

# Staff statement following the ninth post-programme surveillance mission to Portugal

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Press releases

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Staff from the European Commission, in liaison with staff from the European Central Bank<sup>1</sup>, visited Lisbon from 27 to 30 November 2018 for the ninth post-programme mission to Portugal. The mission was coordinated with an International Monetary Fund post-program monitoring visit. Staff from the European Stability Mechanism participated in the meetings in the context of its Early Warning System.

**The economic expansion continued in 2018, albeit at a more moderate pace than in 2017 mainly on account of a slowdown in exports and investment.** This notwithstanding, employment growth has remained strong and unemployment has fallen to a 16-year low and is now below the euro area average. Economic growth is projected to moderate further over the next two years, reflecting a weaker outlook for Portugal's main trading partners as well as low potential growth, which is held back by structural rigidities in the Portuguese economy. The share of exports in GDP is still expected to continue rising though at a slower pace set by the external environment and moderating growth in tourism. Risks to the medium-term growth outlook are tilted to the downside, reflecting uncertainty related to the global environment. However, there are also some upward risks emanating from potentially stronger-than-expected effects of positive labour market developments and the use of EU structural funds.

**Prudent fiscal policy remains essential to strengthen the sustainability of public finances.** Portugal's still high public debt-to-GDP ratio makes it vulnerable to shocks, particularly in the context of rising global economic risks. Therefore, continued structural fiscal adjustment and the use of windfall gains to further reduce

public debt and build up fiscal buffers become even more important. However, the 2019 draft budget appears at risk of deviating significantly from the structural fiscal adjustment required by the Stability and Growth Pact already if analysed on the basis of its own macroeconomic scenario. This risk is particularly evident in respect to the planned growth of net primary expenditure. This strengthens the case for an increased focus on expenditure containment, in particular via further progress in the ongoing spending review and more efficient expenditure control, including in state-owned enterprises and the health sector, in line with the Country-specific Recommendations by the Council.

**Portuguese banks have continued to clean up their balance sheets but remaining vulnerabilities in the banking sector need to be addressed.**

Profitability has improved, mainly reflecting lower impairments. Capital levels are stable but remain low compared to EU peers. Banks continued to reduce non-performing loans (NPLs), supported by increased investor interest, favourable macroeconomic conditions and rising real estate prices. However, important differences remain in banks' capacity to generate profits, attract more capital and further reduce NPLs. Further improving asset quality remains crucial given that NPLs are a drag on bank profitability and weaken banks' resilience, including by making them more vulnerable to a potential deterioration in funding conditions. A faster reduction in NPLs would be facilitated by further measures to improve the efficiency of the judicial system. Against the backdrop of the strong expansion in the real estate sector and still high private sector indebtedness, it will be important to ensure that banks maintain prudent lending standards.

**Addressing impediments to investment, increasing productivity and further improving the business environment remain key for strengthening potential growth and competitiveness.** In the labour market, continuous efforts to improve education and skills as well as the effectiveness and adequacy of active labour market policies are essential for boosting productivity. The adaptability of the labour market remains important in view of the forecast slowdown in economic growth and heightened risks in the external environment. As regards investments, the declining but still high burden of private and public debt calls for increased efforts to attract foreign direct investment through an improved business environment, reduced administrative burden and resilience-enhancing product and services market reforms. These measures should also help raise potential growth and narrow the income gap towards the euro area average. They would also address

the deterioration in the current account outlook, which poses risks against the backdrop of the only gradually declining and still large stock of net external liabilities.

The mission would like to thank the Portuguese authorities for the fruitful and open discussions.

The next PPS mission is planned to take place in the spring of 2019.

<sup>1</sup> European Central Bank (ECB) Staff participated in this mission and the drafting of this statement, in accordance with the ECB's competences and thus provided expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs.

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