, but slightly recovered in 2021.

Net IIP by Functional Categories
(Percent of GDP)



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

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

						Projections					
	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Real GDP	3.5	2.8	2.7	-8.4	4.9	5.8	1.9	2.4	2.1	1.9	1.9
Total domestic demand	3.3	3.2	3.1	-5.6	5.1	3.5	1.7	2.3	2.2	2.0	1.9
Private consumption	2.1	2.6	3.3	-7.1	4.5	3.4	2.0	1.9	1.9	1.9	1.9
Public consumption	0.2	0.6	2.1	0.4	4.1	1.3	1.2	1.1	1.6	1.4	1.8
Gross fixed investment	11.5	6.2	5.4	-2.7	6.5	5.9	1.3	5.0	3.9	2.6	2.1
Private	10.7	6.0	6.7	-5.3	5.6	3.8	1.1	5.8	4.3	4.4	3.6
Government	18.3	7.4	-5.6	21.5	13.5	20.3	2.3	-0.1	1.3	-9.0	-8.8
Exports	8.4	4.1	4.1	-18.6	13.1	7.2	2.5	2.5	2.4	2.4	2.5
Imports	8.1	5.0	4.9	-12.1	13.1	1.7	2.0	2.4	2.6	2.6	2.6
Contribution to Growth											
Total domestic demand	3.3	3.1	3.0	-5.5	5.2	3.5	1.7	2.3	2.2	2.0	1.9
Private consumption	1.4	1.7	2.1	-4.6	3.0	2.2	1.3	1.2	1.2	1.2	1.2
Public consumption	0.0	0.1	0.4	0.1	0.7	0.2	0.2	0.2	0.3	0.2	0.3
Gross fixed investment	1.8	1.0	0.6	-0.5	1.2	1.1	0.3	0.9	0.8	0.5	0.4
Stockbuilding	0.1	0.3	-0.3	-0.6	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Net exports	0.2	-0.3	-0.3	-2.9	-0.3	2.2	0.2	0.1	-0.1	-0.1	0.0
Savings-investment balance (Percent of GDP)											
Gross national savings	18.2	18.5	18.6	17.5	18.3	18.3	18.5	18.6	18.9	18.9	19.0
Gross domestic investment	17.2	18.3	18.5	18.8	19.7	20.2	19.7	20.0	20.2	20.3	20.2
Household saving rate		6.7	7.2	12.6	10.8	8.3	7.5	7.4	7.3	7.2	7.2
Resource utilization											
Potential GDP	0.9	1.4	1.6	-2.4	2.3	3.5	2.0	2.1	2.1	1.9	1.9
Output Gap (Percent of potential)	-1.1	0.3	1.4	-4.9	-2.5	-0.3	-0.4	-0.1	0.0	0.0	0.0
Labor											
Employment	3.3	2.3	0.8	-1.8	1.9	1.2	0.8	0.4	0.3	0.3	0.2
Unemployment rate (Percent; average)	9.2	7.2	6.7	7.1	6.6	6.5	6.4	6.4	6.4	6.3	6.3
Prices											
GDP deflator	1.5	1.8	1.7	1.9	0.7	6.0	3.1	2.5	2.5	2.3	2.2
Consumer prices (Harmonized index)	1.6	1.2	0.3	-0.1	0.9	6.1	3.5	2.3	2.0	1.8	1.7
Consumer prices excl. energy and food	1.2	0.8	0.4	-0.2	0.2	4.5	3.5	2.7	2.2	2.0	1.9
Fiscal indicators (Percent of GDP)											
General government balance	-3.0	-0.3	0.1	-5.8	-2.8	-2.2	-1.0	-0.9	-1.1	-1.1	-1.2
Revenues	42.4	42.9	42.6	43.5	45.3	44.4	44.2	43.8	43.3	42.7	42.6
Expenditures	45.4	43.2	42.5	49.3	48.1	46.6	45.2	44.7	44.4	43.9	43.8
Primary government balance	0.8	2.9	2.9	-3.1	-0.5	-0.1	1.0	1.0	0.7	0.7	0.9
General government debt	126.1	121.5	116.6	135.2	127.4	115.8	110.7	106.4	102.7	99.7	97.0
External sector (Percent of GDP)											
Trade balance (Goods and Services)	1.5	0.9	0.8	-1.9	-2.6	-1.8	-0.9	-0.4	-0.1	0.1	0.2
Current account balance	1.3	0.6	0.4	-1.1	-1.1	-1.3	-0.5	-0.5	-0.4	-0.4	-0.3
Savings-investment balance (Percent of GDP) 1/	1.0	0.3	0.1	-1.2	-1.4	-1.9	-1.2	-1.4	-1.2	-1.3	-1.3
Net international investment position	-110.4	-106.4	-100.0	-104.8	-95.9	-84.5	-78.2	-73.2	-68.6	-64.8	-61.6
REER based on ULC (2010=100)	93.8	95.6	95.3	101.2	104.1	107.2	109.9	111.6	112.8	113.7	114.3
REER based on CPI (2010=100)	96.8	97.8	96.3	97.1	95.8	96.5	98.0	98.6	98.8	98.8	98.7
Nominal GDP (Billions of euros)	195.9	205.2	214.4	200.1	211.3	237.1	249.3	261.5	273.8	285.4	297.1

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

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

Table 2a. Portugal: General Government Accounts 1/

(Billions of euros)

						Projections					
	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Revenue	83.1	88.0	91.3	87.0	95.8	105.3	110.7	115.0	119.2	122.5	127.0
Taxes	48.6	51.6	53.0	49.3	52.8	58.3	61.4	64.5	67.6	70.5	73.5
Taxes on production and imports	29.2	30.9	32.1	29.2	32.3	36.1	37.8	39.6	41.5	43.4	45.0
Current taxes on income, wealth, etc. and capital taxes	19.4	20.7	20.9	20.1	20.6	22.2	23.7	25.0	26.0	27.2	28.5
Current taxes on income, wealth, etc.	19.4	20.7	20.9	20.1	20.6	22.2	23.7	25.0	26.0	27.2	28.5
Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	22.7	23.9	25.4	25.6	27.1	29.5	30.9	32.2	33.3	34.5	35.9
Grants and other revenue	11.8	12.5	12.9	12.1	15.8	17.4	18.3	18.3	18.3	17.4	17.6
Property income	1.3	1.5	1.8	1.5	1.7	1.9	1.9	1.9	1.8	1.9	2.0
Sales of goods and services	6.8	7.1	7.3	6.6	6.7	7.3	7.6	7.8	8.1	8.3	8.6
Other current revenue	3.0	3.0	3.0	3.3	4.9	5.5	5.3	5.2	5.4	5.1	5.3
Capital transfers and investment grants	0.7	1.0	0.8	0.7	2.4	2.8	3.6	3.4	3.0	2.1	1.7
Expenditure	88.9	88.7	91.0	98.7	101.7	110.4	113.3	117.4	122.1	125.7	130.7
Expense	90.6	90.3	92.8	99.8	102.3	109.1	112.0	116.0	120.8	125.4	131.2
Compensation of employees	21.4	22.0	23.1	23.9	24.9	26.6	28.3	29.7	31.1	32.5	33.8
Use of goods and services	10.6	10.8	11.0	11.3	12.2	14.2	13.2	13.9	14.4	14.6	15.4
Consumption of fixed capital	5.2	5.5	5.6	5.6	5.9	6.1	6.5	6.8	7.1	7.4	7.7
Interest	7.4	6.9	6.3	5.8	5.2	5.2	5.6	5.5	5.3	5.6	6.7
Subsidies	0.8	0.8	0.9	3.7	4.2	2.2	1.7	1.1	1.1	1.2	1.2
Social benefits	36.0	37.2	38.8	40.3	41.4	44.6	46.9	49.2	51.7	54.3	56.8
Grants and other expense	9.2	7.0	7.0	9.1	8.4	10.2	9.9	9.8	10.0	9.8	9.6
Other current expense	4.2	4.7	4.7	5.0	5.8	6.1	6.3	6.5	6.6	6.7	6.9
Capital transfers	5.0	2.4	2.4	4.2	2.7	4.0	3.6	3.3	3.4	3.0	2.8
Net acquisition of nonfinancial assets	-1.8	-1.6	-1.8	-1.1	-0.6	1.3	1.3	1.4	1.3	0.4	-0.5
Gross fixed capital formation	3.5	3.8	4.0	4.6	5.4	7.5	7.8	8.2	8.4	7.8	7.2
(-) Consumption of fixed capital	-5.2	-5.5	-5.6	-5.6	-5.9	-6.1	-6.5	-6.8	-7.1	-7.4	-7.7
Acquisitions less disposals of other nonfinancial assets	0.0	0.0	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-2.3	3.1	4.0	-7.1	-0.6	2.3	5.2	5.8	5.5	4.5	3.6
Net lending (+)/borrowing (–)	-5.8	-0.7	0.2	-11.7	-6.0	-5.2	-2.6	-2.4	-2.9	-3.3	-3.6
Memorandum items:											
Primary balance	1.3	5.9	6.3	-6.2	-1.1	-0.3	2.6	2.7	2.0	1.9	2.6
Structural balance	-0.6	-0.3	-0.1	-1.9	-1.4	-1.9	-2.1	-2.3	-2.8	-3.3	-3.6
Structural primary balance	6.4	6.3	5.9	3.6	3.5	3.0	3.1	2.8	2.0	1.9	2.6
Debt at face value (EDP notification)	247.2	249.3	250.0	270.5	269.3	274.6	277.2	279.6	282.5	285.8	289.4
Expenditure growth, nominal, percent	6.3	-0.2	2.6	8.5	3.0	8.6	2.6	3.7	4.0	3.0	3.9

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

[1/] GFSM 2001 presentation.

Table 2b. Portugal: General Government Accounts 1/
(Percent of GDP, unless otherwise noted)

						Projections					
	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Revenue	42.4	42.9	42.6	43.5	45.3	44.4	44.2	43.8	43.3	42.7	42.6
Taxes	24.8	25.2	24.7	24.6	25.0	24.6	24.5	24.6	24.6	24.6	24.6
Taxes on production and imports	14.9	15.1	15.0	14.6	15.3	15.2	15.1	15.1	15.1	15.1	15.1
Current taxes on income, wealth, etc. and capital taxes	9.9	10.1	9.7	10.1	9.7	9.4	9.4	9.5	9.5	9.5	9.5
Social contributions	11.6	11.6	11.8	12.8	12.8	12.4	12.3	12.2	12.1	12.0	12.0
Grants and other revenue	6.0	6.1	6.0	6.1	7.5	7.4	7.3	7.0	6.7	6.1	5.9
Property income	0.6	0.7	0.8	0.8	0.8	0.8	0.7	0.7	0.7	0.7	0.7
Sales of goods and services	3.5	3.5	3.4	3.3	3.2	3.1	3.0	3.0	2.9	2.9	2.9
Other current revenue	1.6	1.5	1.4	1.7	2.3	2.3	2.1	2.0	1.9	1.8	1.8
Capital transfers and investment grants	0.4	0.5	0.4	0.3	1.1	1.2	1.4	1.3	1.1	0.7	0.6
Expenditure	45.4	43.2	42.5	49.3	48.1	46.6	45.2	44.7	44.4	43.9	43.8
Expense	46.3	44.0	43.3	49.9	48.4	46.0	44.7	44.2	43.9	43.7	44.0
Compensation of employees	10.9	10.7	10.8	12.0	11.8	11.2	11.3	11.3	11.3	11.3	11.3
Use of goods and services	5.4	5.3	5.1	5.7	5.8	6.0	5.3	5.3	5.2	5.1	5.1
Consumption of fixed capital	2.7	2.7	2.6	2.8	2.8	2.6	2.6	2.6	2.6	2.6	2.6
Interest	3.8	3.4	3.0	2.9	2.4	2.2	2.2	2.1	1.9	2.0	2.3
Subsidies	0.4	0.4	0.4	1.8	2.0	0.9	0.7	0.4	0.4	0.4	0.4
Social benefits	18.4	18.2	18.1	20.1	19.6	18.8	18.7	18.7	18.8	18.9	19.0
Grants and other expense	4.7	3.4	3.3	4.6	4.0	4.3	4.0	3.7	3.6	3.4	3.2
Other current expense	2.1	2.3	2.2	2.5	2.7	2.6	2.5	2.5	2.4	2.4	2.3
Capital transfers	2.6	1.2	1.1	2.1	1.3	1.7	1.4	1.3	1.2	1.1	0.9
Net acquisition of nonfinancial assets	-0.9	-0.8	-0.9	-0.5	-0.3	0.6	0.5	0.5	0.5	0.1	-0.2
Gross fixed capital formation	1.8	1.9	1.9	2.3	2.5	3.2	3.1	3.1	3.1	2.7	2.4
(-) Consumption of fixed capital	-2.7	-2.7	-2.6	-2.8	-2.8	-2.6	-2.6	-2.6	-2.6	-2.6	-2.6
Acquisitions less disposals of other nonfinancial assets	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-1.2	1.5	1.9	-3.6	-0.3	1.0	2.1	2.2	2.0	1.6	1.2
Net lending (+)/borrowing (–)	-3.0	-0.3	0.1	-5.8	-2.8	-2.2	-1.0	-0.9	-1.1	-1.1	-1.2
Memorandum items:											
Primary balance	0.7	2.9	2.9	-3.1	-0.5	-0.1	1.0	1.0	0.7	0.7	0.9
Structural balance (Percent of potential GDP)	-0.3	-0.1	-0.1	-0.9	-0.6	-0.8	-0.8	-0.9	-1.0	-1.1	-1.2
Structural primary balance (Percent of potential GDP)	3.3	3.1	2.8	1.7	1.6	1.2	1.2	1.1	0.7	0.7	0.9
Change in structural balance (Percent of potential GDP)	-0.2	0.2	0.1	-0.9	0.3	-0.2	0.0	0.0	-0.2	-0.1	-0.1
Debt at face value (EDP notification, percent of GDP)	126.1	121.5	116.6	135.2	127.4	115.8	110.7	106.4	102.7	99.7	97.0
Nominal GDP (Billions of euros)	195.9	205.2	214.4	200.1	211.3	237.1	250.5	262.8	275.1	286.7	298.5

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

[1/] GFSM 2001 presentation.

Table 3a. Portugal: Balance of Payments 1/

(Billions of euros)

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
						Projections					
Current and Capital account	4.2	3.2	2.8	0.0	1.4	2.1	5.4	3.6	3.6	2.8	2.2
Current account	2.5	1.1	0.9	-2.1	-2.4	-3.1	-1.2	-1.4	-1.0	-1.1	-0.8
Balance on goods and services	2.9	1.8	1.7	-3.9	-5.6	-4.2	-2.3	-1.1	-0.3	0.3	0.7
Balance on trade in goods	-13.3	-15.6	-16.3	-12.5	-15.0	-19.5	-19.4	-19.6	-20.3	-21.2	-22.3
Exports, fob	53.3	56.2	58.0	52.1	62.1	74.1	74.3	74.5	75.3	76.3	77.4
Imports, fob	66.6	71.9	74.2	64.6	77.1	93.6	93.7	94.1	95.6	97.4	99.7
Balance on trade in services	16.2	17.5	17.9	8.6	9.5	15.3	17.1	18.6	20.0	21.4	23.0
Exports	30.8	33.4	35.7	22.3	27.1	34.2	37.2	39.9	42.5	45.3	48.2
Imports	14.6	15.9	17.8	13.7	17.6	19.0	20.1	21.3	22.5	23.9	25.2
Of which:											
Balance on tourism	11.5	12.5	13.2	5.0	6.4	12.0	14.4	15.9	16.8	17.7	18.7
Exports	15.6	17.1	18.3	7.7	9.9	16.0	18.7	20.6	22.0	23.4	24.9
Imports	4.1	4.6	5.1	2.7	3.6	3.9	4.3	4.7	5.2	5.7	6.2
Primary income, net	-4.5	-4.9	-5.1	-2.7	-2.5	-3.1	-3.6	-4.1	-4.3	-4.4	-4.2
Secondary income, net	4.2	4.2	4.4	4.5	5.7	4.2	4.7	3.7	3.6	3.0	2.7
Private remittances, net	5.1	5.4	5.7	5.7	6.1	5.7	5.7	5.8	5.8	5.8	5.8
Official transfers, net	-1.0	-1.2	-1.3	-1.3	-0.4	-1.5	-1.0	-2.1	-2.2	-2.8	-3.1
Capital account	1.7	2.0	1.9	2.2	3.8	5.2	6.6	5.0	4.6	3.9	3.0
Financial account	4.2	3.5	3.2	0.3	1.9	2.1	5.4	3.6	3.6	2.8	2.2
Direct investment, net	-7.5	-5.3	-7.8	-4.7	-8.0	-7.2	-7.5	-7.8	-7.9	-8.1	-8.4
Direct investment assets	2.0	1.3	1.4	-1.5	-1.8	-0.4	-0.4	-0.4	-0.5	-0.5	-0.5
Direct investment liabilities	9.5	6.6	9.2	3.2	6.2	6.8	7.0	7.4	7.5	7.6	7.9
Portfolio investment, net	9.2	8.9	8.1	4.8	12.7	4.7	-1.3	4.7	17.2	16.8	20.2
Financial derivatives	0.0	0.6	0.1	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment, net	3.8	0.2	5.0	0.2	-6.3	4.4	14.0	6.4	-5.9	-6.2	-9.9
Reserve assets	-1.2	-0.9	-2.3	-0.4	3.5	0.2	0.2	0.2	0.2	0.2	0.2
Errors and omissions	0.0	0.3	0.3	0.3	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Nominal GDP	195.9	205.2	214.4	200.1	211.3	237.1	250.5	262.8	275.1	286.7	298.5

Sources: Bank of Portugal; and IMF staff projections.

1/ End-of-period data.

Table 3b. Portugal: Balance of Payments 1/

(Percent of GDP, unless otherwise noted)

						Projections					
	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Current and Capital account	2.2	1.5	1.3	0.0	0.7	0.9	2.2	1.4	1.3	1.0	0.7
Current account	1.3	0.6	0.4	-1.1	-1.1	-1.3	-0.5	-0.5	-0.4	-0.4	-0.3
Balance on goods and services	1.5	0.9	0.8	-1.9	-2.6	-1.8	-0.9	-0.4	-0.1	0.1	0.2
Balance on trade in goods	-6.8	-7.6	-7.6	-6.3	-7.1	-8.2	-7.8	-7.5	-7.4	-7.4	-7.5
Exports, fob	27.2	27.4	27.0	26.0	29.4	31.3	29.7	28.4	27.4	26.6	25.9
Imports, fob	34.0	35.0	34.6	32.3	36.5	39.5	37.4	35.8	34.8	34.0	33.4
Balance on trade in services	8.3	8.5	8.4	4.3	4.5	6.4	6.8	7.1	7.3	7.5	7.7
Exports	15.7	16.3	16.7	11.2	12.8	14.4	14.8	15.2	15.5	15.8	16.2
Imports	7.5	7.8	8.3	6.8	8.3	8.0	8.0	8.1	8.2	8.3	8.5
Of which:											
Balance on tourism	5.9	6.1	6.1	2.5	3.0	5.1	5.8	6.0	6.1	6.2	6.3
Exports	7.9	8.3	8.5	3.9	4.7	6.7	7.5	7.8	8.0	8.2	8.3
Imports	2.1	2.2	2.4	1.4	1.7	1.7	1.7	1.8	1.9	2.0	2.1
Primary income, net	-2.3	-2.4	-2.4	-1.4	-1.2	-1.3	-1.4	-1.5	-1.6	-1.5	-1.4
Secondary income, net	2.1	2.0	2.0	2.2	2.7	1.8	1.9	1.4	1.3	1.1	0.9
Private remittances, net	2.6	2.6	2.7	2.9	2.9	2.4	2.3	2.2	2.1	2.0	2.0
Official transfers, net	-0.5	-0.6	-0.6	-0.6	-0.2	-0.6	-0.4	-0.8	-0.8	-1.0	-1.0
Capital account	0.9	1.0	0.9	1.1	1.8	2.2	2.7	1.9	1.7	1.4	1.0
Financial account	2.1	1.7	1.5	0.2	0.9	0.9	2.2	1.4	1.3	1.0	0.7
Direct investment, net	-3.8	-2.6	-3.6	-2.4	-3.8	-3.0	-3.0	-3.0	-2.9	-2.8	-2.8
Direct investment assets	1.0	0.6	0.7	-0.8	-0.8	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Direct investment liabilities	4.9	3.2	4.3	1.6	2.9	2.9	2.8	2.8	2.7	2.7	2.6
Portfolio investment, net	4.7	4.4	3.8	2.4	6.0	2.0	-0.5	1.8	6.2	5.9	6.8
Financial derivatives	0.0	0.3	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment, net	1.9	0.1	2.4	0.1	-3.0	1.9	5.6	2.4	-2.1	-2.2	-3.3
Reserve assets	-0.6	-0.4	-1.1	-0.2	1.7	0.1	0.1	0.1	0.1	0.1	0.1
Errors and omissions	0.0	0.1	0.2	0.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Tourist receipts (percent of total exports)	18.5	19.0	19.5	10.4	11.2	14.7	16.8	18.0	18.6	19.3	19.8
Net international investment position (% GDP)	-110.4	-106.4	-100.0	-104.8	-95.9	-84.5	-77.9	-72.9	-68.3	-64.5	-61.3
Annual Change in NIIP valuation1/	-11.8	-5.3	-1.0	-0.5	..	..	..	..	..	..	..

Sources: Bank of Portugal; and IMF staff projections.

1/ End-of-period data.

Table 4. Portugal: Selected Financial Indicators of the Banking System 1/

(Percent of GDP, unless otherwise noted)

	2017				2018				2019				2020				2021			
	2017Q1	2017Q2	2017Q3	2017Q4	2018Q1	2018Q2	2018Q3	2018Q4	2019Q1	2019Q2	2019Q3	2019Q4	2020Q1	2020Q2	2020Q3	2020Q4	2021Q1	2021Q2	2021Q3	2021Q4
Capital adequacy																				
Regulatory capital to risk-weighted assets	13.9	14.4	14.7	15.1	15.0	15.2	15.3	15.1	16.0	16.1	16.4	16.9	16.7	17.2	17.5	18.0	17.7	17.8	17.8	18.0
Common Equity Tier 1 capital to risk-weighted assets	12.6	13.2	13.5	13.9	13.5	13.4	13.5	13.2	13.8	13.9	13.9	14.3	14.1	14.6	14.8	15.3	15.2	15.3	15.2	15.5
Regulatory tier 1 capital to risk-weighted assets	13.2	13.8	14.0	14.4	14.2	14.1	14.1	13.9	14.8	14.8	15.0	15.4	15.3	15.7	15.9	16.4	16.2	16.3	16.3	16.3
Capital to assets 1/	7.1	7.3	7.3	7.6	7.6	7.4	7.3	7.0	7.4	7.4	7.4	7.6	7.5	7.2	7.2	7.4	7.1	7.0	NA	NA
Asset composition and quality																				
Non-performing loans to total gross loans	16.3	15.4	14.4	13.3	12.7	11.7	11.3	9.4	8.9	8.3	7.7	6.2	6.0	5.6	5.3	4.9	4.6	4.3	4.0	3.6
Sectoral distribution of loans																				
Residents	88.3	89.3	89.8	90.8	91.6	91.4	91.6	91.5	91.3	91.6	91.0	91.7	91.4	92.1	92.0	92.4	NA	NA	NA	NA
Nonresidents	11.7	10.7	10.2	9.2	8.4	8.6	8.4	8.5	8.7	8.4	9.0	8.3	8.6	7.9	8.0	7.6	NA	NA	NA	NA
Earnings and profitability																				
Return on assets	0.0	0.1	0.2	0.0	0.8	0.6	0.6	0.3	0.6	0.6	0.6	0.4	0.2	0.1	0.1	0.0	0.4	0.4	0.5	0.5
Return on equity	0.2	1.1	2.0	-0.3	8.2	6.1	6.3	3.0	6.7	6.0	6.2	4.8	2.5	0.9	1.6	0.5	4.7	5.2	5.4	5.4
Interest margin to gross income	54.4	50.5	50.6	47.8	50.4	50.8	51.7	54.9	53.2	53.4	54.5	55.6	55.2	58.4	57.0	56.4	50.6	50.5	NA	NA
Noninterest expenses to gross income	70.3	64.4	64.3	57.5	60.6	61.2	59.6	62.6	59.8	60.7	60.7	62.3	63.6	65.5	62.3	62.0	57.4	59.6	NA	NA
Liquidity																				
Liquid assets to total assets 2/	11.5	13.0	13.1	14.2	14.1	15.3	15.0	16.1	17.1	17.5	17.6	18.5	18.5	21.7	21.3	21.7	23.2	24.0	NA	NA
Liquid assets to short-term liabilities 2/	17.3	19.3	19.3	21.0	20.9	22.0	21.7	23.3	26.4	23.9	23.9	25.3	24.9	31.3	31.1	31.6	33.9	31.9	NA	NA
Loans to deposits 3/	94.4	93.6	94.0	92.5	92.5	89.1	89.5	89.0	87.8	88.1	87.8	87.1	86.4	84.6	85.2	84.7	83.5	82.5	82.4	81.2
Foreign-currency-denominated liabilities to total liabilities 4/	4.7	4.5	4.0	4.1	4.1	4.2	4.3	4.6	4.2	4.0	4.3	4.1	4.1	3.7	3.6	3.5	3.5	3.2	NA	NA

Sources: Bank of Portugal; and IMF Financial Soundness Indicator Database.

1/ On accounting basis; consolidated.

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

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

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

Annex I. Status of Past Article IV Recommendations

Recommendations	Progress
Labor markets	
Labor market flexibility. Safeguard reforms during 2012-14 to make: (i) hiring and collective bargaining more flexible; and (ii) permanent contracts more flexible rather than restricting temporary contracts.	**Partially implemented.** Agreed measures would mostly discourage temporary contracts, and constrain flexibility afforded by "banks of hours;" however, allowances would be made for sectoral differences, and longer probation periods would improve permanent contracts.
Gender gap. Develop strategies to reduce the under-representation of women in positions with higher qualifications and higher pay and the overrepresentation in low-paying occupations with part-time and fixed-term contracts to not only close gender pay gaps but also reduce overqualification mismatches.	**Partially implemented**: Gender pay gap is on a declining path. ALMPs introduce incentives to increase employment of women in under-represented professions. Initiative *Portugal INCoDe.2030* targets increasing the share of women in the ICT and higher education.
Structural reforms	
Private pensions. Enact the regulations needed for the complementary second-tier occupational pension schemes mandated in the pension law.	**Implemented.** Decree-Law 27/2020 has introduced new rules applicable to employer-provided pension funds, reflecting changes required by the European Union (EU) Institutions for Occupational Retirement Provision (IORP) Directive (EUD 2016/2341 on the activities and supervision of institutions for occupational retirement provision) as well as certain further reforms. To implement the changes, effective August 1, 2020, external pension fund managers must modify existing pension fund agreements. For some of the changes, an implementation period of up to 12 months will be permitted. European Union (EU) Directive on the activities and supervision of institutions for occupational retirement provision (IORP) that aims to improve the governance of workplace pensions and ease workers' job mobility within the EU. The law generally took effect in Portugal on 1 Aug 2020. https://www.mercer.com/our-thinking/law-and-policy-group/portugal-introduces-new-pension-rules-eu-iorp.html
Investment and productivity. Improve the regulatory environment, strengthen competitiveness, and make more efficient use of labor, building on past reforms. Promote competition in network industries.	**Partially implemented**: The NRRP envisages reforms to improve vocational education and training, strengthen cooperation between higher education and companies, remove restrictions in highly regulated sectors and reduce gender inequality. ALMPs under Ativar.pt promote employment and improve workers' skills. Recent changes to Labor Code (July 2021) introduce new reskilling and upskilling programs (Upskill, EU Sou Digital, Impulso Jovens STEAM). To address labor shortages, hiring and training subsidies to promote employment of underrepresented and disadvantaged (long-term unemployed) groups have been increased.
Education. Raise the quality of education and training in vocational schools. Foster exchanges between universities and industry.	**Partially implemented:** New Special Technological Centers connecting students with companies contribute to improved on-job training. Authorities remain committed to improve quality of education of middle aged workers; however, participation in adult education remains low. Recent changes to Labor Code (July 2021) introduce new reskilling and upskilling programs (Upskill, EU Sou Digital, Impulso Jovens STEAM). The NRRP Component 6 focuses on upskilling. Other programs focus on improving matching between labor demand and supply.
Financial sector and Macro-financial Issues	
Profitability. Supervisors to ensure that banks improve their operational efficiency and profitability.	**Implemented.** A thorough supervisory review of banks' business models has been conducted in the context of SREP, leading to recommendations to improve operational efficiency and streamline activities. Progress has been made on these two fronts. Nevertheless, further efforts are needed to continue to improve profitability.
Non-performing loans. Supervisors to ensure that banks should follow through their NPL reduction targets and strengthen their corporate governance, internal controls, and risk management.	**Ongoing**. Prudential supervisors are actively monitoring NPL levels and NPL reduction strategies.
Capital. Supervisors to ensure that banks' capital ratios are resilient to adverse macro scenarios.	**Ongoing.** In the context of the SREP capital decision, supervisors are monitoring capital adequacy. Stress tests are performed to complement these efforts.
Fiscal sector	
Budgetary process, monitoring and control. Finalization the Budget Framework Law to improve budget preparation and execution.	**Ongoing.** Implementation of the Budgetary Framework Law (BFL) saw a number of milestones in the 2021 Budget, such as inclusion of no policy change scenario, enhanced fiscal risk disclosure and tax expenditure reporting. Implementation of accrual accounting and reporting, and performance-based budgeting has proceeded with delays. Amendments to the Budgetary Framework Law approved in April-2022 will strengthen the ex-post evaluation of macroeconomic forecasts, and the role of the Public Finance Council. Further reforms are needed to strengthen and better integrate the annual and medium-term budgets.
Structural primary adjustment. One percent of GDP tightening of the structural primary balance (relative to 2018) over 2019–2020.	**Not applicable**. As per guidance, given the size of the COVID-19 shock, this falls under "past policy advice may no longer be relevant in many cases".
Public employment. Review the level, composition and rules of public employment comprehensively to identify ways to control increases in the wage bill without affecting service delivery.	**Not implemented.** Public employment has grown, though in part in response to urgent and immediate service sector delivery needs in the healthcare and education sectors. Offsetting measures have been introduced.
Civil service reform. A well-designed reform of the civil service, aimed at improving the level and composition of public employment, and guided by the demographic needs of the population.	**Partially implemented.** While there has been no wholesale review or reform of the civil service, the authorities have demonstrated restraint on wages and career unfreezing, and have focused new hiring in areas where the demographic demands are highest (in particular, health personnel).
Capital spending. In the context of changing the expenditure composition, increase capital spending to maintain the level of public capital stock.	**Not applicable**. As per guidance, given the size of the COVID-19 shock, this falls under "past policy advice may no longer be relevant in many cases". Although public investment has increased markedly, this has not been done via the changing expenditure composition.
Pension reforms (1). Revisit recent pension reforms to reduce grandfathering.	**Not implemented.** No major reforms of the pension system have been implemented.
Pension reforms (2). Identify measures to offset the costs of reducing the penalties for the early retirement of long-career employees	**Not implemented.** No offsetting measures introduced.
Pension reforms (3). Re-examine the highest pensions, to enhance equity in the system and keep a tight control on the trajectory of pension spending. For instance, the accrual rates for the largest earning brackets could be reduced in order to gradually converge to EU average replacement rates.	**Not implemented.** Bonus regime for those retiring after statutory age remains generous and unchanged. Also, new flexibility rule for early retirement entered into force in 2019. It exempts from the application of the sustainability factor all workers aged 60 or more, and who have attained a contributory period of at least 40 years at the age of 60.
Public sector payments discipline. Address the root causes of arrears, particularly from hospitals, such as under-budgeting, as well as weaknesses in monitoring and enforcement practices.	**Partially implemented.** In the context of the ongoing spending review, the initiatives in the healthcare sector to increase central control of budgetary execution, decrease arrears, strengthen the joint performance monitoring and control from the MoF and MoH have improved efficiency but have been insufficient to prevent hospitals from accumulating new arrears.

Annex II. Key Policy Measures in Response to Covid-19, 2020–2021

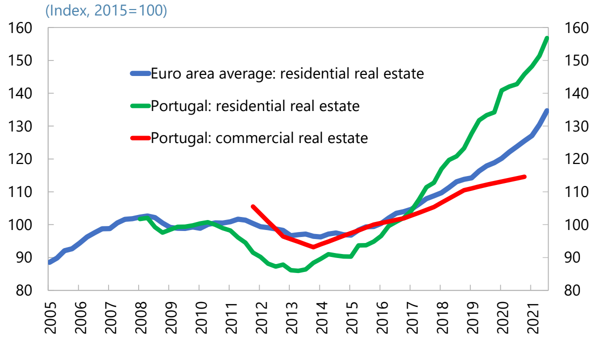
Period	Objective	Measures
March -April 2020	**Emergency measures**	
	Containment of the outbreak	- Duty of self isolation - Temporary reinstatement of border controls - Closure of selected activities
	Secure jobs	- Short term employment protection scheme - Deferral of tax/social security payments - State guaranteed credit lines - Moratoria on bank credits
	Ensure adequate welfare provision	- Moratoria on households' bank loans - Enhanced social benefits - Increase the response capacity of the National Health Service
May - September 2020	**Stabilize economic and social conditions**	
	Boost employment	- Extension of short term employment protection scheme - Incentives to the gradual increase in working hours and labor income - Launch of small public works
	Increase firms' capital and liquidity	- Extension of moratoria on bank credits - Maximum amount of State guaranteed credit lines increased to 6.6 percent GDP - Added flexibility in compliance with tax obligations - Suspension of insolvency filing obligations for debtors - Launch of the Portuguese development bank, tasked with direct lending, managing state guarantees and company capitalization - Incentives to SME consolidation and improved access to capital markets
	Increase banks' capital and liquidity	- Relaxation of macroprudential policies
	Enhance social welfare	- Wider range of social benefits enhancement of the National Health Service - Digital transition in public schools - Improved access to affordable housing
	Improve institutional set up	- Streamlined public administration procedures - Added support/flexibility for local and regional administrations - Focus on the judicial system
End 2020	**Bolster up policy support**	
	Strengthen capacity of the National Health Service	
	Additional liquidity to the most affected firms	- Entertainment, restaurants, exporting, firms
	Adjust the short term employment protection scheme	- Accumulation with other measures allowed
January - September 2021	**Refocus on public health**	
	Contain the surge in COVID 19 cases	- Closure of non essential activities; closure of schools universities from 22 Jan - Duty of self isolation - Country wide mobility restrictions - Tighter control; heavier fines
	Support to firms	- Turnover loss and fixed cost compensation grants to firms in the most affected sectors (Apoiar programs). - Credit guarantees up to 25 percent to support loan renegotiation of most affected sectors. - Resilience and Capitalization Fund (€1.3 billion) supporting debt reduction and recapitalization of firms via equity and quasi-equity instruments.
	Strengthen policy action	- Extension/recalibration of employment support schemes - Enhanced support to the cultural sector and businesses impacted by the new lockdown - Renewed benefits for the educational community amidst the new lockdown, including parental leave and support to vulnerable students.

Annex III. Residential Housing and Mortgage Market Development

1. Since 2015, Portuguese house price growth outpaced the EA average by almost 30 percentage points. This pace was sustained throughout the pandemic, with residential real estate prices gaining nearly 20 percentage points in real terms and relative to rents.

Real Estate Prices Index

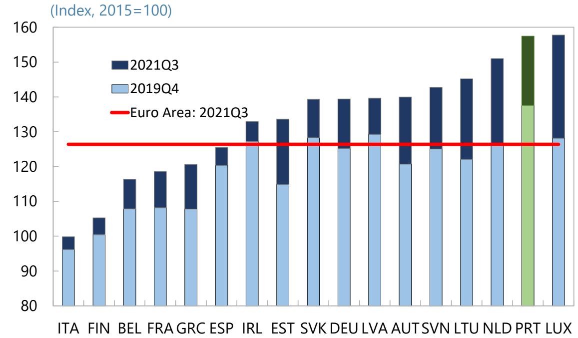
(Index, 2015=100)



Source: Eurostat and National Statistical Institute (INE).

Real House Price Index, 2021Q3

(Index, 2015=100)

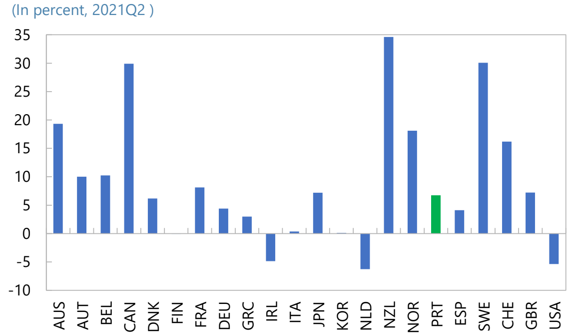


Source: OECD.

2. Available estimates suggest overvaluation of residential real estate. Based on indicators developed by the ECB, Banco de Portugal estimates point to an over-valuation of 8 to 16.5 percent (see Banco de Portugal, December 2021 Financial Stability Report). IMF model-based estimates of house price misalignments relative to fundamentals point to an overvaluation of 7 percent as of mid-2021. However, since mid-2021 house prices increased by 5.7 percent by end-2021. Price-to-rent and price-to-income ratios have reached the highest levels since 2000.

House Price Misalignment

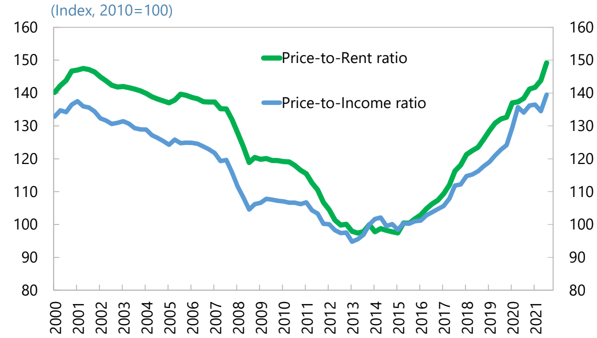
(In percent, 2021Q2)



Source: IMF staff calculations.

House Price-to-Income and Price-to-Rent Ratios

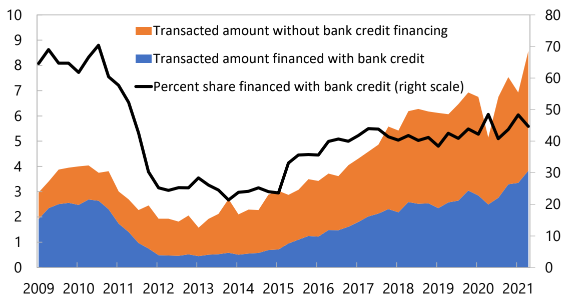
(Index, 2010=100)



Source: OECD.

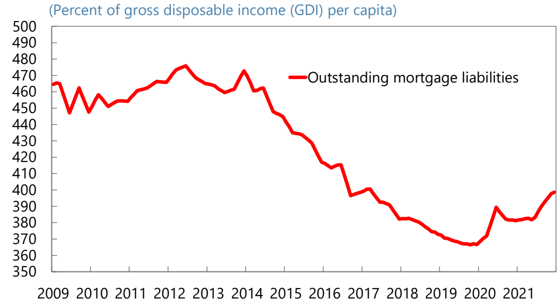
3. Domestic bank credit has not been a key driver of house prices yet. Even before the pandemic, Portugal had become one of EA's most dynamic real estate markets partly reflecting tax incentives for foreigners and the Golden Visa program, whereby non-resident flows contributed to drive up housing prices.[1] With households deleveraging since 2012–13, outstanding house credit to disposable incomes declined by 100 pp between 2014 and 2019. Housing credit growth turned positive only from 2019, driven by improved consumer confidence and low interest rates. While credit it still below historical averages, some estimates suggest small but positive credit gaps emerging in recent years. Housing supply shortages also played a role in boosting prices, with relatively subdued construction activity in the pre-pandemic years, although the construction sector remained resilient throughout the pandemic. Some cities (e.g., Lisbon) also saw a compression in price variation, with lower-end prices seeing steep gains.

House Purchase Transactions and New Housing Loans
(In billion euros)



Source: Banco de Portugal.

Housing Credit Outstanding
(Percent of gross disposable income (GDI) per capita)

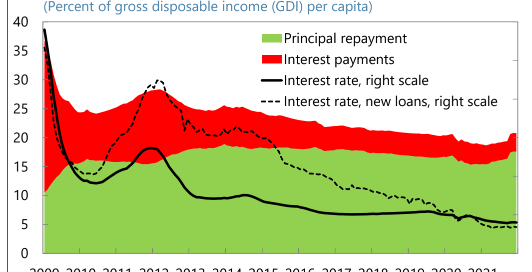


Source: Haver Analytics and IMF staff calculations.
Note: GDI is not adjusted for in-kind transfers and is on per capita as opposes to per household basis.

4. **Although aggregate housing debt service as a share of disposable income was declining before the pandemic, this trend has slowed.** On a per capita basis, average mortgage payments correspond to about 1/5th of household gross disposable income, marginally lower than the peak during the 2012–13 sovereign debt crisis. Also, mortgage interest payments declined from about 12 percent of disposable income in 2012H1 to about 3 percent in 2021. Principal repayments dipped temporarily due to moratoria.

5. **With house lending relying predominantly on variable rate mortgages, a significant increase in interest rates would quickly erode household incomes**. Three quarters of housing loans have rate fixation of up to one year, with Euribor as the benchmark, while only a small fraction has fixed rates for longer than 10 years. Compared to early 2021, 2-year swap rates have widened by over 150 basis points reflecting expectations of ECB monetary tightening. With historic and euro-area's lowest mortgage interest rates as of 2021Q4 – 0.7 percent for new mortgages

Housing Credit Payments
(Percent of gross disposable income (GDI) per capita)



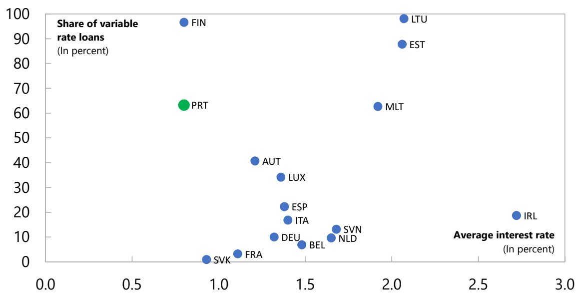
Source: Haver Analytics and IMF staff calculations.
Note: GDI is not adjusted for in-kind transfers and is on per capita as opposes to per household basis.

[1] Portugal grants a 5-year residency permit to non-EU citizens who buy a minimum of €500,000 worth of property, allowing holders to work or study, and travel to Schengen countries. They can apply for permanent residency after five years. Since the program started in 2012, it has accounted for 40 percent of the FDI in the real estate sector, bringing in over 5 billion euros. The Golden Visa for residential real estate was ended in Lisbon, Porto, and Algarve from January 2022.

and 0.8 percent for all outstanding –a 1 pp higher rate could raise household interest payments from 3.2 percent to about 7.2 percent of average household income, potentially also impacting aggregate demand.[2] As per BdP's borrower-based macroprudential policy measures, banks are recommended to consider a 300 basis point interest rate shock in the calculations of DSTIs for new mortgages.

Loans for house purchase, end-2021

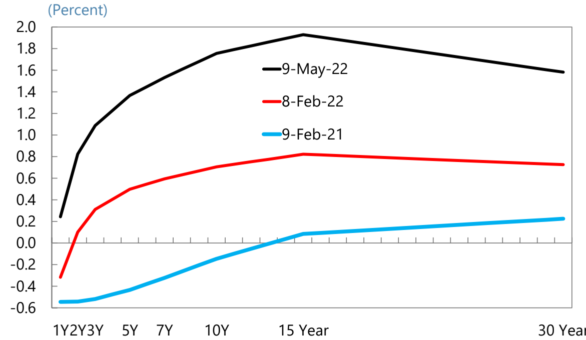
(In percent of total loans for house purchase)



Source: ECB Risk Assessment Indicators Database.
Note: Variable rate loans includes only loans with up to 1 year interest rate fix; average interest rate is volume-weigheted for all loans for house purchase.

3-month EURIBOR Swap Curve

(Percent)

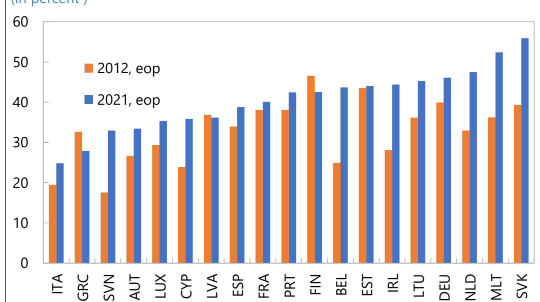


Source: Bloomberg L.P.

6. **The Bank of Portugal expanded its macroprudential toolkit in 2018, including measures on new credit agreements relating to residential property and consumer credit** (also see Neugebauer and others 2021, Banco de Portugal Financial Stability Report, December 2021)**.** Supervisory data indicate that borrower profiles improved in 2019, partly reflected in the increase in the share of mortgage credit granted to borrowers with net income above median. Nonetheless, the average maturity of new loans has not undergone gradual convergence towards 30 years, which prompted new macroprudential guidance from April 2022 on limits to maximum maturities. As regards the interest rate risk, and as mentioned above, the measures stipulate that banks should take into account the impact of higher interest rates in the calculations of DSTI, which is a mitigating factor.[3] More generally, risks need to be closely monitored

Share of housing loans in total bank credit to residents

(In percent)



Source: ECB Risk Assessment Indicators Database.

[2] Despite the low interest rates, borrowers in Portugal pay one of the highest annual percentage rates to cover their mortgage loan charges in the EU (apart from the interest payments, these charges also include maintenance costs for the accounts required to conclude the credit agreement and, more importantly, insurance costs required to obtain the loan).

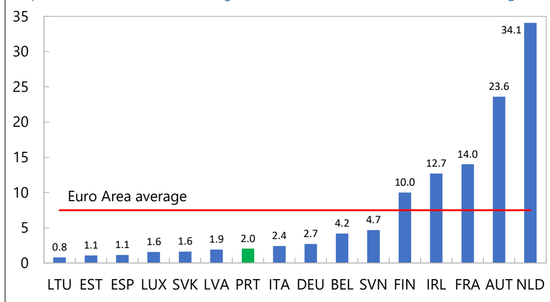
[3] The Mortgage Credit Directive requires creditors to create two illustrative examples for variable rate mortgages, including a warning that the variability could affect the actual level of the annual percentage rate of charge. For mortgage loans, Banco de Portugal recommends a 300 basis point illustrative scenario in the setting of the DSTI. Nonetheless, no warning is foreseen that there is no maximum limit of the borrowing rate. Portuguese loans are full recourse, although isolated judicial rulings have limited borrower liability when liquidation sale value fell significantly below bank's appraisal furnished at the mortgage contract stage.

and consideration should be given on further strengthening capital positions, in accordance with the ESRB guidance, should vulnerabilities from the residential real estate sector continue increasing.

7. In view of rising house prices and limited social housing, housing affordability has also been a growing concern. House prices to disposable income are high among EA countries. Social housing is also limited, at about 2 percent of the total housing stock compared to EA average of 7.5 percent. In this context, the NGEU financed NRRP provides an opportunity for such investments to increase the stock of affordable rental housing for low-income families, which can also facilitate job mobility.

Social Housing Stock, 2020 or latest

(In paercent, social rental dwellings as a share of the total number of dwellings)



Source: OECD affordable housing database.

Annex IV. External Sector Assessment, 2021

<table>
<tr><td colspan="2">Overall Assessment: The external position in 2021 was broadly in line with the level implied by medium-term fundamentals and desirable policies. The large adjustment in the current account since the 2012–13 sovereign debt crisis helped reduce the large negative NIIP on the back of higher tourism revenues and an improvement in the public sector savings-investment balance arising from fiscal adjustment. As in 2020, the current account remained at -1.1 percent in 2021, reflecting a sharp decline in tourism revenues due to the pandemic. Over the medium term, the NIIP is projected to strengthen from its level of –95.8 percent of GDP in 2021 to below -62 percent in 2027.

Potential Policy Responses: Once the recovery is on a firm ground, sustained fiscal consolidation and structural reforms to improve Portugal's saving rate, competitiveness, diversification, and economic resilience are needed to keep the current account balance in line with the norm. Public investments under the RRP provide an opportunity to facilitate resource reallocation and a transition to a greener, more competitive, and digital economy. Private investment can be spurred by enhancing business conditions, streamlining regulations, and increasing the flexibility and responsiveness of institutions and markets.</td></tr>
<tr><td>Foreign Asset and Liability Position and Trajectory</td><td>Background. The negative net international investment position (NIIP) declined from its peak in 2014 of 124 percent of GDP to 96 percent of GDP in 2021, after a rebound to 106 percent in 2020 because of the pandemic-induced decline in GDP. The pre-pandemic improvement was driven by positive current account balances on the back of strong tourism revenues, partly offset by improving external debt valuations. Gross external debt remains high at 193 percent of GDP in 2021. Both NIIP and gross external debt are expected to continue to decline, but at a decelerating rate over the medium term as the evolution of the CA remains less favorable.

Assessment. The large negative NIIP position induces external vulnerabilities, particularly from the large gross financing needs from external debt, as well as potential valuation changes. However, past debt management efforts to reduce sovereign external risk, including by smoothing the profile for redemptions and lengthening the average maturity have mitigated this risk. The sovereign debt purchases through the asset purchase programs have helped alleviate financing concerns, reducing Portugal's vulnerability. Going forward, the NIIP is projected to decline to -85 percent in 2022 and to below 70 percent in 2025 on the back of the RRP primary (current) and secondary (capital) transfers and the recovery of tourism revenues.</td></tr>
<tr><td>2021 (% GDP)</td><td>NIIP: -95.8 | Gross Assets: 177.4 | Debt Assets: 53 | Gross Liab.: 273.2 | Debt Liab.: 47.5</td></tr>
<tr><td>Current Account</td><td>Background. The Portuguese current account was in surplus during 2013–19, after an extended period of deficits, was driven by a significant improvement in the balance of trade in goods and services, including on the heels of strong growth in tourism, and a substantial improvement in the savings-investment balance from fiscal adjustment. The current account registered a deficit of 1.1 percent of GDP in 2021, similar to 2020, driven by lower tourism revenues despite the compression in goods imports. The CA is expected to further deteriorate in 2022 due to the negative impact of deteriorating terms of trade and adverse spillovers from the Russia-Ukraine war impacting Portuguese exports through lower growth in EA trade partners and supply chain disruptions.

Assessment. EBA model-based estimates suggest a cyclically adjusted current account balance at -1.2 percent of GDP. Adjusting by 3.4 percent to account for the effect of the Covid-19 pandemic on tourism, medical imports, and shift in household consumption composition and by -1.0 percent to offset the uncertainty in estimates of the retained earnings and inflation biases, yields a staff cyclically adjusted current account amounting to 1.2 percent of GDP. The EBA CA model suggests a norm of -1.2 percent of GDP. However, given external risks from a large and negative NIIP, staff's assessment puts more weight on external sustainability, aligned with past advice (see staff reports of the 2018-19 IMF Article IV Consultations). Guided by the objective of increasing the NIIP to under -50 percent over the medium-term, and assuming no valuation effects, a CA norm of 1 percent of GDP is estimated (within a range of 0 to 2 percent which recognizes the uncertainty in the economic outlook), implying a staff gap 0.2 percent of GDP. Accounting for uncertainty in the estimates, this implies a CA gap in the range of -0.8 to 1.2 percent of GDP. Policy gaps, reflecting deviations of current policy settings in Portugal from their desired settings, contribute 2.1 percent while the unexplained residual represents -2.2 percent. Key to strengthen the external position, given the high level of public debt, is sustained fiscal adjustment paired with structural reforms to support both saving and investment.</td></tr>
<tr><td>2021 (% GDP)</td><td>CA: -1.1 | Cycl. Adj. CA: -1.2 | EBA Norm: -1.2 | EBA Gap: 0.0 | Covid-19 Adj.: 3.4 | Other Adj.: -3.2 | Staff Gap: 0.2</td></tr>
<tr><td>Real Exchange Rate</td><td>Background. CPI-based real effective exchange rate (REER) and the unit labor cost (ULC)-based REER have diverged in 2021, with CPI-based REER appreciating to pre-2015 level, while ULC-based REER depreciating for a second consecutive year, as a result of support measures to the labor market during the Covid-19 pandemic. Both REER measures were appreciating between 2015 and 2019, and the trend is expected to resume for ULC-based REER once support measures are withdrawn. Cost competitiveness will be challenged if the appreciating trend continues.

Assessment. The EBA REER index model[1] suggest a marginal undervaluation of -1.0 percent while the level REER model implies a marginal overvaluation of 1 percent in 2021.[2] However, putting the NIIP on a faster downward track will require a stronger adjustment in the REER that could be accomplished through continued and sustained quality upgrades and innovation to improve non-price competitiveness.</td></tr>
<tr><td>Capital and Financial Accounts: Flows and Policy Measures</td><td>Background. Financing conditions remained favorable in 2021 on the back of the ECB asset purchases and other policy measures by European institutions. As a result, sovereign spreads were lower than 70 basis points at end-December 2021, after being above 300 basis points in early 2017, but have recently started to increase following Russia's invasion of Ukraine. Credit ratings have been stable at investment grade since end-2018, with the last notch upgrade by Moody's in September 2021. Higher foreign direct investment liabilities were more than offset by higher net portfolio investment inflows, resulting in a financial account of 0.9 percent of GDP in 2021.

Assessment. An active debt management has not only helped support external financing rollover needs for the near term in the public sector but has also had positive spillover effects for the private sector, including by lowering funding costs.</td></tr>
<tr><td>FX Intervention and Reserves Level</td><td>Background. The euro has the status of a global reserve currency.

Assessment. Reserves held by the Euro Area are typically low relative to standard metrics, but the currency is free floating.</td></tr>
<tr><td colspan="2">[1] EBA REER models are based on CPI-based REER.

[2] Based on the 0.36 model elasticity, the REER gap obtained from the staff-assessed CA gap is assessed to be in the range of -3.4 to 2.1 percent, with a midpoint at -0.7 percent.</td></tr>
</table>

Annex V. The National Recovery and Resilience Plan (NRRP)

1. The Next Generation EU (NGEU) package of 9 percent of 2020 GDP—of which 7 percent of GDP is for the NRRP—provides a unique opportunity to transform the economy.[1] Portugal is receiving €13.9bn (7 percent of 2020 GDP) in grants. Another €14.2 bn (7 percent of 2020 GDP) is available in loans, although the government plans on utilizing only (1½ percent of GDP) of the latter during 2021–26. The government has set up three key pillars in its NRRP: (i) Economic Resilience (€11.13 bn); (ii) Climate Transition (€3.06 bn), and (iii) Digital transition (€2.46 bn). The three major areas are themselves divided into twenty components. The authorities have set up a well-designed portal to report its execution of these milestones (Resiliência - Recuperar Portugal).

2. The NRRP identifies reforms that could address many long-standing gaps in the Portuguese economy. To address longstanding labor market issues, the plan envisages reforms to improve vocational education and training, strengthen cooperation between higher education and companies, remove restrictions in highly regulated sectors and reduce gender inequality. The NRRP aims at raising exports to 53 percent of GDP and R&D investment to 3 percent of GDP by 2030. It envisages sizable green investment for energy efficiency of residential and administrative buildings and increasing the share of renewable sources of energy. Investments are also planned for affordable social housing and student accommodation, to support integration of disadvantaged communities and more inclusive growth. Beyond the resolute implementation of structural reforms, strong governance and spending accountability will be key.

3. If implemented in an efficient and in a timely manner, these underlying investments and reforms are likely to deliver a sizeable temporary growth boost and contribute to reduce scarring. Assuming frontloaded deployment of NGEU funds over 2021–26 and a public investment multiplier of 0.8 and 0.4 respectively in the first two years and a public consumption multiplier of 0.3 and 0.1, respectively, staff estimates the GDP impact at 2 percent by 2025, which would close almost 40 percent of the gap between the projected 2026 GDP relative to its pre-pandemic projected level. The authorities' estimates are more optimistic projecting to raise real GDP level by 3.5 percent by 2025.

4. Potential growth may also be boosted depending on the quality of the projects and speed of absorption of the funds. However, structural bottlenecks (ageing, low share of skilled labor and typically low investment absorption capacity, and risks to productivity), coupled with global supply-side bottlenecks public investment and reforms may result in a longer lag before potential growth bears fruit. On the upside, an efficient absorption of EU funds in public investment complemented with well-sequenced structural reforms could additionally boost potential growth.

[1] The remaining 2 percent funds the reforms under REACT-EU.

Next Generation EU Grants, 2021–26

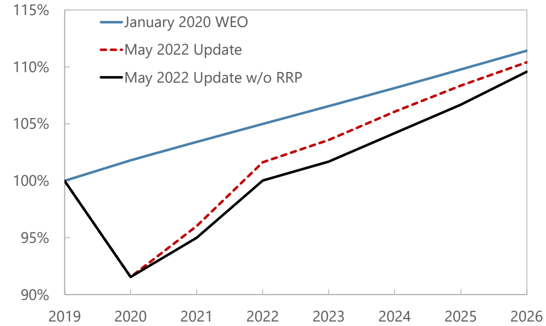
(Millions of current euros)

	2021	2022	2023	2024	2025	2026
Total new spending	2940	3088	3460	3065	2499	1091
Consumption	1544	577	720	643	569	100
RRF 1/	225	577	720	643	569	100
REACT	856	556	0			
Investment	1396	2511	2740	2422	1930	991
RRF 1/	884	2262	2740	2422	1930	991
REACT	188	122				
Other 2/	105	256	119			

Source: Portuguese Authorities and IMF staff estimates.
1/ Based on the timeframe of the Recovery and Resilience Plan.
2/ Just Transition, European Agricultural Fund for Rural Development

Real Output Loss

(2019=100)



Sources: Portuguese Authorities and IMF staff estimates.

Recovery and Resilience Plan: Investments Areas and Reforms to be Financed by Grants

mil EUR

Resilience 11125 bn (67 percent)	**National Health Service**	**1383**
	Primary health care reform	
	Mental health reform	
	Completion of the reform of the governance model for public hospitals	
	Housing	**2733**
	National Plan for Urgent and Temporary Accommodation	
	Social responses (services)	**833**
	Reform of the Provision of Equipment and Social Responses	
	National Strategy for the Inclusion of People with Disabilities 2021-2025	
	Contracting of Integrated Community Support Programs Disadvantaged Areas in Metropolitan Areas	
	National Strategy to Combat Poverty	
	Culture	**243**
	Capitalization and innovation of firms	**2914**
	Promotion of R & D & D and innovative investment in companies	
	Creation and development of Banco Português de Fomento	
	Expansion and Consolidation of the Network of Interface Institutions	
	Research and innovation agenda for the sustainability of agriculture, food and agribusiness	
	Development of the capital market and promotion of capitalization of non-financial companies	
	Qualifications and skills	**1324**
	Reform of vocational education and training	
	Reform of cooperation between Higher Education and Public Administration and companies	
	Reduction of restrictions in highly regulated professions	
	Decent Work Promotion Agenda	
	Combating inequality between women and men	
	Infrastructure	**690**
	Forestry	**615**
	Landscape Transformation of Vulnerable Forest Territories	
	Reorganization of the rustic property registration system and the Occupation Monitoring System	
	Prevention and Combat of Rural Fires	
	Water management (utilities)	**390**
	Integrated and Circular Management of Water Resources in Situations of Scarcity	
Climate Transition 3059bn (18 percent)	**Maritime infrastructure**	**252**
	Reform of the Blue Economy Support Infrastructure Ecosystem	
	Decarbonization of industry	**715**
	Decarbonisation of the industry	
	Sustainable bioeconomy	**145**
	Sustainable bioeconomy	
	Energy efficiency of buildings	**610**
	Long-Term Strategy for Renovation of Buildings	
	Resource Efficiency Program in Public Administration 2030 (ECO.AP 2030)	
	Long-term National Strategy to Combat Energy Poverty	
	Hydrogen and renewables	**370**
	National Hydrogen Strategy (EN-H2)	
	Sustainable mobility	**967**
	Transport Ecosystem Reform	
Digital Transition 2460bn (15 percent)	**Enterprises 4.0 (digitalization of firms)**	**650**
	Digital transition of the business fabric	
	Quality of public finances	**406**
	Modernization and Simplification of Public Financial Management	
	Economic justice and business environment	**267**
	Economic justice and business environment	
	More efficient public administration	**578**
	Digital public services, simple, inclusive and safe for citizens and for companies	
	Functional and organic reform of Public Administration	
	Public Administration trained to Create Public Value	
	Digital schooling	**559**
	Reform for digital education	

Annex VI. Risk Assessment Matrix[1]

Sources of Risk (Likelihood)	Impact if Realized	Policy Responses
Global Risks		
Russia's invasion of Ukraine leads to escalation of sanctions and other disruptions. (High) Sanctions on Russia are broadened to include oil, gas, and food sectors. Russia is disconnected almost completely from the global financial system and large parts of the trading system. This, combined with Russian countersanctions and secondary sanctions on countries and companies that continue business with Russia, leads to even higher commodity prices, refugee migration, tighter financial conditions, and other adverse spillovers, which particularly affect LICs and commodity-importing EMs.	**High:** Extended supply-side disruptions, higher commodity prices and tighter financial conditions will hurt the recovery and impact private and public balance sheets. Inflow of refugees could induce social tensions.	• Reduce scarring effects through additional but temporary and targeted support to viable firms under pressure, particularly if production activity is forced to slow or stop (e.g., through short-term work schemes). • Protect the most vulnerable households through additional targeted measures. • Broaden the scope of ALMPs to facilitate employment of refugees in sectors facing labor shortages,
Outbreaks of lethal and highly contagious Covid-19 variants. (Medium) Rapidly increasing hospitalizations and deaths due to low vaccine protection or vaccine-resistant variants force more social distancing and/or new lockdowns. This results in extended supply chain disruptions and a reassessment of growth prospects, triggering capital outflows, financial tightening, currency depreciations, and debt distress in some EMDEs.	**Medium:** Given high vaccination rates, and typically targeted restrictions in activity during resurging waves, the negative impact on activity is limited. However, demand in contact-intensive sectors remains low for longer. Slow recovery in the tourism sector results in larger scarring with disproportionate impact on low-skilled and young workers. Supply chain disruptions could also slow down recovery in manufacturing and construction activity.	• Scale up public health measures. • Reintroduce some targeted and time-bound support to contain the effects of the pandemic on viable firms and workers (e.g., short-term work schemes
Rising and volatile food and energy prices. (High) Commodity prices are volatile and trend up amid supply constraints, war in Ukraine, export restrictions, and currency depreciations. This leads to short-run disruptions in the green transition, bouts of price and real sector volatility, food insecurity, social unrest, and acute food and energy crises (especially in EMDEs with lack of fiscal space).	**High:** Higher input cost for production, and higher energy costs for households will dampen output from both, supply, and demand side channels.	• Consider increasing targeted support to the most vulnerable households. • Promote a faster transition to higher shares of renewable energy while supporting energy efficiency.
De-anchoring of inflation expectations in the U.S. (Medium) and/or advanced European economies. (Medium-Low). Worsening supply-demand imbalances, higher commodity prices (in part due to war in Ukraine), and higher nominal wage growth lead to persistently higher inflation and/or inflation expectations, prompting central banks to tighten policies faster than anticipated. The resulting sharp tightening of global financial conditions and spiking risk premia lead to lower global demand, currency depreciations, asset market selloffs, bankruptcies, sovereign defaults, and contagion across EMDEs.	**Medium:** Repricing of risk assets may widen sovereign spreads further and increasing sovereign refinancing costs, amplify credit-related financial strains on households and firms, weaken banks' balance sheets and reduce credit supply, thereby exacerbating liquidity and solvency risks in the corporate sector.	• A coordinated monetary policy response will be needed at the euro area level. • Focus supervision on credit origination and refinancing. Protect existing capital by restricting dividends and bonuses where needed to strengthen bank balance sheets

[1] As of April 2022. The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Sources of Risk (Likelihood)	Impact if Realized	Policy Responses
Global Risks		
Natural disasters related to climate change (**Medium**). Higher frequency of natural disasters cause severe economic damage to smaller vulnerable economies and accelerate emigration. Severe events in large economies hitting key infrastructure reduce global GDP, cause further supply chain disruptions and inflationary pressures, and prompt a recalculation of risk and growth prospects.	Medium: Slower recovery and lower medium-term growth.	• Support affected sectors and rebuild damaged infrastructure.
Domestic Risks		
A sharp tightening of financial conditions combined with an unexpected house price correction (Low) deepen macro-financial strains and affect financial stability	**Medium/High.** Sharply higher interest rates will weaken private and public sector balance sheets, amplified by falling equity/collateral values of houses and sovereign-bank-corporate linkages. Sharp reversal in house prices would deteriorate banks' credit quality, given sizeable exposure to housing mortgages. The negative wealth effect and weaker consumer confidence would weigh on consumption. The improving risk profile of borrowers and longer-term maturity of public debt are risk-mitigating factors	• Announce credible plans to strengthen bank capital buffers to build bank resilience while reducing risks from a sudden decline in financial intermediation • Continue close monitoring of financial conditions and recalibrate macro-prudential policy as needed
Lower absorption of NGEU funds (Medium). Slow implementation of the NGEU investment and reform agenda	Medium: Reforms setback could slow growth and affect disbursement of funds from NGEU.	• Strengthen administrative capacity facilitating implementation of projects.

Annex VII. Public Debt Sustainability Analysis (DSA)

The economic contraction due to Covid-19 and the fiscal response led to a sizable increase in Portugal's public debt from an already high level, thereby increasing debt sustainability risks. Nevertheless, under the baseline, the debt-to-GDP ratio is projected to resume its downward trajectory and decline to 97 percent of GDP by 2027, benefiting from sustained strong growth, still-low interest rates, and primary fiscal surpluses. The materialization of a growth shock or combined shock to public finances and growth could, however, add close to 20 pp of GDP to public debt over the medium term. Contingent liabilities, emanating from Covid-19 state-backed credit guarantees, could also impact debt. An interest rate shock would not lead to significant deviations of the debt during the forecasting horizon due to improved debt maturity profile. Stronger consolidation plans should be put in place to reduce the high public debt while creating space for much-needed investment and addressing longer-term ageing and health spending pressures.

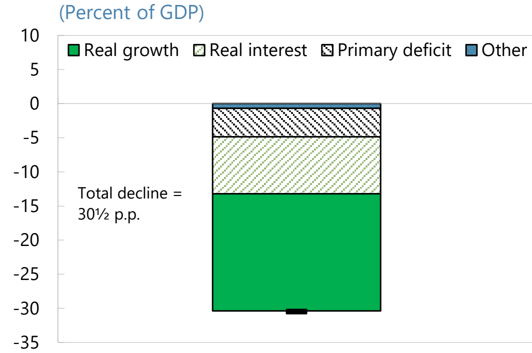
A. Background

1. Prior to the pandemic, Portugal's public debt, while high, was on a declining trend. The debt-to-GDP ratio declined from its pre-pandemic peak of 132.9 percent in 2014 to 116.6 percent at the end of 2019, although it was still well above the pre-GFC level of 75 percent of GDP. Fiscal consolidation was a cornerstone of Portugal debt reduction, with structural primary surpluses averaging 3¾ percent of GDP during 2014–19. With sustained market access and low yields, Portugal extended the maturity profile of outstanding marketable debt from 5 to 7 years over 2014–19. The benchmark bond yield (10-year) declined from about 5½ percent in early 2014 to 0.4 percent at the end of 2019. As a result, the interest bill declined from 5 to 3 percent of GDP over the same period. Based on staff's pre-pandemic baseline projections, the debt level was projected to decline to about 100 percent of GDP by 2024.

B. Baseline Scenario

2. Portugal's debt is projected to decline by an average of about 5 percent of GDP during 2022–27 a year, driven by the economic recovery and a gradual return to primary surpluses. The sharp recession and fiscal response in 2020 caused the debt-to-GDP ratio to rise by 18.6 pp to 135.2 percent of GDP in 2020. Nonetheless, the debt-to-GDP ratio declined to 127.4 percent in 2021 driven by real GDP growth of 4.9 percent. As well, 2021 primary deficit narrowed to 0.5 percent of GDP from 3.1 percent of GDP in 2020 and is expected to return to a surplus of about 1.0 percent of GDP by 2023. GDP is projected to grow by 5.8 percent 2022 and average 2 percent during 2023–2027.

Projected Change in Debt, 2022–2027
(Percent of GDP)



Source: IMF staff estimates.

3. Baseline projections: The debt-to-GDP ratio is projected to decrease by 30.4 pp over the six-year forecast period—with 25.5 pp accounted by interest-growth dynamics, and primary deficit contributing 4.2 pp to increase in debt over the forecast horizon. The real interest rate is projected to reduce the public debt ratio by 5.1 pp in 2022 and by a further 3.3 pp over 2023–27. Specifically,

- **GDP growth.** Under the baseline, medium-term growth is expected to converge to below 2 percent, helped by investments and reforms under the NRRP (see Annex V). However, medium-term TFP growth could weaken materially in the event of materialization of the risks from corporate vulnerabilities, zombification, or further amplification of these risks from war-related shocks.

- **Fiscal deficit.** Staff projects the primary fiscal balance to improve from -0.5 percent of GDP in 2021 to 1.0 percent of GDP in 2023 and stay at an average of around 0.8 percent of GDP in 2024–27. The improvement in the primary balance over the near term is underpinned by: (i) the expiration of exceptional Covid-19 stimulus measures, such as job retention schemes and turnover loss compensation programs, and (ii) the winding down of support via automatic stabilizers with the output gap narrowing from about 2.5 percent of potential GDP in 2021 to 0.1 percent by 2024. The baseline scenario is based on the current policy framework (draft 2022 Budget, 2022 Stability Program, and NRRP), and no additional consolidation effort is assumed during the forecasting horizon in the baseline. The structural primary balance is assumed to deteriorate (¾ of a percentage point) over the forecast horizon from 1.6 percent of potential GDP in 2021 to about 0.9 percent in 2027 driven by the rise of demographic ageing-related social spending.

- **Interest rates and gross financing needs.** Under the baseline, the gross financing needs of the government would decline from a recent peak of 16.5 percent of GDP in 2020 to 11.5 percent in 2027. Long-term interest rates on Portuguese sovereign bonds and spreads to German bunds are projected to gradually increase over the projection horizon from current levels. Specifically, the Portuguese 10-year yield is assumed to rise from the average of 0.3 percent in 2021 to an average of 2.2 percent in 2022 and further to 3.5 percent in 2027. The effective interest rate is projected to decline from 2.3 percent in 2020 to 1.9 percent in 2025, as maturing debt would continue to be refinanced at lower rates, and then gradually pick up to 2.4 percent in 2027

C. Risk Assessment

4. Public debt would remain high despite the downward momentum under the baseline. Over the past decade, Portugal has experienced two deep recessions (real GDP cumulative decline of 6.5 percent during 2011–13 and an 8.4 percent drop in 2020) accompanied by a sharp fall in inflation (which is now being reversed), as well as spikes in borrowing costs in the face of elevated financing needs. Near-term reoccurrences of such shocks would translate into a spike in the debt ratio.[1] In addition, a high share of public debt[2] held by non-residents generates vulnerabilities from foreign risk appetite and financial conditions but does not bear foreign exchange rate risk. While still-low interest rates and the extended maturity profile offer comfort, risk perceptions may change abruptly. Risks related to the sharp increase in contingent liabilities, such as calling of state guarantees on bank lending extended during the pandemic or capital support needs stemming from larger-than-expected impacts of the end of moratoria on firms and banks, could translate into fiscal costs through higher primary deficit and drag on growth.

5. Mitigating factors. While risks from elevated debt and its external financing profile under the baseline are deemed to be high, important mitigating factors include: (i) the ECB's accommodative monetary stance is expected to keep Portugal's funding costs low for some time, even after the ending of the APP and commencement of policy rate hikes; (ii) the financing from the EU; (iii) the negligible share of foreign currency debt; and (iv) comfortable cash buffers, currently about 6 percent of GDP, and the availability of NGEU loans that are not currently envisaged to be utilized would reduce rollover risks during temporary market pressure episodes. A comfortable cash position remains relevant, in anticipation of a lumpy redemption schedule in 2022. Moreover, the composition of debt—with a high average residual maturity of 7.7 years[3] and a considerable share of official debt (19.8 percent)[4]—offer comfort. Lastly, the projected return to primary surpluses together with the extended maturity profile mean that gross financing needs remain below the relevant benchmark of 20 percent of GDP.

6. The authorities' fiscal strategy under the Stability Program 2022–2026 entails a stronger medium-term growth than staff's baseline. The authorities foresee a stronger improvement in the primary balance and real GDP growth in the medium term compared to staff's baseline projection: 2026 primary balance of 2.0 percent of GDP vs. 0.7 percent of GDP, and GDP growth of 2.5 percent vs 1.9 percent, respectively. Staff projection for 2022 nominal GDP growth at 12.2 percent exceeds Stability Program's 7.4 percent (as of April-2022) and hence implies an additional impact of automatic debt dynamics, close to 4½ pp, on the 2022 debt ratio. Nonetheless, debt-to-GDP reach is projected to reach a similar level of close to 100 percent under both the authorities' and staff's baseline scenario.

7. Realism of baseline projections. The median forecast error for real GDP growth during 2012–20 is 0.15 suggesting a downward bias in staff projections for growth. This is associated with median forecast errors of -1.42 percent for the primary balance and 0.19 percent for inflation,

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[1] The severity of the last decade's two deep recessions implies that a historical scenario based on 10-year average values of real GDP growth of 0.5 percent as well as primary balance of -0.1 percent of GDP would entail a smaller decline in debt-to-GDP from 127.4 percent in 2021 to 111.4 percent of GDP in 2026.

[2] At the end of 2020, 43.5 percent of outstanding general government debt securities were held by non-resident investors. Non-euro area holders comprise about 16 percent of total public debt.

[3] Average residual maturity of debt excluding loans from European institutions is 7 years as of March-2022.
[4] Official loans include EFSF and EFSM loans under Economic and Financial Assistance Program, as well as SURE and RRF loans.

respectively. The size of the forecast error for the primary balance is explained by the two economic crises, namely the sovereign debt and the Covid-19 pandemic, in the reference sample.

8. Projected fiscal adjustment. The three–year adjustment of the cyclically-adjusted primary balance (CAPB) put Portugal around the median, with the percentile rank of 57 percent, the projected fiscal adjustment remains feasible as pandemic-related emergency responses are expected to unwind by 2022 and GDP growth is expected to remain strong in 2022.

9. Heat map and fan chart. Risks from the debt level are deemed high, given that Portugal is above the threshold of 85 percent of GDP under the baseline and all stress scenarios. The high share of public and private (mainly banks) debt held by non-residents also results in high external financing requirements. The fan chart analysis with no restriction on the distribution of shocks indicates a 50 percent probability of debt reaching between 87.7 and 107.9 percent of GDP by 2027. When upside risks are constrained, the analysis indicates a 50 percent probability of debt being between 94.3 and 111.6 percent of GDP by 2027.

D. Shocks and Stress Tests

10. Portugal's debt dynamics would worsen significantly under the growth shocks:

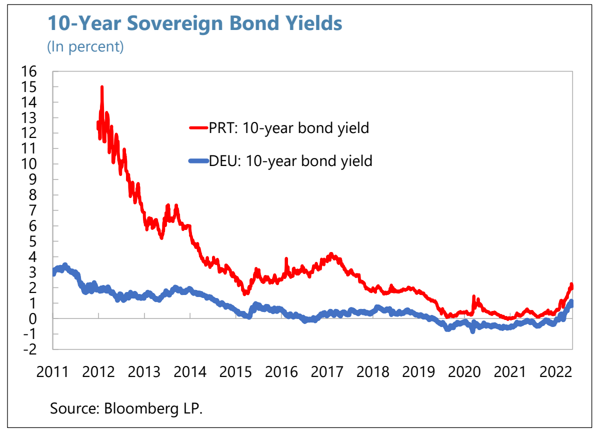
- **Growth shock.** Under this scenario, real output growth rates in 2023–24 are assumed to be lower than in the baseline by one standard deviation (2011–2020: 4.0 pp). The assumed declined in growth leads to lower inflation (0.25 percent per 1 pp decrease in GDP growth) and the interest rate is assumed to increase by 25 basis points for every 1 percent of GDP worsening in the primary balance. Public debt would rise to 124.5 percent of GDP in 2024 and decline towards 114.4 percent of GDP by 2027 under this scenario. Gross financing needs would peak at 17.0 percent of GDP in 2024 before declining to about 13.7 percent of GDP in 2027.

- **Financial contingent liabilities shock.** This scenario assumes ½ percent of GDP in bank recapitalization needs[5] and a 3 percent of GDP in Covid-19 guarantees being called (representing approximately ¾ of the guaranteed credit lines)[6]. The total magnitude of the contingent liability shocks is equal to about 3½ percent of GDP. Real growth is also assumed to be 2 pp (0.5 standard deviation) lower than in the baseline. Under this scenario, debt rises to around 118.6 percent of GDP in 2023, but then declines steadily towards 106.8 percent of GDP in 2027.

[5] Based on MDA shortfall, with the NPLs increase to about 12 pp, doubling from the end 2019 level, to about 2/3 of the peak 17.9 percent in mid-2016 (for underlying methodology, see Aiyar, S, C. Mai, A. Jobst, A. Mineshima, S. Mitra, M. Pradhan, "Covid-19: How Will European Banks Fare?", IMF Departmental Paper No. 2021/008).

[6] The assumption on the share of called loans represents an adverse scenario compared to: (i) authorities estimate of the low fiscal risk from state guarantees to NFCs with expected cumulative multiannual fiscal cost of about 0.2 percent of GDP, and (ii) the share of guaranteed loans classified under IFRS stage 2 and 3 at 18 percent of total guaranteed loans as of end-2021.

- **Interest rate shock** would not lead to significant deviation of the debt path or entail a spike in gross financing needs to above 20 percent threshold during the forecasting horizon. In the stress scenario, the interest rate is increased by 560 basis points, which is the difference between the average effective real interest rate level over the projection period and the maximum historical level of 4.5 percent experienced during the sovereign debt crisis. However, the impact of the shock would be backloaded—the deterioration of public debt and gross financing needs—as old debt matures gradually and new debt is contracted at higher rates. By 2027, the effective interest rate would rise from 1.9 percent in the baseline to 3.9 percent, still below the peak of 4.2 percent reached in 2012 owing to much lower gross financing needs (average of 26 percent during 2012–14 vs. average of about 13 percent during 2025–27). The gross financing needs to GDP ratio, despite the rise by 3 pp from 2023, would remain below the 20 percent of GDP threshold.



- **The combined macro-fiscal shock** would result in debt peaking at 125 percent of GDP in 2024 and declining to 119.3 percent of GDP by 2027. GFNs would peak at 17.6 percent of GDP. The combined macro-fiscal shock also incorporates the interest rate shock as calibrated above, allowing for a feedback loop between higher interest rates and increased financing need. The effective interest rate would rise to 4.2 percent by 2027, which is 0.3 p.p. higher than under the interest rate shock on account of higher gross financing needs. Such a scenario would significantly raise concerns over debt sustainability. The main driver of the macro-fiscal component of this scenario is the growth shock, described above.

- **The other standardized macro shocks.** The primary balance shock and the real exchange rate shock would not lead to significant deviations from the baseline debt path over the forecast horizon.

Box 1. Portugal: Sovereign Risk and Debt Sustainability Analysis[1]

The Box presents an assessment of the sovereign risk using the tools of the new Sovereign Risk and Debt Sustainability Framework for Market Access Countries under a preliminary calibration:

Portugal: SRDSF Tools Assessment

	Mechanical Signal	Final Assessment
Medium-term risk assessment		
Medium-term index	Moderate	Moderate
Debt fan chart	Moderate	Moderate
GFN financeability module	Moderate	Moderate

Source: IMF staff estimates.

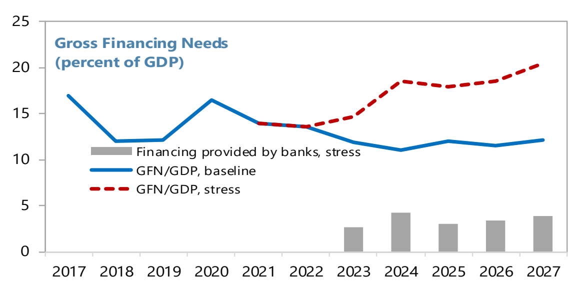
Medium-term risks (up to 5-years ahead) are assessed as moderate. This reflects the results from: (i) the financing risk module to analyze rollover risks, considering creditor composition, and (i) a debt fan chart to probabilistically assess prospects for debt stabilization.

The analysis suggests that Portugal's financing risks are moderate. Gross financing needs under the baseline are moderate (averaging 12 percent of GDP over the 2022–27 period), while initial bank claims on government are low (around 9.6 percent of banking sector assets). The large size of the banking sector relative to the economy (assets at 210 percent of GDP) and the negligible share of foreign currency debt are key risk mitigating factors, along with the composition of holders (the Eurosystem[2] at 29½ percent and foreign official creditors at 20.5 percent).[3] The domestic banking sector may have to provide an additional 3 percent of bank assets to provide residual absorption of sovereign debt in case of a stress scenario, which appears manageable. This analysis currently assumes that the Eurosystem's holdings of sovereign debt, which have risen in recent years to 29½ percent of total debt, act as shock absorbers. However, as ECB support normalizes over time and financing becomes more market reliant, the impact of these mitigating factors will weaken over time. That said, overall risks may be relatively stable given the strengths discussed above.

Figure 1. Portugal: Gross Financing Needs Module

Signal from the GFN module

Indicator	Weight	Value
Average GFN/GDP, baseline projections	0.35	12.0
Initial bank claims on government/asset	0.32	9.6
Change in bank claims on govt in stress	0.33	3.1
Total index		8.3
Signal		**Moderate risk**



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[1] See Review of The Debt Sustainability Framework for Market Access Countries, IMF Policy Paper 2021/003.

[2] The Eurosystem comprises the ECB and the national central banks of those countries that have adopted the euro.

[3] Official loans include EFSF and EFSM loans under Economic and Financial Assistance Program, as well as SURE and RRF loans.

Box 1. Portugal: Sovereign Risk and Debt Sustainability Analysis (concluded)

The fan chart module assesses Portugal at moderate risk of medium-term sovereign stress. The main factors contributing to the fan chart risk index are the fan's width (a measure of uncertainty) at 51.1 percent of GDP and the debt level indicator (median debt level interacted with the institutional quality index)—a proxy of debt carrying capacity—projected for 2027 at 123 percent of GDP. Nonetheless, there is a high probability (93 percent) of debt stabilization.

Figure 2. Portugal: Fan Chart Module

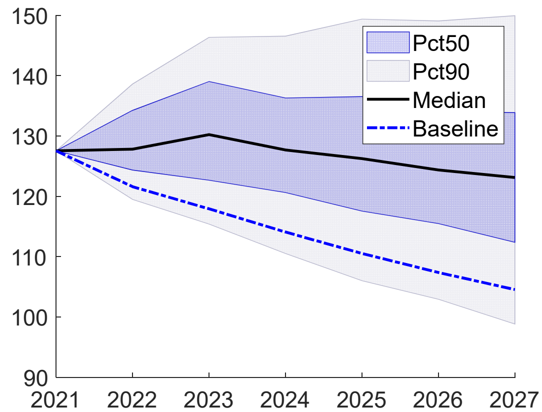


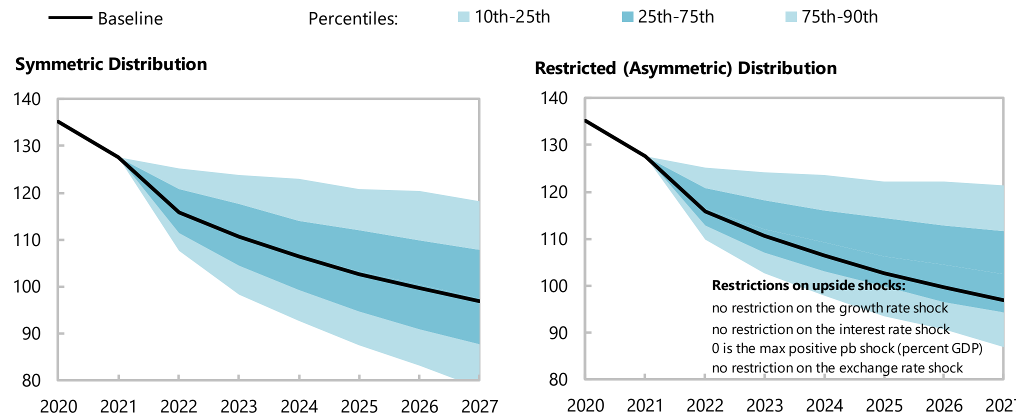
Figure 1. Portugal: Public DSA Risk Assessment

Heat Map

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

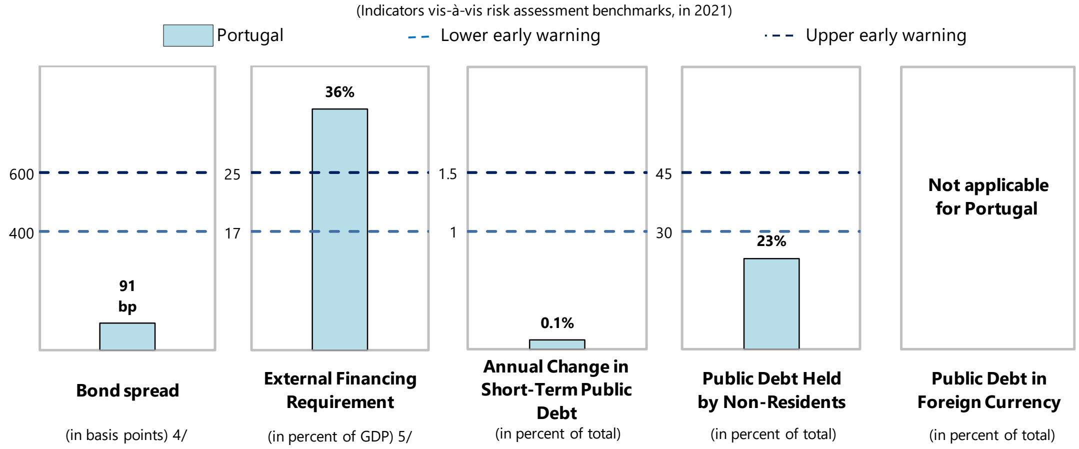
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2021)



Source: IMF staff.

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

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

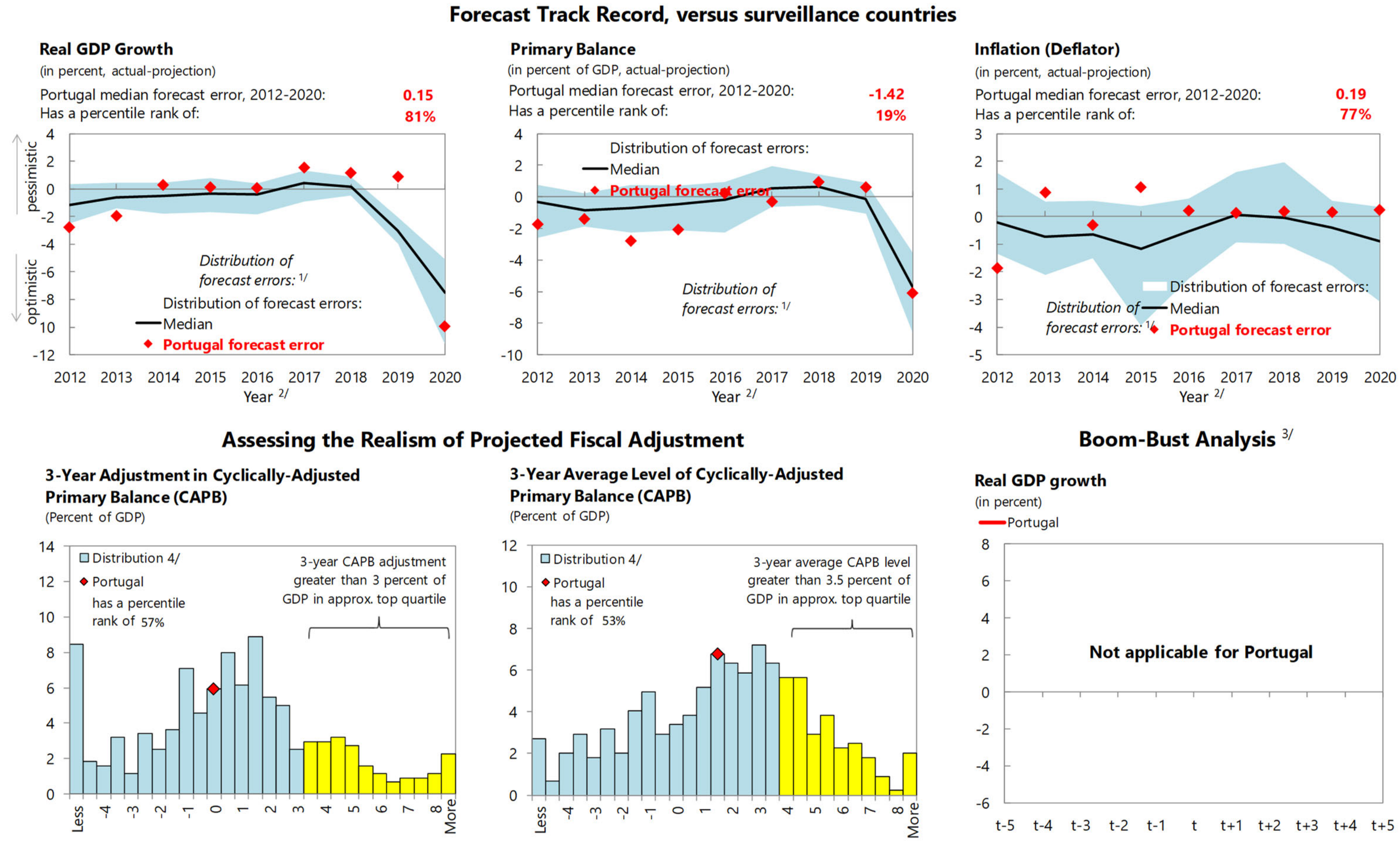
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant,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

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

4/ Long-term bond spread over German bonds, an average over the last 3 months, 09-Feb-22 through 10-May-22.

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

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



Source: IMF Staff.

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

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

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

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

Figure 3. Portugal: Public Sector DSA—Baseline Scenario

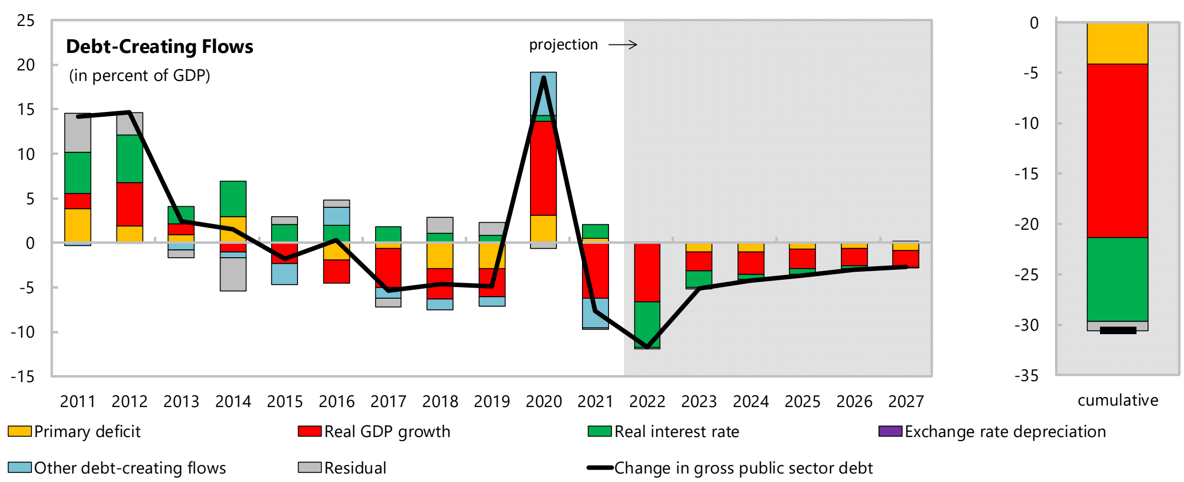
(In percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of May 10, 2022		
	2011-2019 [2/]	2020	2021	2022	2023	2024	2025	2026	2027			
Nominal gross public debt	126.1	135.2	127.5	115.8	110.7	106.4	102.7	99.7	97.0	Sovereign Spreads		
Of which: guarantees	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	EMBIG (bp) 3/		109
Public gross financing needs	21.5	16.5	13.9	12.8	10.7	10.3	11.4	11.1	11.5	5Y CDS (bp)		53
Net public debt	115.6	123.2	119.5	108.7	103.9	100.0	96.5	93.8	91.3			
Real GDP growth (in percent)	0.8	-8.4	4.9	5.8	1.9	2.4	2.1	1.9	1.9	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	1.2	1.9	0.7	6.1	3.6	2.4	2.5	2.3	2.2	Moody's	Baa2	Baa2
Nominal GDP growth (in percent)	2.0	-6.7	5.6	12.2	5.6	4.9	4.7	4.2	4.1	S&Ps	BBB	BBB
Effective interest rate (in percent) [4/]	3.5	2.3	1.9	1.9	2.0	2.0	1.9	2.0	2.4	Fitch	BBB	BBB

Contribution to Changes in Public Debt

	Actual			Projections							
	2011-2019	2020	2021	2022	2023	2024	2025	2026	2027	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	1.8	18.6	-7.6	-11.7	-5.1	-4.3	-3.7	-3.0	-2.7	-30.6	
Identified debt-creating flows	1.1	19.2	-7.5	-11.6	-5.0	-4.1	-3.6	-2.9	-2.6	-29.7	
Primary deficit	0.1	3.1	0.5	0.1	-1.0	-1.0	-0.7	-0.7	-0.9	-4.2	-1.7
Primary (noninterest) revenue and grants	42.8	43.4	45.2	44.2	44.0	43.6	43.2	42.6	42.4	260.0	
Primary (noninterest) expenditure	43.0	46.4	45.7	44.4	43.0	42.6	42.5	41.9	41.5	255.9	
Automatic debt dynamics [5/]	1.6	11.2	-4.7	-11.7	-4.0	-3.1	-2.8	-2.2	-1.7	-25.5	
Interest rate/growth differential [6/]	1.6	11.2	-4.7	-11.7	-4.0	-3.1	-2.8	-2.2	-1.7	-25.5	
Of which: real interest rate	2.6	0.7	1.5	-5.1	-1.8	-0.6	-0.7	-0.3	0.2	-8.3	
Of which: real GDP growth	-1.0	10.5	-6.3	-6.6	-2.1	-2.5	-2.2	-1.9	-1.8	-17.1	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.6	4.9	-3.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Increase in deposits and other	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Net Assets in Net Debt Calculation	-0.3	4.9	-3.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.7	-0.6	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.9	



Source: IMF staff.

1/ Public sector is defined as general government and includes public guarantees, defined as COVID19 guarantees.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

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

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

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

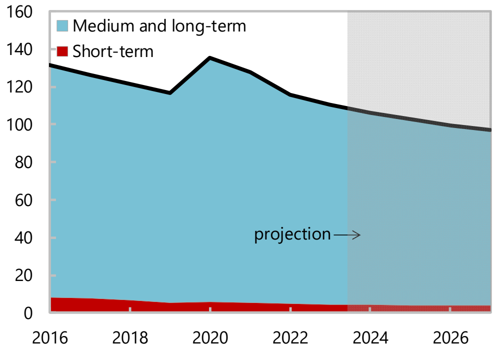
8/ Includes changes in the stock of guarantees, asset changes, and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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

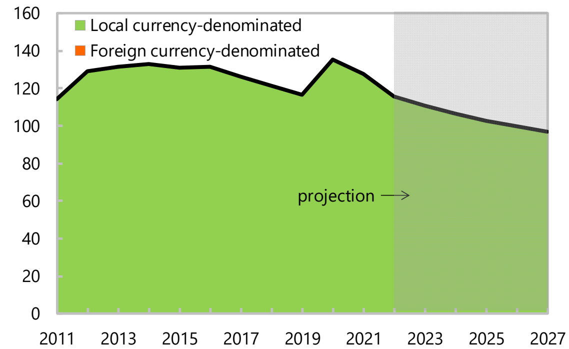
Figure 4. Portugal: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



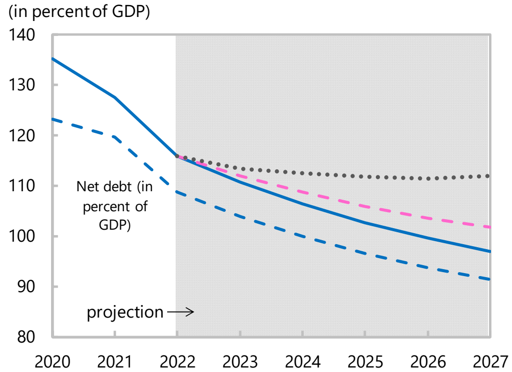
By Currency
(in percent of GDP)



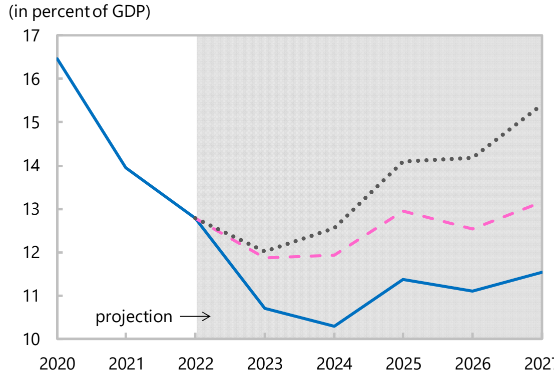
Alternative Scenarios

Baseline   Historical   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

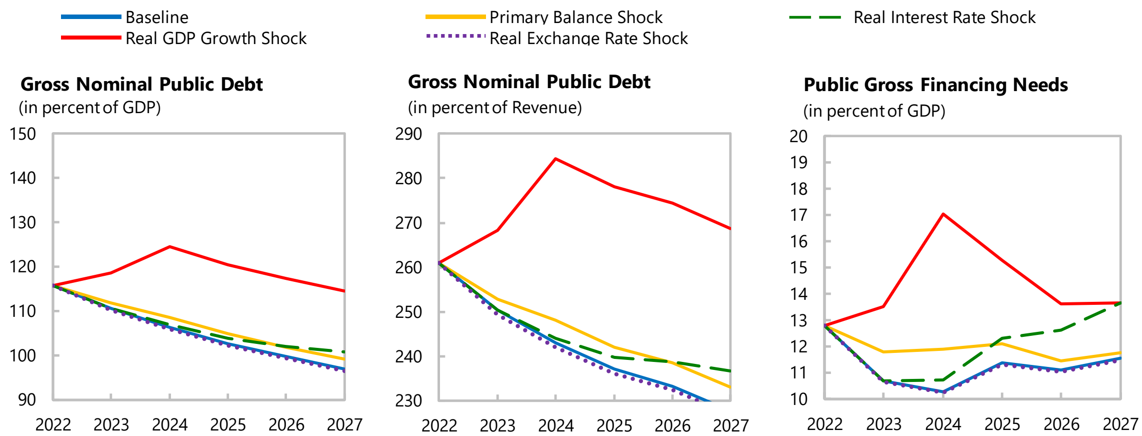
Baseline Scenario	2022	2023	2024	2025	2026	2027
Real GDP growth	5.8	1.9	2.4	2.1	1.9	1.9
Inflation	6.1	3.6	2.4	2.5	2.3	2.2
Primary Balance	-0.1	1.0	1.0	0.7	0.7	0.9
Effective interest rate	1.9	2.0	2.0	1.9	2.0	2.4
Constant Primary Balance Scenario						
Real GDP growth	5.8	1.9	2.4	2.1	1.9	1.9
Inflation	6.1	3.6	2.4	2.5	2.3	2.2
Primary Balance	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Effective interest rate	1.9	2.0	2.0	1.9	2.0	2.4

Historical Scenario	2022	2023	2024	2025	2026	2027
Real GDP growth	5.8	0.5	0.5	0.5	0.5	0.5
Inflation	6.1	3.6	2.4	2.5	2.3	2.2
Primary Balance	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Effective interest rate	1.9	2.0	2.2	2.3	2.6	3.2

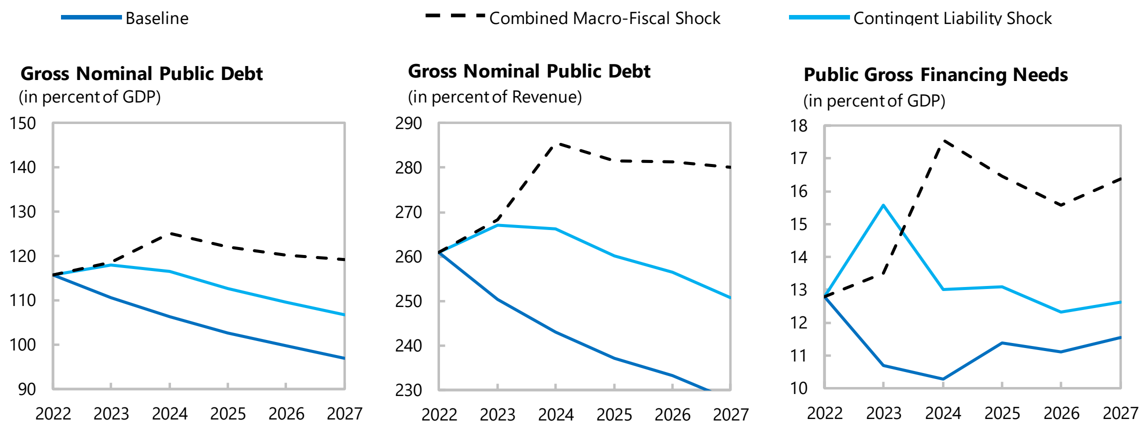
Source: IMF staff.

Figure 5. Portugal: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2022	2023	2024	2025	2026	2027
Real GDP growth	5.8	1.9	2.4	2.1	1.9	1.9
Inflation	6.1	3.6	2.4	2.5	2.3	2.2
Primary balance	-0.1	-0.1	-0.1	0.7	0.7	0.9
Effective interest rate	1.9	2.0	2.0	1.9	2.0	2.4
Real Interest Rate Shock						
Real GDP growth	5.8	1.9	2.4	2.1	1.9	1.9
Inflation	6.1	3.6	2.4	2.5	2.3	2.2
Primary balance	-0.1	1.0	1.0	0.7	0.7	0.9
Effective interest rate	1.9	2.0	2.4	2.6	3.1	3.9
Combined Shock						
Real GDP growth	5.8	-2.1	-1.6	2.1	1.9	1.9
Inflation	6.1	2.6	1.4	2.5	2.3	2.2
Primary balance	-0.1	-1.2	-3.5	0.7	0.7	0.9
Effective interest rate	1.9	2.0	2.5	2.9	3.4	4.2

Real GDP Growth Shock	2022	2023	2024	2025	2026	2027
Real GDP growth	5.8	-2.1	-1.6	2.1	1.9	1.9
Inflation	6.1	2.6	1.4	2.5	2.3	2.2
Primary balance	-0.1	-1.2	-3.5	0.7	0.7	0.9
Effective interest rate	1.9	2.0	2.0	2.1	2.2	2.5
Real Exchange Rate Shock						
Real GDP growth	5.8	1.9	2.4	2.1	1.9	1.9
Inflation	6.1	4.0	2.4	2.5	2.3	2.2
Primary balance	-0.1	1.0	1.0	0.7	0.7	0.9
Effective interest rate	1.9	2.0	2.0	1.9	2.0	2.4
Contingent Liability Shock						
Real GDP growth	5.8	-0.1	0.4	2.1	1.9	1.9
Inflation	6.1	3.1	1.9	2.5	2.3	2.2
Primary balance	-0.1	-3.5	1.0	0.7	0.7	0.9
Effective interest rate	1.9	2.1	2.1	2.0	2.1	2.5

Source: IMF staff.