Statement by the EC, ECB, and IMF on the Seventh Review Mission to Portugal

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Staff teams from the European Commission (EC), European Central Bank (ECB), and International Monetary Fund (IMF) visited Lisbon during February 25-March 14 for the seventh quarterly review of Portugal's economic adjustment program.

Program implementation remains broadly on track, against the background of difficult economic conditions. The end-2012 fiscal deficit target was met, financial sector stability has been safeguarded, and a wide range of structural reforms is progressing. External adjustment continued to exceed expectations. And the government has resumed issuance in the bond market, while domestic financing conditions have eased somewhat. At the same time, weakening export demand, particularly from the euro area, low confidence, and the private sector debt overhang are providing stronger-than-expected headwinds to economic activity. As during previous reviews, policy choices and implementation of the program were re-evaluated in the light of the new circumstances.

Although the recession will be deeper than expected, a recovery is still expected late in the year. Real GDP growth fell sharply in the last quarter of 2012, with overall real GDP in 2012 declining by 3.2 percent. Economic activity is now projected to contract by 2.3 percent in 2013, with the economy returning to growth toward the end of the year, and to expand by 0.6 percent in 2014. Reflecting lower activity, unemployment could peak at over 18 percent.

The weaker growth prospects require an adjustment of the fiscal deficit path.. The fiscal deficit reached 4.9 percent of GDP in 2012. The statistical treatment of specific transactions, such as the airport concession (ANA), will however result in a higher headline deficit. While the government is committed to keeping to a spending path broadly consistent with structural fiscal adjustment as planned earlier, less growth and higher unemployment will reduce revenues and increase social transfers. To allow the operation of automatic fiscal stabilizers, the government requested — and EC-ECB-IMF staff supported — to revise the deficit targets from 4.5 percent to 5.5 percent of GDP in 2013, and from 2.5 percent to 4 percent of GDP in 2014. The 2015 deficit target, at 2.5 percent of GDP, will be below the 3 percent excessive deficit threshold of the Stability and Growth Pact.

The new deficit targets will be underpinned by a permanent, targeted, spending-based consolidation effort. The government is undertaking a thorough and transparent review of public expenditures to identify savings necessary to meet the 2013-2014 deficit targets. These measures aim at rationalizing and modernizing public administration, improving the sustainability of the pension system, and achieving additional cost savings across ministries. To anchor the credibility of the revised fiscal deficit path, the government is committed to adopting and publishing a detailed medium-term fiscal framework in the coming weeks, allowing formal completion of this review. Public sector reforms will continue to strengthen financial management, fight tax evasion, restructure state enterprises, and reduce costs of public-private partnerships.

Financial stability risks are well managed, but tight credit conditions for viable Small and Medium Enterprises (SMEs) remain a concern. The recapitalization of the banking sector has been completed, banks' funding and liquidity conditions have improved further, and the strengthening of banking supervision and resolution frameworks is almost complete. New tools for restructuring corporate and household debts are in place and gaining traction, although the effectiveness of these tools will need to be monitored closely. At the same time, despite improved access to the international debt markets by the government, larger companies, and financial institutions, credit conditions remain difficult, particularly for SMEs, which face high lending rates. Additional measures to ensure adequate funding to viable SMEs include a review of the effectiveness of government-guaranteed credit lines, the development of a commercial paper market for SMEs, and improved information sharing on credit quality through the credit registry.

The implementation of structural reforms to remove bottlenecks to growth and job creation is advancing. The revision of the law to reduce severance pay will promote labor market efficiency and job creation. Cost reductions in ports and cuts in administrative burdens and licensing will reduce companies' operating costs. The strengthened framework law for regulators and service sector reforms in line with EU directives will increase competition in the non-tradable sectors. Preparatory work for a comprehensive reform of the corporate income tax is advancing well. The main objectives are to simplifying the overly complex tax structure, reducing compliance and administrative costs, and gradually lowering the tax rate. Judicial reforms, in particular in the areas of civil procedure and court management, aimed at unclogging the court system, are progressing. However, the desired payoff from structural reforms — sustainable growth and job creation — only materializes over time as reforms are effectively implemented and followed through.

This seventh review confirms that program implementation is progressing, and the process for a full return to markets is underway. Reflecting weaker growth and the new deficit targets, public debt will now peak at 124 percent of GDP and remains sustainable. The authorities are committed to cover the additional financing needs arising from the revised fiscal deficit targets, including from privatization proceeds. Provided the authorities persevere with strict program implementation, euro area member states have declared they stand ready to support Portugal until full market access is regained. Continued strong program implementation and the envisaged adjustment of the maturities of EFSF and EFSM loans to smooth the debt redemption profile will support the government's return to full market financing during 2013. Continued broad political and social consensus remains an important factor for the success of the program.

The government's program is supported by loans from the European Union amounting to €52 billion and a €26 billion Extended Fund Facility with the IMF. The conclusion of this review could take place in May, subject to the approval of ECOFIN and EUROGROUP and of the IMF Executive Board, and will allow the disbursement of €2.0 billion (€1.3 billion by the EU, and about €0.7 billion by the IMF). The joint mission for the next program review is expected to take place in May 2013.