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IMF's Fifth Review of the Portuguese Adjustment Program

SUMMARY

The IMF has issued the fifth review of the Portuguese Economic Adjustment Program. The report concludes that good progress has been made although the program has now entered a more challenging period.

The International Monetary Fund (**IMF**) has issued its fifth review of the Portuguese Economic Adjustment Program on October 15th, which confirms that Portugal has been complying with the Memorandum of Understanding entered into with the IMF, the European Union and the European Central Bank in May 2011 (MoU).

The IMF concluded that progress has been made regarding the reduction of macroeconomics imbalances at a faster-than-expected pace, although the program is now entering in a more challenging phase.

The IMF also reports that all the end-June performance criteria and structural benchmarks were met and that spending was kept under control and well under budgetary appropriation, although the government deficit target was missed due to a large shortfall in tax revenue collections.

According to the IMF, the recession will extend into 2013 as a reflection of the slowdown in the Euro area as well as an effect of further fiscal adjustments to be implemented in Portugal.

On a positive note, the report states that the yields on Portuguese government bonds have fallen to their lowest since the beginning of the program. Also, the on-going deleveraging process of the economy has been praised in the report, allowing the conclusion that bank liquidity remains adequate.

Notwithstanding, social and political resistance to further austerity measures that result from rising unemployment and the reduction of real disposable income puts pressure on the broad-based political and social consensus. The IMF also recognizes that the program remains short on policies that offer any upsides to near-term employment and competitiveness prospects

Regarding future measures to mitigate the risks of falling short on fiscal targets, the IMF is relying on a more conservative macroeconomic assumption, which is considered appropriate as the IMF agrees that the fiscal gap is essentially outside the control of the Portuguese government. Accordingly, the mission proposed adjustments to the deficit targets for 2012 and the two following years (5% of GDP in 2012, 4.5% in 2013 and 2.5% in 2014). As a result, the IMF now forecasts that public debt will peak at a higher level in 2014 (124% of GDP) while the current account deficit will fall below 2% of GDP in 2013.

The IMF acknowledges that the continued tension in the Euro area and in Spain have the potential to contaminate Portugal and advises the government to prepare contingency measures, which means that the IMF believes that there is a risk that Portugal may not meet the new targets.

The fifth review shows that Portugal faces a more difficult challenge to balance its accounts than originally envisaged. The Portuguese government must make serious and long term cuts to public expenditure in a difficult social and political environment while the private sector must brace for the consequences on private consumers of the new income tax increases which will see the middle class disposable incomes fall more than 10%, in some cases edging 20%.

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