again in 2004, while profitability remained comfortable, amid an environment of strong competition. A similarly favorable pattern could be observed as regards the insurance sector, where cost-cutting, an improved balance of premiums to risk and the recovery of capital markets allowed for enhanced profitability. As the overall financial system stands solid, and preparations for regulatory changes such as the new IFRS and Basle II are on-track, the authorities look forward to receiving the first FSAP mission by year-end.

Portugal has endured sizeable shocks over the last decades, and yet managed to develop at a pace matched by few other countries in the world. There certainly seems to be no reason to think it will be different this time.

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# IMF Executive Board Concludes 2005 Article IV Consultation with Portugal

On October 14, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Portugal.[1]

**Background**

Portugal has yet to emerge from the downturn that followed the bursting of the euro adoption bubble. A gradual domestic demand-driven recovery started in 2004, but activity weakened during the second half of last year amid ongoing concerns about competitiveness. Preliminary data show year-on-year GDP growth of 0.3 percent in the first half of 2005. Private consumption has proven resilient, reflecting low interest rates and lengthening tenors on bank lending, while investment and export growth remained weak. Meanwhile, the unemployment rate reached a seven-year high of 7.5 percent in the first quarter of 2005, before moderating slightly to 7.2 percent in the second quarter. Due in part to weak demand, inflation fell to just over 2 percent in the first half of 2005. Poor productivity growth has weakened external competitiveness. As a result, export shares shrank and the current account deficit (excluding capital transfers) widened to 7.2 percent of GDP last year.

[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. 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.

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High private indebtedness, especially among households, weak competitiveness, and planned significant fiscal consolidation are expected to constrain growth in the near future. Real GDP is projected to grow by about ½ percent in 2005 and 1¼ percent in 2006.

Extensive use of one-off measures kept the budget deficit within the SGP ceiling of 3 percent of GDP over the last few years. These measures, however, did not address the underlying source of fiscal problems: the steady rise in current expenditure over the last decade. After an independent audit forecasted a deficit of about 6½ percent of GDP this year without one-off measures, the authorities announced their intention to reduce the deficit below 3 percent of GDP without one-off measures by 2008. In July, a series of revenue measures—including an increase in the VAT rate—were introduced, with a view to reducing the 2005 deficit to 6 percent of GDP. Over time, expenditure measures, especially pension and civil service reforms, are expected to constitute the bulk of the adjustment effort. Some key elements of the consolidation effort remain to be defined, however.

Strong growth of bank lending to households, especially for mortgages, led to a continued increase in the private sector credit-to-GDP ratio, which reached about 144 percent by the end of 2004 (well above the EU average). The banking sector has, however, proven resilient to the economic downturn: indicators point to improved capitalization, solid profitability and low levels of Non-Performing Loans.

**Executive Board Assessment**

Executive Directors concurred that in an unfavorable context marked by large fiscal and external imbalances, slow growth, and a weak competitive position, the challenge confronting the Portuguese government is to create the conditions to restart Portugal's per capita income convergence toward the euro area average as soon as possible. Accordingly, Directors underscored the need to pursue sustainable fiscal adjustment and measures to improve product and labor markets, enhance the business environment, and strengthen human capital development. Directors welcomed the authorities' policy outlines in these areas, but called for early action in implementing them to build confidence and credibility.

Directors agreed that short-term growth prospects are not auspicious, owing to weak competitiveness, high private debt ratios, and the need for significant fiscal adjustment to reduce the public sector deficit. Most Directors welcomed the authorities' commitment to proceed with fiscal adjustment despite the weak economic outlook, agreeing that a determined consolidation effort is essential to lay the foundation for a resumption of growth and a reduction of the current account deficit.

Directors therefore commended the authorities' fiscal strategy, which emphasizes medium-term expenditure containment and sets an appropriately ambitious pace of adjustment. Directors noted that steady rises in the public wage bill and in pension spending in recent years have been at the heart of current fiscal difficulties; they thus supported the authorities' intention to focus measures on these items. Directors also supported the decision to largely

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abandon one-off measures, which they agreed have tended to create uncertainty about the true state of the public finances and to complicate future budget execution. They underscored that bringing the deficit below 3 percent of GDP by 2008 would strike an appropriate balance between the need to make rapid progress in reducing the deficit and the focus on longer-term reforms. Directors were encouraged by the authorities' willingness to take additional measures—ideally on the expenditure side—if needed to achieve the deficit targets.

Directors noted, however, that adjustment in 2005 has come primarily from revenue measures. They recognized that this is true in part because a number of key expenditure-side elements of the authorities' program are still being defined, including reforms of the public administration and of the retirement system for private sector workers. They stressed, however, that early definition and implementation of these bedrock spending reforms will be essential to distinguish the current adjustment effort from previous fiscal consolidation efforts, which had failed to produce durable gains. They considered that sufficient progress to allow these reforms to be reflected in the 2006 budget will be critical for the credibility of the consolidation effort.

Directors cautioned that the fiscal adjustment planned for the next four years is but the first stage of a longer process of deficit reduction that should aim at achieving overall budget balance. They noted that the looming rise in pension and health care spending from population aging underscores the need to find durable measures to improve the quality and efficiency of public expenditure. Directors agreed that greater use of Public-Private Partnerships could help raise spending efficiency, but cautioned that care will be needed to ensure that these transactions involve an appropriate transfer of risk to the private sector, that contracts and associated liabilities are recorded transparently (including in budget documents), and that commitments to make payments over time to private partners do not unduly constrain future budget flexibility. Directors supported the government's intention to consider reforms to local government financing arrangements—including possible binding expenditure limits—as these could help reduce medium-term fiscal pressures.

Directors stressed the need to pursue structural reforms that improve labor productivity and enhance competitiveness, and, ultimately, speed income convergence. In this respect, while recognizing that initiatives to promote research and development and information technology spending could play an important role in stimulating growth, they also praised ongoing and planned reforms to the education and training system and to the business environment. Directors stressed the important complementarities among these reforms. They were encouraged by recent measures to reduce the time required to open a new business, while noting that reducing delays in the legal system and accelerating the process of granting licenses and permits should remain a high priority. Directors stressed the need to enhance competition in key sectors like telecommunications and transportation, where relatively high costs undermine competitiveness.

Directors called on the authorities to pursue additional steps to raise labor market flexibility and improve the responsiveness of wages to productivity and skill differentials. They observed that restrictions on collective dismissals exceed the EU average, and those on individual dismissals are the tightest in the OECD. While recognizing that these restrictions are less binding in

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practice because of extensive use of temporary contracts and self-employment, Directors cautioned that such mechanisms can create a segmented labor market, with strong protection for some workers and considerable job instability for others. They noted that such conditions raise equity concerns and can hamper productivity growth by slowing the movement of protected workers from low-growth sectors to higher-growth ones.

Directors' welcomed the resiliency of the financial sector to the economic slowdown. They noted that banks have remained adequately capitalized and liquid, that profitability has been solid, and that the quality of banks' loan portfolios has remained broadly stable. Directors cautioned, however, about potential vulnerabilities arising from high household and corporate debt and the concentration of loans across sectors and enterprises. They therefore welcomed the authorities' commitment to continue to monitor developments carefully, to intensify oversight of risk management practices, and to undertake a Financial Sector Assessment Program this year.

Directors encouraged the authorities to actively support progress in multilateral trade liberalization under the Doha round, and to increase Portugal's overseas development assistance toward the UN target level of 0.7 percent of gross national income.

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