

2. ECONOMIC POLICIES

2.1. Monetary policy of the ECB and Monetary and financial conditions of the Portuguese economy

Monetary policy of the ECB

During the first half of 2008, the ECB left its key interest rates unchanged, with the minimum bid rate of main refinancing operations standing at 4 per cent (Table 2.1.1).

In early 2008, the prospects were that inflation would remain significantly above 2 per cent in the following months, and would decrease very gradually over the course of the year, returning to levels compatible with the definition of price stability only in 2009. Despite moderation at the beginning of the year, available information continued to point for a continued growth in GDP at rates close to potential. Additionally, external demand was expected to continue to support euro area exports, assuming world economy would remain resilient, with economic slowdown in the United States compensated by a continued dynamic in emerging market economies. Tight labour market conditions and the possibility of capacity constraints suggested the possibility of stronger than expected wage growth. This fact, together with the possibility of further rises in oil and agricultural prices, as well as increases in administered prices and indirect taxes, represented an upward risk on price stability over the medium term in the euro area. According to the Governing Council of the ECB, these risks were confirmed by continued high money and credit growth. In contrast, risks associated with the outlook for economic activity were on the downside, and were particularly related with the potentially broader than expected impact of the ongoing reappraisal of risks in financial markets on world and euro area economic growth. There were also downward risks associated with new rises in oil and other commodity prices, protectionist pressures and possible abrupt adjustments of the global imbalances.

During the first half of the year, the continuation of the sharp upward trend in world prices of energy and food made it clear that euro area inflation would remain at high levels for a longer than previously anticipated period. Year-on-year inflation, measured by the HICP (Harmonised Index of Consumer Prices), was sharply up over the first half year, to a historical maximum of 4 per cent in June and July. The projected inflation profile for 2008 and 2009 was also gradually revised upward, pointing to inflation rates

Table 2.1.1

INTEREST RATES OF THE EUROPEAN CENTRAL BANK			
Per cent			
Decision date	Deposit facility	Main refinancing operations	Marginal lending facility
6 Jun. 2007	3.00	4.00	5.00
3 Jul. 2008	3.25	4.25	5.25
8 Oct. 2008	3.25	3.75	4.25
6 Nov. 2008	2.75	3.25	3.75
4 Dec. 2008	2.00	2.50	3.00
15 Jan. 2009	1.00	2.00	3.00
5 Mar. 2009	0.50	1.50	2.50
2 Apr. 2009	0.25	1.25	2.25
7 May. 2009	0.25	1.00	1.75

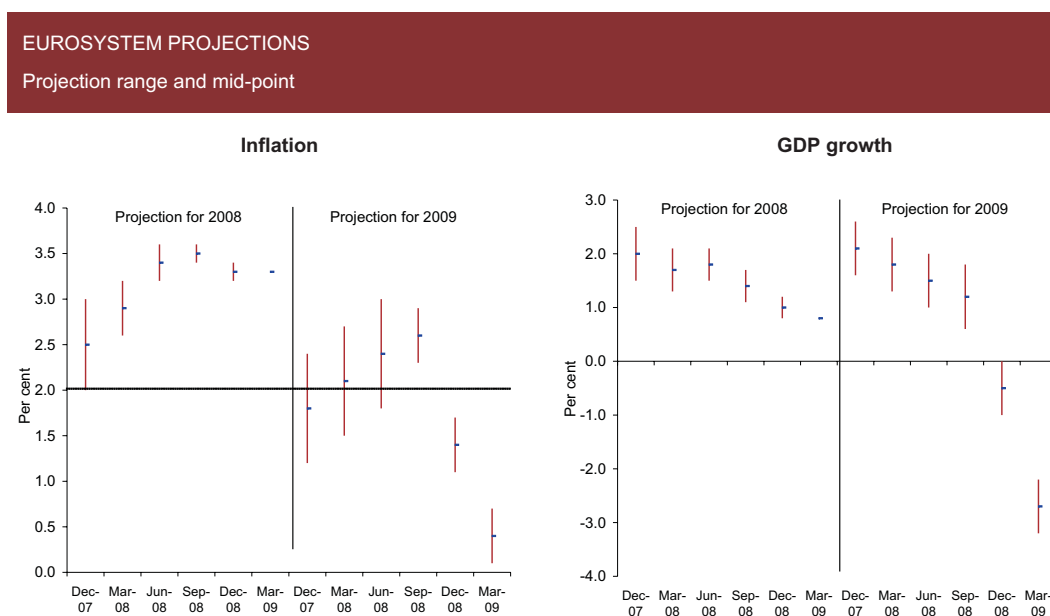
Source: ECB.

above 2 per cent until the end of 2009 (Chart 2.1.1). In this context, the Governing Council of the ECB, at its meeting of July 3, 2008, decided to increase its key interest rates by 25 b.p., with the minimum bid rate of main refinancing operations being at 4.25 per cent, and the interest rates of marginal lending and deposit facilities being at 5.25 and 3.25 per cent, respectively. This decision was justified by the need to prevent broadly based second-round effects on inflation, and to counteract the growing risks to medium term price stability. The Governing Council reaffirmed a strong determination in keeping medium and long term inflation expectations on levels compatible with price stability, and considered that after this decision the monetary policy stance would contribute to pursue the ECB objective. Reference should be made that during the first half of 2008, long term inflation expectations for the euro area derived from financial instruments showed an upward trend, which was not so evident in the inflation expectations reported in surveys (Chart 2.1.2).

The Governing Council of the ECB maintained its assessment over the following months, with key interest rates remaining unchanged until September. Information available during this period showed strong increases in labour costs, which raised concerns over generalised second-round effects. On the other hand, on what concerns economic activity, the expectations were that the weakening observed in the second quarter reflected in part the unwinding of technical factors that contributed to the strong growth seen in the first quarter, and that it would be followed by a gradual recovery in the second half of the year.

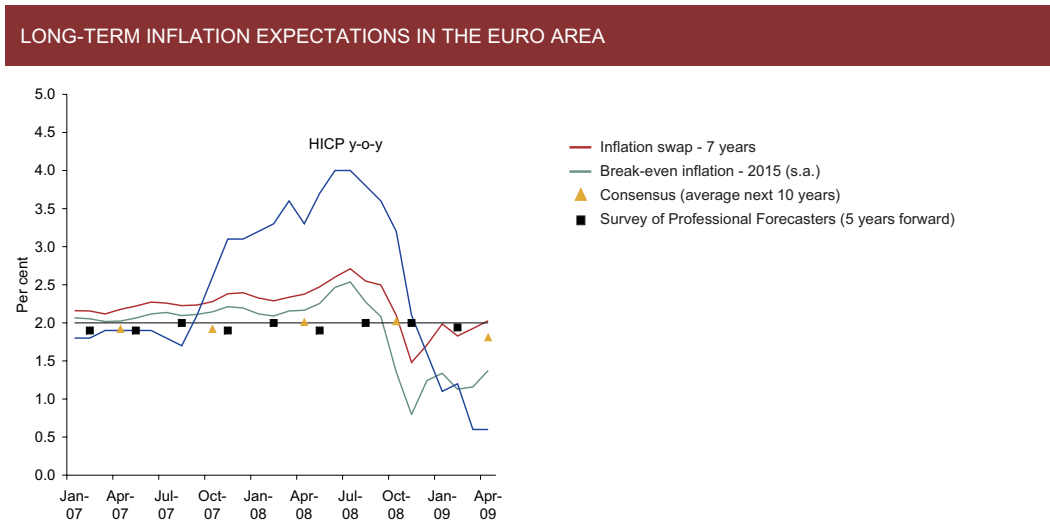
With the worsening and generalisation of the turmoil in the financial markets from mid-September the main downward risks for economic activity, previously identified by the Governing Council, materialised, and the upward risks for price stability decreased. There was a significant deterioration of global economic prospects in the last quarter of the year, as it became evident that the effects of the financial turbulence on the real economy would be more significant and would spill over from the advanced economies to the emerging market economies. The available indicators relating to activity in the euro area indicated further weakening in the second half of 2008, and real GDP projections for 2008 and 2009 were substantially revised downward. In this context, and taking into account the sharp fall in

Chart 2.1.1



Source: ECB.

Chart 2.1.2



Sources: Bloomberg, Consensus Economics, ECB, Thomson Reuters (ICAP) and Banco de Portugal calculations.

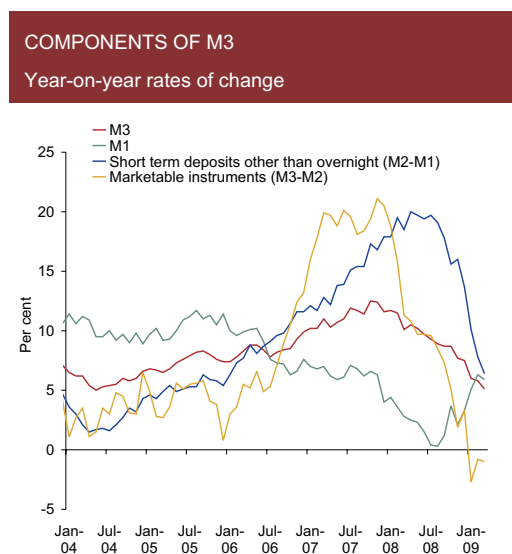
commodity prices since the summer, inflationary pressures diminished and risks to price stability over the relevant horizon for monetary policy became more balanced, according to the Governing Council. Expectations suggested that the year-on-year inflation rate, as measured by the HICP, would continue to fall to a level compatible with price stability in early 2009. Inflation projections for 2008 and 2009 were significantly revised downward in this period. Against this background, the Governing Council of the ECB reduced the rates of the main refinancing operations by a total of 175 b.p. on three occasions, between early October and early December. On October 8, in a joint action with other central banks (Bank of Canada, Bank of England, US Federal Reserve, Central Bank of Sweden and Central Bank of Switzerland), the ECB reduced the official interest rates in 50 b.p. (the interest rate of the main refinancing operations to 3.75 per cent). In the same day the ECB announced a narrowing in the standing facility corridor around the interest rate of the main refinancing operations from 200 to 100 b.p.. On both subsequent meetings (November 6 and December 4), the official interest rates were reduced by a total of 125 b.p..

In 2009, the Governing Council continued to reduce the official interest rates, in a framework of continuing dampening of inflationary pressures and further indications of a significant downturn of global and euro area economic activity. Available information confirmed strong contraction of economic activity in the euro area in the last months of 2008, and an additional weakening during the first quarter of 2009. Real GDP projections for 2009 and 2010 have been substantially revised downward. The Council considered that the risks for economic activity in the euro area were more balanced during this period owing to the possibility of stronger than anticipated positive effects from the economic stimulus measures. Year-on-year inflation measured by the HICP registered a sharp decrease since the summer of 2008, to 0.6 per cent in April of 2009, reflecting mainly a fall in international commodity prices. There have also been signs of a more generalised reduction of inflationary risks, associated with the impact of weakening economic activity on wages and prices. In this context, Eurosystem projections for inflation were revised substantially downward. The Council considers that inflation risks are broadly balanced. In the first five months of 2009, the interest rate of the main refinancing operations was reduced by 150 b.p., placing the accumulated reduction in 325 b.p. since October of 2008. In January, the standing facility corridor was widened to 200 b.p., but decreased again to 150 b.p. in May.

In the meeting of May 7, besides the interest rate reduction, the Governing Council decided to continue to enhance its credit support approach, namely through the performance of longer term refinancing operations with a 12 month maturity, and announced that, in principle, the Eurosystem will acquire euro-denominated covered bonds issued in the euro area.¹ The Governing Council decided also that the European Investment Bank will be an eligible counterparty in the Eurosystem's monetary policy operations and under the same conditions as any other counterparty. The set of measures adopted by the ECB's Governing Council in May had the objective to promote the ongoing decline in the money market term rates, encourage banks to maintain and expand their lending to the economy, improve market liquidity in some important private debt market segments and to ease funding conditions for banks and companies.

In a context of weakening prospects for economic activity and tighter financing conditions there was a moderation of money and credit growth in the course of 2008, which was more marked since September, a tendency prolonged during 2009. The aggregate M3 was down from 11.5 in December of 2007 to 5.1 per cent, year-on-year, in March of 2009 (Chart 2.1.3). The intensification of the financial turmoil, since September, also brought about changes to the portfolio composition of economic agents, leading to changes in components of M3. In particular, the decrease in the M1 contribution to the growth rate of M3, observed since 2006, which reflected the impact of interest rates increase in the opportunity cost for holding money, was reversed from September of 2008, with the year-on-year growth rate of M1 rising to 5.9 per cent in March of 2009 (compared to 0.2 per cent in August of 2008). This increase in liquidity preference was probably associated to the rise in uncertainty regarding the economic prospects, and was also supported by the decrease in the opportunity cost of holding this type of assets. Note that the demand for euro banknotes registered an exceptional increase in October of 2008, surrounded by generalised concerns on the financial health of the banking system in the wake of Lehman Brothers bankruptcy. Following the government support measures to the financial system, namely the increase in deposit guarantees, the demand for euro banknotes normalised in the next months (see "Box 1.3 Government measures to support the financial sector and stabilize the financial markets", of this Report). Regarding the other M3 components there was a decrease in the contribu-

Chart 2.1.3



Source: ECB.

(1) The detailed modalities will be announced after the ECB's Governing Council meeting of June 4, of 2009.

tion of marketable instruments (i.e., M3-M2)² and of short term deposits other than overnight (i.e., M2-M1).³ The year-on-year growth rate of marketable instruments showed a sharp fall from 21 per cent in December of 2007 to 3.3 in December of 2008, becoming negative in 2009 (-1.0 per cent in March). That results mostly from the evolution of debt securities with a maturity of up to 2 years that, since November of 2008, registered very sharp falls year-on-year, as well as from a reduction in the growth rate of money market funds/shares, which reflects investor concerns regarding asset quality in these fund's portfolios. Short term deposits other than overnight while continued to show the greatest contribution for the year-on-year growth rate of M3 in the period under analysis, evidenced a strong deceleration from the third quarter of 2008 onwards to 6.4 per cent in March of 2009.

The credit deceleration for euro area residents reflected the evolution of credit to the private sector, as lending to general government stopped contracting and moved into positive territory in the second half of 2008. Loans continued to be the dominant form of credit to the private sector provided by MFI in the euro area. In early 2008, the annual growth rates of loans to the private sector remained very high, at around 11 per cent in the first quarter, although decreasing during the course of the year and more noticeably from the third quarter, to 3.2 per cent in March of 2009. It should be noted that in this period these rates underestimate the growth of loans to the private sector owing to the practice of derecognition of loans in the balance sheet, due to their sale or securitisation. Indeed, estimates adjusted for loan sales and securitisation point to a year-on-year growth rate of 5.0 per cent of loans to the private sector in March of 2009 (Table 2.1.2)

The deceleration of bank loans was common to all sectors of economy. Household loans continued the tendency of strong deceleration seen in 2007, with the year-on-year growth rate falling to 0.4 per cent in March of 2009 (compared to 6.2 per cent in December of 2007), resulting from credit deceleration both for house purchase and consumption.⁴ The evolution of loans for house purchases reflected a deterioration of housing market conditions and general economic prospects, as well as tighter financing conditions. Bank interest rates on loans to households tended to increase, up to October of 2008, with

Table 2.1.2

EURO AREA – MONETARY AND CREDIT AGGREGATES							
Year-on-year rates of change, seasonally adjusted, per cent, end-of-period							
	2006	2007	2008				2009
			I	II	III	IV	
Monetary aggregates							
M1	7.6	4.0	2.8	1.5	1.2	3.3	5.9
M2	9.4	10.2	9.9	9.7	9.0	8.3	6.2
M3	9.9	11.6	10.1	9.7	8.7	7.5	5.1
Loans							
Loans to the private sector	10.8	11.2	10.9	9.9	8.5	5.8	3.2
Loans to the private sector ^(a)	11.6	12.3	11.8	11.1	9.6	7.5	5.0
Non-financial corporations	13.1	14.5	14.9	13.7	12.1	9.6	6.3
Households ^(b)	8.2	6.2	5.4	4.2	3.8	1.7	0.4
House purchase	9.6	7.1	6.1	4.3	4.0	1.5	0.1
Consumer credit	7.7	5.4	5.4	5.0	4.5	1.7	0.9

Source: ECB.

Notes: (a) Adjusted for sales and securitisation. (b) Includes loans to non-profit organizations.

(2) Includes, for example: repurchase agreements, money market fund shares/units, and debt securities issued with maturities up to 2 years.

(3) Includes, for example: deposits with agreed maturity of up to 2 years and deposits redeemable at notice up to 3-months.

(4) According to information available, loans for house purchase were the most affected by the derecognition of loans in the balance sheets by sale or securitisation.

a reversal at the end of the year in the context of abrupt reductions of official interest rates. In this period as a whole, interest rates for housing loans decreased slightly, and were in February of 2009 about 80 b.p. below the end of 2007 values, while interest rates for loans on consumption registered an increase of about 0.1 p.p. (Chart 2.1.4). At the same time there was an increase in the proportion of banks reporting tighter credit standards to households for housing and consumption. With respect to terms and conditions, the net tightening of credit standards reflects increases in bank margins but also tighter non-price conditions, such as loan-to-value ratios and guarantees. In the case of consumption loans there was a significant increase in the interest rate differentials *vis-à-vis* key market rates, however on loans for house purchase the increase in differentials is only shown in loans with initial interest rate setting maturities up to 1 year (see “Box 1.4 *Financing of the private non-financial sector in the euro area, United States and United Kingdom*”, of this Report). According to the banks, the tightening of credit standards applied to loans to households reflects the deterioration of expectations regarding general economic activity and housing market prospects, in the case of loans for house purchase, but also an increase in the cost of banks’ funds and balance sheet constraints (Chart 2.1.5).

Loans to non-financial corporations, in turn, started to moderate from the second quarter of 2008 onward, with the year-on-year growth rate having fallen to 6.3 per cent in March of 2009, against a peak of 14.9 per cent in the previous year. This evolution occurred in a context in which interest rates on corporate loans were moving upwards until October, followed by a very sharp fall up to the end of the year that continued at the beginning of 2009, greatly associated with the evolution in the official interest rates. Note that between September of 2008 and February of 2009, interest rates on loans to corporations (new business) decreased by 2.4 p.p. over the short term, while short term money market rates decreased 3.1 p.p., with the implicit margins registering a slight increase to levels close to those registered before the financial crisis. During the same period, long term loan rates to corporations registered a decrease in line with the medium term public debt yields, with no significant changes in the spreads. This behaviour of the spreads on loans to non-financial corporations contrasts with the results of the bank lending surveys that revealed, since mid-2007, an increasing trend in the net percentage of banks that applied tighter credit standards to companies, especially through the increase in

Chart 2.1.4

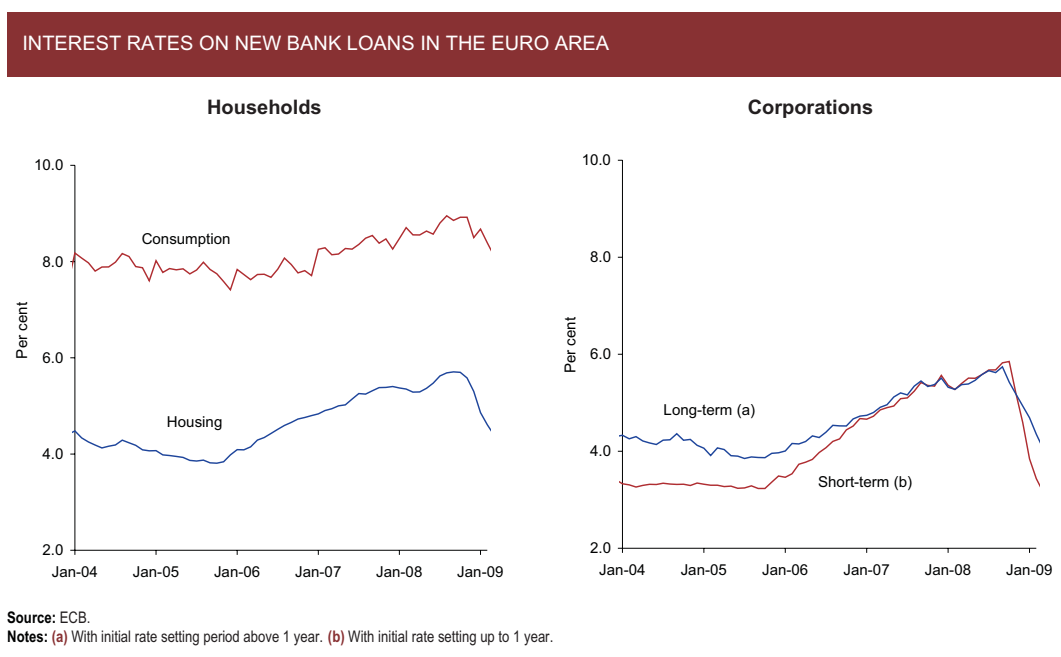
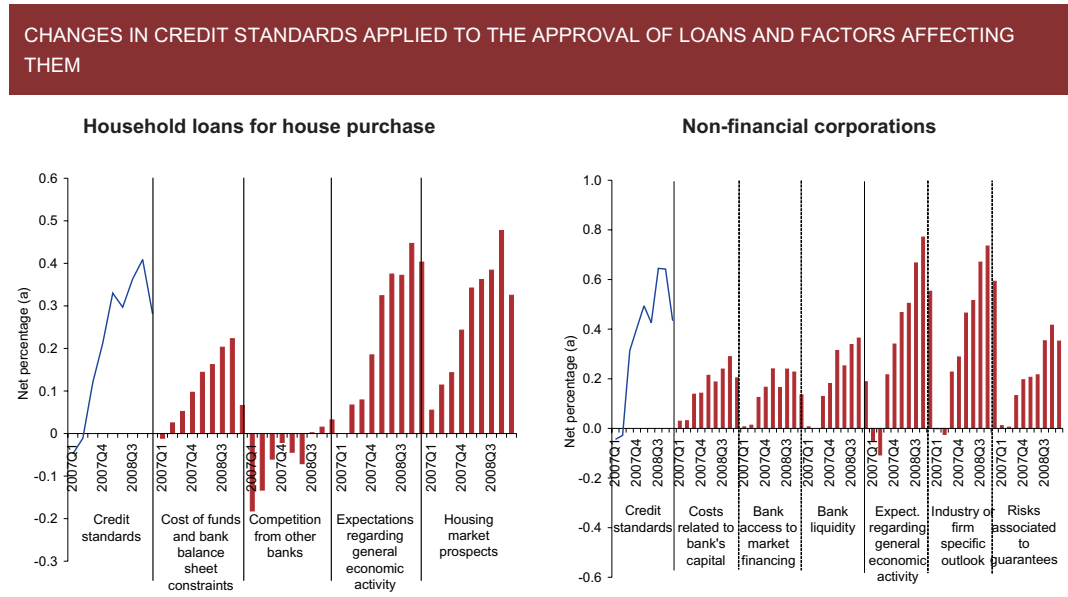


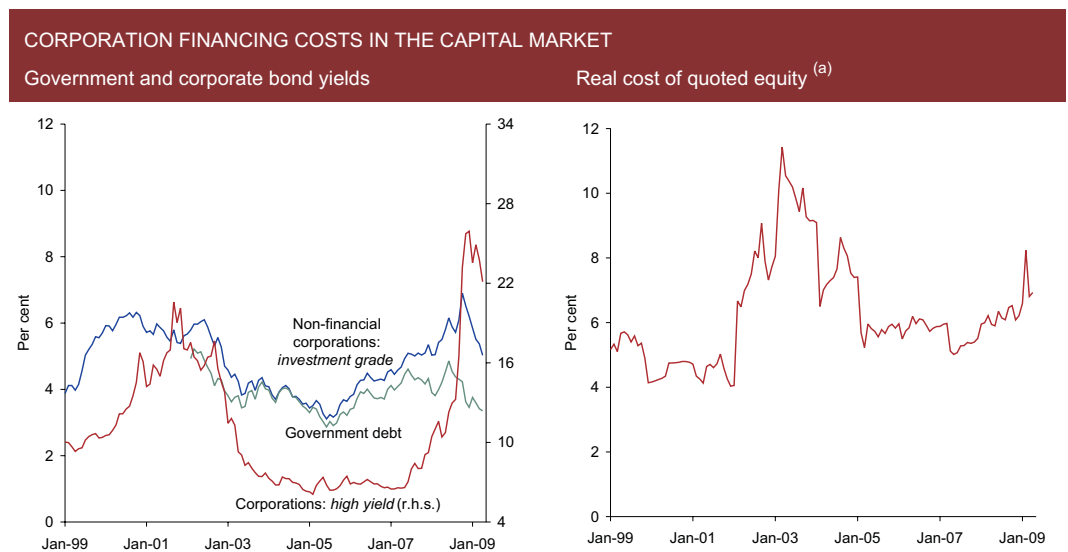
Chart 2.1.5



Source: ECB (Bank Lending Survey).
Note: (a) Net percentages refer to the difference between the sum of the percentage of banks that reply "tightened considerably" and "tightened somewhat" and the sum of the percentage of banks that reply "eased somewhat" and "eased considerably" in the Bank Lending Survey. A positive value represents a tightening of credit standards compared to the previous quarter.

spreads. Banks also report a tightening in the non-price terms and conditions. The tightening of credit standards to companies reflected a deterioration of general economic prospects, but also constraints related to banks' balance sheets. Financing conditions in the private debt securities market, assessed based on the spread of corporate bonds yields versus government bond yields, significantly deteriorated in 2008, and more markedly so in the inferior rating categories. In the beginning of 2009 corporate bond yield spreads decreased somewhat (Chart 2.1.6). The cost of equity financing increased

Chart 2.1.6



Sources: Consensus Economics, ECB, Merrill Lynch, Thomson Reuters and Banco de Portugal calculations.
Note: (a) Estimations for DJ Eurostoxx, using a Three Stage Dividend Discount Model and earnings per share forecasts from the International Brokers Estimate System (IBES), deflated by the average of expected inflation rates from Consensus.

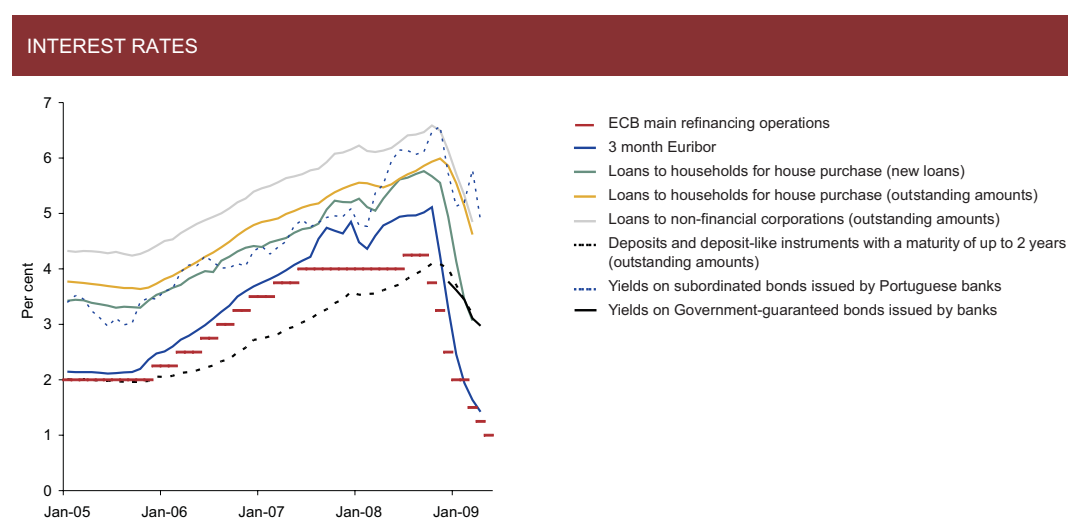
about 2.7 p.p. in real terms between the end of 2007 and February of 2009 and registered some downward correction in the following months to values around 7.0 per cent. In this context, the issuance of quoted shares was almost zero since the second half of 2008. The financing through the issuance of debt securities other than shares registered some recovery starting in the middle of the year, after presenting a decrease during the first half of 2008. In fact, the growth rate for securities issued by non-financial corporations decrease from 8.2 per cent in December of 2007 to 2.6 per cent in July of 2008 and recovered to 7.8 per cent in February of 2009.

Monetary and financial conditions of the Portuguese economy

The crisis erupting in the international financial markets in the summer of 2007 and its crescent interaction with the global economic deceleration imposed significant constraints on the evolution of the monetary and financial conditions of the Portuguese economy during 2008. These constraints have been leveraged by the Portuguese economy's high level of economic and financial integration, intensified since the start of its participation in the euro area. In this context, note that policy responses to face these developments, as defined by authorities at a global level, have allowed a softening in the adverse evolution of monetary and financial conditions of the Portuguese economy.

In the first three quarters of 2008, short term money market interest rates, used as reference for the bank interest rates in Portugal, continued the upward trend began in the last quarter of 2005, notwithstanding the almost stability of the ECB's main refinancing operations rate (Chart 2.1.7 and Table 2.1.3). To a large extent, this evolution reflected the high uncertainty in international financial markets, the generalised loss of confidence and the increase in counterparty risk, facts that, since the beginning of the financial crisis, led the banks to restrict the offer of funds on the interbank money market, while also endeavouring to prevent eventual liquidity problems. To a lesser extent and in a more restricted time period, namely in June, short term money market interest rates also reacted to the level of inflation occurring in the euro area and to reinforced expectations of an increase in the ECB's reference rates. At the beginning of the fourth quarter there was a marked reversal in the official interest rates' evolution in the euro area, a movement common to other countries' monetary authorities. This reduction occurred in a context of intensification of the global economic and financial crisis, and of the ex-

Chart 2.1.7



Sources: Bloomberg, ECB and Banco de Portugal.

Note: Government guarantees on bonds issued by Portuguese banks are part of a series of financial stability support measures announced by the government on 12 October 2008. The bonds were issued with a maturity of 3 years.

Table 2.1.3

MONETARY AND FINANCIAL CONDITIONS OF THE PORTUGUESE ECONOMY

	Annual evolution			Quarterly evolution				Monthly evolution			
	2006	2007	2008	2008Q1	2008Q2	2008Q3	2008Q4	Jan-09	Feb-09	Mar-09	Apr-09
Nominal interest rates - average figures for the period (per cent)											
3-month Euribor	3.1	4.3	4.6	4.5	4.9	5.0	4.2	2.5	1.9	1.6	1.4
12-month Euribor	3.4	4.4	4.8	4.5	5.1	5.4	4.4	2.6	2.1	1.9	1.8
10-year Treasury bond yields	3.9	4.4	4.5	4.3	4.7	4.8	4.3	4.3	4.5	4.7	4.5
Bank interest rates											
On outstanding amounts of bank loans											
Non-financial corporations	4.9	5.8	6.3	6.2	6.2	6.4	6.4	5.7	5.3	4.8	
Households for house purchase	4.3	5.1	5.7	5.5	5.5	5.8	5.9	5.5	5.1	4.6	
Consumer credit and other lending to households	8.0	8.6	9.0	8.8	8.9	9.1	9.2	9.0	8.8	8.5	
On deposits with an agreed maturity											
Non-financial private sector - up to two years (excluding overnight deposits, redeemable at notice)	2.3	3.1	3.8	3.5	3.7	3.9	4.1	3.7	3.4	3.2	
On new loans											
Households for house purchase	4.0	4.8	5.4	5.1	5.4	5.7	5.4	4.1	3.4	3.1	
Exchange rate - average figures for the period											
Nominal effective exchange rate index ^{(a),(b)}	100.9	101.8	103.0	102.9	103.5	103.2	102.5	103.3	103.0	103.6	103.4
Nominal effective exchange rate index - percentage change from the previous comparable period ^{(a),(b)}	0.2	0.8	1.2	0.5	0.6	-0.3	-0.7	0.0	-0.4	0.7	-0.2
Stock market - percentage change from the previous comparable period (end-of-period figures)											
PSI <i>Geral</i> Index	33.3	18.3	-49.7	-18.8	-10.8	-11.4	-21.6	2.5	-5.8	-2.1	15.9
Dow Jones Euro Stock	20.3	4.9	-46.3	-16.4	-7.3	-12.1	-21.2	-7.0	-11.0	-7.5	19.5
Prices in the housing market - end-of-period annual rate of change											
<i>Índice Confidencial Imobiliário</i> ^(c)	2.1	1.3	3.9	1.6	2.3	3.2	3.9	4.1	4.2	4.0	
Bank evaluation (<i>INE</i>)	0.3	0.5	-4.3	-0.2	-1.7	-3.0	-4.3	na	na	-5.4	
Indebtedness ratio											
Households (percentage of disposable income)	127	136	135								
Non-financial corporations (as a percentage of GDP)	123	130	141								
Credit to the non-financial private sector - end-of-period annual rate of change											
Loans granted by resident monetary financial institutions ^(d)											
Non-financial private sector	8.7	9.9	7.1	10.4	9.7	8.7	7.1	6.2	5.7	5.0	
Households - Total	9.9	9.0	4.6	8.5	7.8	6.3	4.6	3.9	3.5	3.1	
For house purchase	9.9	8.5	4.3	7.8	7.1	5.8	4.3	3.8	3.5	3.2	
Consumer credit and other lending	10.1	11.3	6.2	11.3	10.6	8.7	6.2	4.3	3.6	2.9	
Non-financial corporations	7.1	11.2	10.6	13.0	12.3	12.0	10.6	9.3	8.7	7.5	
Loans granted by resident financial institutions - end-of-period annual rate of change											
Non-financial private sector	4.2	5.7	10.6	10.1	9.6	11.4	10.6	10.5	11.0	10.5	
Memo:											
HICP - end-of-period average annual rate of change											
Portugal	3.0	2.4	2.7	2.6	2.7	2.9	2.7	2.4	2.2	1.9	
Euro area	2.2	2.1	3.3	2.5	2.9	3.4	3.3	3.1	2.9	2.7	

Sources: Euronext Lisbon, Eurostat, *Imométrica*, *INE*, Thomson Reuters and Banco de Portugal.

Notes: (a) A positive change corresponds to an appreciation of the effective exchange rate index. (b) Calculations against a group of 22 trading partners. For a detailed description of the methodology see Gouveia, A. C. and Coimbra, C. (2004), "New Effective Exchange Rate Index for the Portuguese Economy", Banco de Portugal, *Economic Bulletin*-December. (c) The *Confidencial Imobiliário* index tracks developments in the residential market in Portugal, particularly in the Lisbon and Porto metropolitan areas. In October 2006 this index adopted a new methodology and broadened its background information. The index uses information available at the *Lardocel* property portfolio which, in 2005, contained around 280,000 property entries. For further details on the methodology used see the article "Índice Confidencial Imobiliário: procedimentos metodológicos" by Isabel Fonseca and Ricardo Guimarães, in the *Imobiliária Portuguesa - Confidencial Imobiliário* Newsletter of October 2006. (d) The annual growth rates are obtained from the relation between the outstanding amounts of bank loans at the end of the months, adjusted for securitisation operations, and the monthly transactions, which are calculated from the outstanding amounts corrected of reclassifications, write-offs/write downs, exchange rate changes and price revaluations.

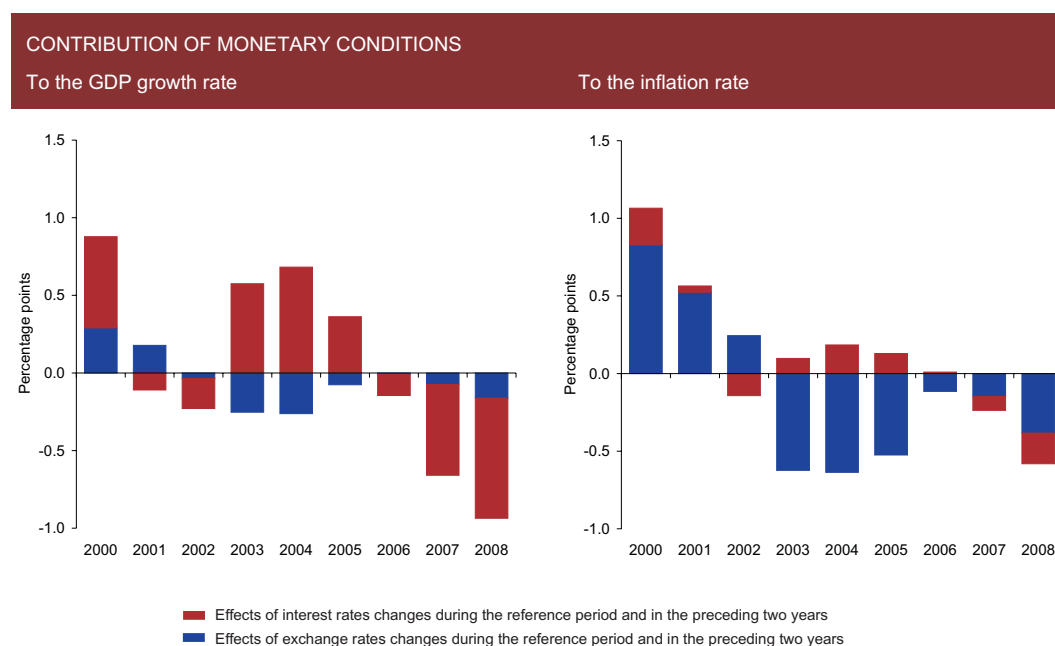
pression of its effects in terms of lower risks for price stability, especially given the evolution of international raw materials prices. The reduction of the official interest rates in the euro area since October (3.25 p.p. until the end of May of 2009) was accompanied by a sharper fall in the money market interest rates, reflecting both a significant decrease in the risk premium associated with non-collateralised operations and added expectations of further reductions in official interest rates, owing to the particularly negative context observed and expected regarding economic activity in the euro area and on a global level.

In turn, the effective exchange rate index for Portugal maintained until July of 2008 the tendency to appreciate started at the end of 2005 (about 1 per cent in the first 7 months of 2008). Later, it depreciated about 1.5 per cent until October, recovering after, from December, to a level similar to the annual maximum reached in July of 2008. On average, annually, the appreciation was of 1.2 per cent in 2008 (after 0.8 per cent in 2007).

According to the monetary conditions index for the Portuguese economy, the evolution of interest rates over the last years might have had a particularly restrictive impact on economic activity growth in 2008, reflecting both the upward cycle of official interest rates, started at the end of 2005, and the more recent increase in money market risk premiums (Chart 2.1.8). The behaviour of the effective exchange rate index should have given a similar contribution, although with a clearly lesser impact. Also in terms of the monetary conditions index, both the interest rates evolution and, mainly, the appreciation of the effective exchange rate should have contributed to a reduction in inflation in the same period.

There has been a significant change in the performance context of Portuguese banks since mid-2007, in an environment of particularly adverse evolution in capital markets and marked deterioration in prospects regarding the evolution of the economic activity. Similarly to what was observed on a European level, Portuguese banks have been affected, both in terms of securing funding in wholesale markets, in what regards their asset quality and profitability, and also in what concerns their solvency. Accordingly,

Chart 2.1.8



Source: Banco de Portugal.

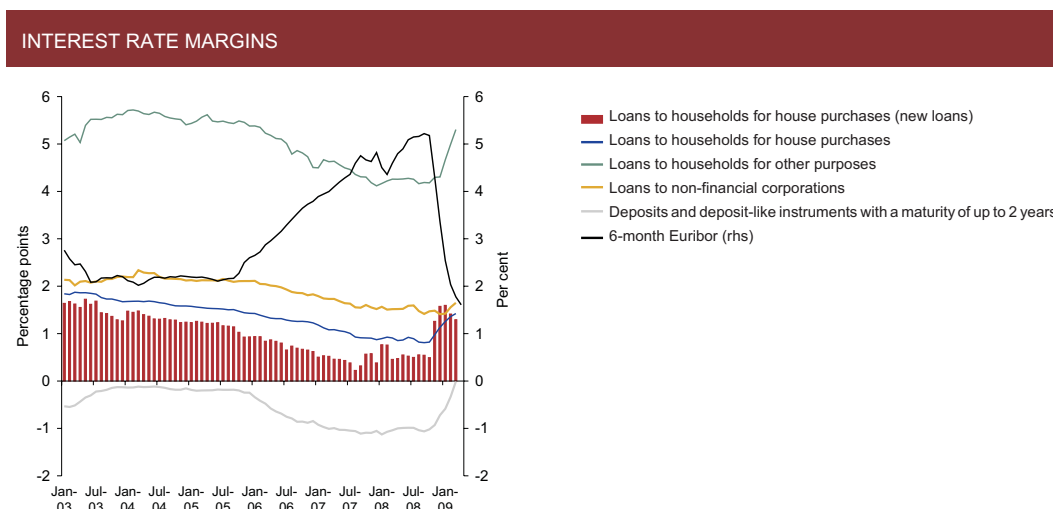
Note: For methodological information see Esteves, Paulo Soares (2003), "Monetary Conditions Index for Portugal", Banco de Portugal, *Economic Bulletin*-June. The multipliers underlying the construction of this index (corresponding to the impacts of exchange and interest rate changes) were updated taking into consideration the key model currently used for the construction of economic projections for the Portuguese economy.

the financial intermediation role between foreign and resident sectors, developed by the Portuguese banking system over the last years, shall have been significantly conditioned. It should be remembered that, under the terms of its participation in the euro area and in the particularly favourable financial context in force for a very long period up to the emergence of the financial crisis, Portuguese banks found it easy to secure euro funding for long maturities in international financial markets, permitting them to sustain a high differential between growths in domestic demand and domestic income, translated into significant deficits on the current plus capital account.

In this context, it is worth mentioning that restrictions and lack of liquidity in the interbank money markets and commercial paper markets have been decreasing recently, allowing a gradual regaining of bank financing. In the same way, access to international wholesale funding markets might be benefiting, since the last quarter of 2008, from government support measures to the banking system, similarly to what was seen in other European countries, namely from the provision of debt issuance guarantees. Benefiting from such guarantees, some of the main Portuguese banking groups carried out market debt issuances in December of 2008 and in the first four months of 2009, in an amount close to 5000 million euros. Finally, notwithstanding the adverse conditions in global wholesale funding markets, especially in what regards issuance of medium and long term securities, even if at relatively high costs and with shorter maturities, Portuguese banks have succeeded in maintaining some access to primary debt securities markets. In fact, more than half the issuances made in 2009 until the beginning of May were placed without using the mentioned guarantee.

The access difficulties to wholesale funding markets in terms of quantities and prices since mid-2007, led banks to change their relationship with customers on several levels, in line with what was observed in several other European countries. On one hand, by adopting more competitive strategies to capture customer deposits, reducing interest rate spreads on these operations *vis-à-vis* money market interest rates (Chart 2.1.9). On the other hand, increasing lending restrictions to the non-financial private sector, regarding both interest rates (increasing spreads) and other contractual conditions (such as maturities, amounts lent, collateral required, as well as the relationship between these two latter variables). During the first three quarters of 2008, in Portugal, the higher interest on deposits with an agreed maturity date was not clearly reflected in a reduction of spreads between interest rates on the outstanding

Chart 2.1.9



Sources: ECB and Banco de Portugal.

Note: The interest rate margin on the outstanding amounts of loans is calculated as the difference between the interest rate on outstanding amounts and the six month moving average on 6-month Euribor. In the case of new operations, the interest rate margin is the difference between the interest rate on new operations and 6-month Euribor.

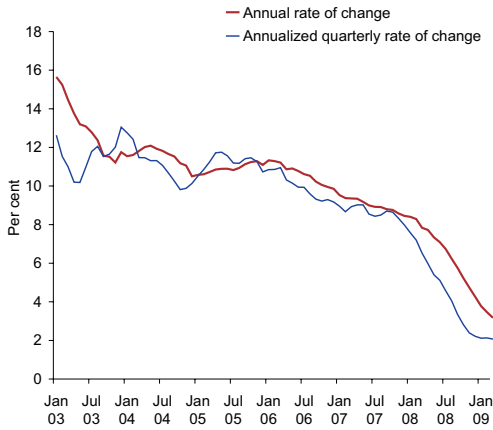
amounts of deposits with an agreed maturity of up to 2 years and money market rates. In addition to the usual gradual transmission of changes in short term money market interest rates to banking interest rates on new operations, the increase in rates shall have benefited only a small proportion of total deposits outstanding amounts, particularly new deposits made in the meantime, or renewals comprising a renegotiation of rates in the form of active customer involvement. Similarly, the evolution of interest rate spreads on outstanding lending operations may have reflected these inertia factors. Additionally, it shall have been also constrained by the impact of an eventual higher prevalence of collateralised operations and, on the opposite way, by the imposition of higher spreads on operations with the same risk level. At a later stage, owing to the marked reduction of money market rates, there was a substantial broadening of spreads on lending operations (and a reduction on deposit operations), which also points to the possibility of relatively significant reductions on bank interest rates in the future. However, given the worsening of the economic and financial situation and the consequent increase in credit risk, a stabilisation of such spreads to levels higher than those observed in recent years is to be expected. The most recent information regarding interest rate spreads for new lending operations to households for house purchase seems to confirm this change.

Even though showing a tendency to a clear slowdown during the second half of 2008 (maintained in early 2009), bank lending to the private resident non-financial sector maintained during 2008 (and early 2009) an annual rate of change that one could consider high, taking into account, namely, bank's financing constraints in international wholesale markets and the slowdown in economic activity, translated into a significant deceleration in nominal GDP of about 5 per cent in 2007 to 1.8 per cent in 2008. Differentiation, however, continued to exist between loans to households and to non-financial corporations. In the case of loans to households, the slowdown was part of a trend began in mid-2006, which accentuated in the second quarter of the year, when the rate of change for consumer credit and for other purposes hit its highest value for the year at 11.4 per cent. In December of 2008, the rate of change of bank loans to the sector was of 4.6 per cent (in comparison to the preceding year's 9.0 per cent), with housing and consumer and other credit rates having reached 4.3 and 6.2 per cent (8.5 and 11.3 per cent in December 2007), respectively (Charts 2.1.10 and 2.1.11). In March 2009, the rates of change of total bank loans to households and of the housing and consumer and other credit segments were further reduced to 3.1, 3.2 and 2.9 per cent, respectively, with reference being made to the fact that the most recent loan dynamics (assessed by annualised quarterly rates of change, calculated on the basis of seasonally adjusted values) clearly points to additional reductions of annual rates of change in the course of the coming months (in March, the annualised quarterly rate of change of bank loans to households was 1.7 per cent). The profile of a progressive slowdown in the intra-annual evolution of loans to households is in line with the results of the Bank Lending Survey, pointing as factors inducing such an evolution the continued reduction of consumer confidence, the deterioration of housing market prospects and the reduction of consumer expenditure on durable goods (e.g. cars and furniture).

The growth of bank loans to non-financial corporations was, in turn, significant over a large part of 2008 (between 12 and 13 per cent), indicating a significant deceleration only in the last quarter (Chart 2.1.12). Nevertheless, they still continued to evidence high rates of expansion in March 2009, with a year-on-year rate of 7.5 per cent and 3.7 per cent in the case of the annualised quarterly rate of change (calculated on seasonally adjusted values). Further, bank financing to non-financial corporations in 2008 also involved the acquisition of very substantial volumes of debt securities, particularly commercial paper. In the first half of the year, net issuances of this instrument were up strongly (to around 3700 million euros, in comparison to around 1000 million euros in the same period of 2007, and slightly more than 2700 million in the second half of 2007), and were mostly acquired by banks, which fact was associated with the difficulties involved in the issuance of debt securities for the longer maturities by the

Chart 2.1.10

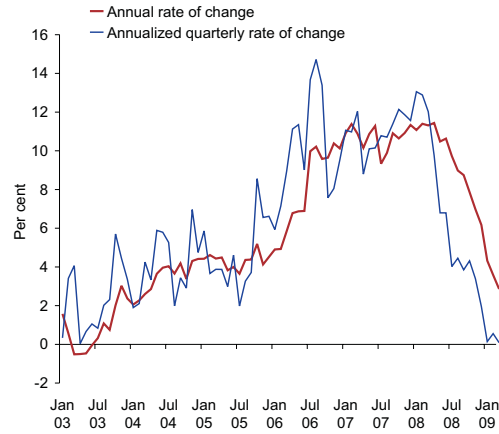
LOANS TO HOUSEHOLDS FOR HOUSE PURCHASE GRANTED BY RESIDENT MONETARY INSTITUTIONS



Source: Banco de Portugal.
Note: The annual and quarterly rates of change are calculated on the basis of the relationship between the outstanding amounts of bank loans at the end of the month, adjusted for securitisation operations, and monthly transactions, which are calculated on outstanding amounts corrected for reclassifications, write-offs and foreign exchange and price revaluations. The quarterly rate of change is seasonally adjusted.

Chart 2.1.11

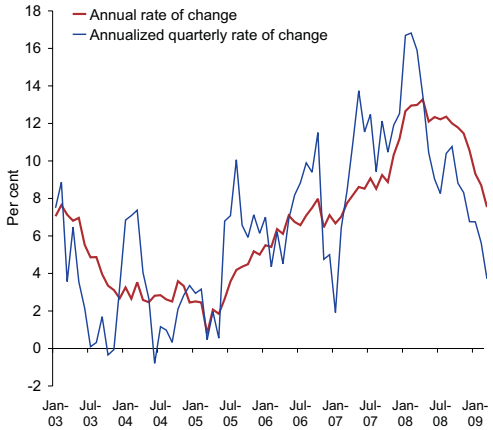
LOANS TO HOUSEHOLDS FOR CONSUMPTION AND OTHER PURPOSES GRANTED BY RESIDENT MONETARY INSTITUTIONS



Source: Banco de Portugal.
Note: The annual and quarterly rates of change are calculated on the basis of the relationship between the outstanding amounts of bank loans at the end of the month, adjusted for securitisation operations, and monthly transactions, which are calculated on outstanding amounts corrected for reclassifications, write-offs and foreign exchange and price revaluations. The quarterly rate of change is seasonally adjusted.

Chart 2.1.12

LOANS TO NON-FINANCIAL CORPORATIONS GRANTED BY RESIDENT MONETARY INSTITUTIONS



Source: Banco de Portugal.
Note: The annual and quarterly rates of change are calculated on the basis of the relationship between the outstanding amounts of bank loans at the end of the month, adjusted for securitisation operations, and monthly transactions, which are calculated on outstanding amounts corrected for reclassifications, write-offs and foreign exchange and price revaluations. The quarterly rate of change is seasonally adjusted.

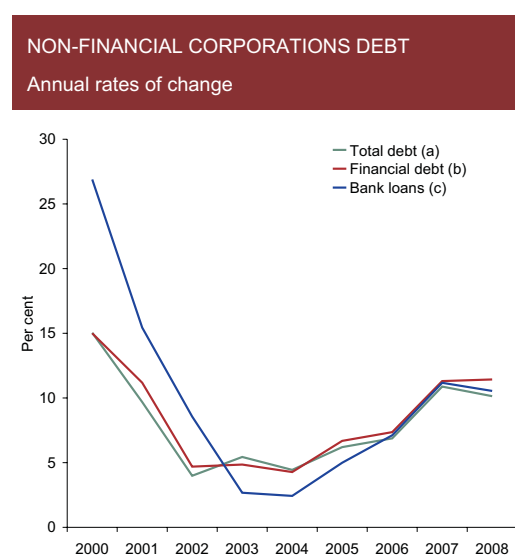
companies. There was, however, a drastic reduction in the issuance of debt securities by this sector in the last quarter, particularly commercial paper. Therefore, bank portfolios, encompassing loans to non-financial corporations and debt securities issued by this sector, recorded even stronger growth levels than bank loans, of around 16 per cent, in the first three quarters of 2008, although also slowing down in the last quarter (year-on-year growth of 8.8 per cent and 3.9 per cent in terms of the

annualised quarterly rate of change in March of 2009). According to the institutions participating in the Bank Lending Survey, the credit slowdown shall be associated with the decrease in needs for investment financing and for mergers/acquisitions and corporate restructuring operations (simultaneously reporting a progressive decrease in demand for long term loans). In opposition, factors incentivising demand for credit included debt restructuring operations, inventory financing and working capital requirements.

Total financial debt of non-financial corporations, which includes loans and debt securities placed with banks and other investors (resident and non-resident), has accompanied the evolution of the mentioned broader aggregate of bank financing to non-financial corporations, recording at the end of 2008 a growth rate of 11.4 per cent, similar to the one observed at the end of 2007 (Chart 2.1.13). In this context, note the significant increase in the indebtedness of the sector, assessed both in terms of a percentage of GDP and, mostly, in terms of their respective capital, reflecting also in this case the significant loss of market value regarding corporate equity capital.

The relative sustainment of bank lending, notwithstanding the unfavourable environment existing in international wholesale debt markets, was enabled by the significant expansion of customer resources, notably deposits by resident individuals, with a rate of growth of close to 13 per cent in March of 2009 (about 15 per cent at the end of 2008). In addition to reflecting the already mentioned adoption of more competitive strategies by banking institutions in securing customer resources, this evolution is essentially reflecting increased investor demand for financial investments less sensitive to market fluctuations. The supply of credit was also supported by added recourse to funding through the Eurosystem's monetary policy operations. In this respect, note the importance of the securitisation of loans. In fact, despite the demand for securities resulting from securitisation operations registered in the current framework a sharp decrease, some Portuguese banks bought the securities resulting from these operations from securitisation vehicles owned by third parties, using them as collateral in Eurosystem credit

Chart 2.1.13



Source: Banco de Portugal.

Notes: (a) Includes loans granted by resident and non-resident institutions; loans/supplementary payments granted by non-resident companies from the same economic group (excluding those granted to non-financial corporations in Madeira off-shore); commercial paper and bonds issued by non-financial corporations held by other sectors and trade credit received from other sectors. (b) As in (a) excluding commercial credit received from other sectors. (c) Includes loans granted by resident monetary financial institutions, adjusted for securitisation operations and corrected for reclassifications, asset write-downs and exchange rate and price revaluations.

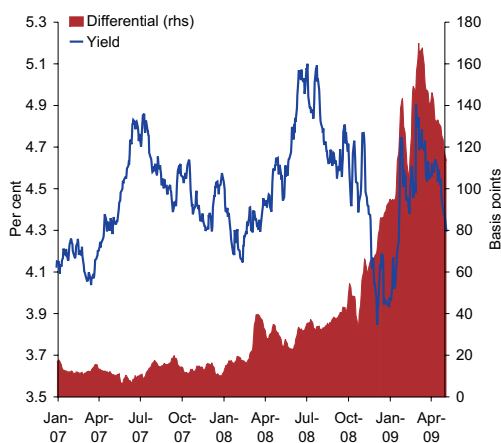
operations, similarly to what was done by other European banks. In this context, these operations were also an important source of financing for Portuguese banks, albeit indirectly.

As already referred to in the preceding section and similarly to other euro area countries, in the last quarter of 2008 and until March of 2009 an increase in the differential between the yield of Portuguese Treasury bonds with a residual 10-year maturity *vis-à-vis* German debt was observed (Chart 2.1.14). This evolution should have reflected higher liquidity and credit risk premiums as well as the reduction in the rating notation of the Portuguese Republic by the Standard & Poor's. After that, the differential was reduced, ending April at about 120 b.p., a value which compares to an average of around 165 b.p. in the second half of March. Note that the demand of higher risk premiums as a compensation for public debt tends to add a penalty to domestic economic agent's financing costs. Reference should, however, be made to the fact that, after peaking in June and July (at around 5.1 per cent), the yields on Portuguese Treasury Bonds with a 10-years residual maturity maintained a downward trajectory up to the end of 2008, to an end-of-year level of close to 4 per cent, around 50 b.p. less than at the end of 2007. The first months of 2009 witnessed an upward trend on the Portuguese public debt rate, in line with the increase in the differential *vis-à-vis* the interest rate regarding German public debt, an evolution later reversed, with the rate reaching 4.4 per cent at the end of April.

Similarly, in the same context of risk reassessment by market participants, implying a clearly more significant price discrimination between the different levels of risk, 2008 witnessed a clear increase in the interest rate differentials regarding bonds of non-financial Portuguese corporations *vis-à-vis* public debt securities with a comparable maturity (Chart 2.1.15). That evolution was particularly pronounced in the last quarter of the year, although partly reversed at the beginning of 2009. Reference should be made, in this case, to the fact that, both in terms of the annual average as in end-of-period values, 2008 witnessed an increase in the level of interest rates and, therefore, in the financing costs of non-financial corporations through the use of this instrument. It should be remembered, however, that financing via the issuance of bonds only represents a small proportion of the total financing operations of non-financial corporations in Portugal.

Chart 2.1.14

PORTUGUESE PUBLIC DEBT YIELD AND SPREAD
VIS-À-VIS GERMAN PUBLIC DEBT (10 YEARS)

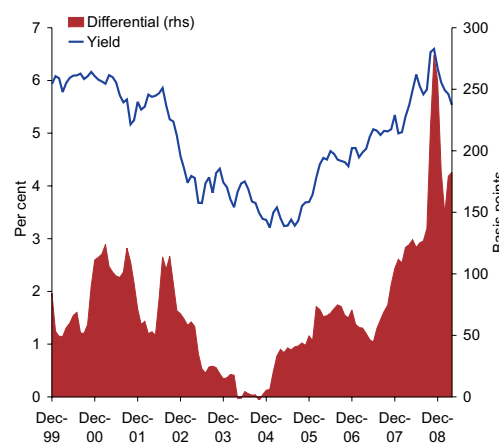


Sources: Thomson Reuters and Banco de Portugal.

Notes: Yields obtained at close of business. The spread was calculated by interpolating the German yield curve, to guarantee that the yield on the 10 year Portuguese benchmark is being compared with a German yield with a similar maturity. The spread was calculated on the basis of a 5 day moving average.

Chart 2.1.15

PORTUGUESE NON-FINANCIAL CORPORATE
BOND YIELDS AND SPREAD *VIS-À-VIS* PUBLIC
DEBT SECURITIES OF A COMPARABLE MATURITY



Sources: Barclays Capital and Banco de Portugal.

Note: The indicator considers a set of issues with an Investment grade rating notation.

Global financial conditions were significantly affected by the major loss of value in equity markets in 2008. The *PSI Geral* Index fell in value by 50 per cent during the course of the year, similarly to what happened in the euro area. This evolution reflected increasing problems in the global financial system and a growing interaction with the observed and forecasted deceleration of economic activity. In addition to having a very direct effect on the profitability and solvency of financial institutions, this evolution has also compounded the financing difficulties of the non-financial sector, by increasing the cost of finance through shareholders' equity. In this context, it is important to mention that in the first four months of 2009, the Portuguese stock index registered an appreciation of about 12 per cent, particularly market in April.

Owing to the developments occurring in several financial market segments, the real financing cost of Portuguese non-financial corporations in the major categories of financial instruments (considering jointly the costs associated with shares and other investments, bank loans and debt securities) were up in 2008 over the level of the preceding year. This evolution essentially derived from the increased estimate of financing costs via share holders' equity, which reflected the significant fall in share prices, although the indicator's remaining components also recorded a slight increase.

One of the most marked aspects of the international economic and financial crisis is associated with the adjustment of property markets overvaluation in several countries (United States, United Kingdom, Ireland and Spain), where prices have already decelerated sharply, even with significant nominal decreases. The available evidence does not point to the possibility of a comparable adjustment in Portugal. In aggregate terms, Portugal does not appear to suffer from situations of excessive valuation of property assets, namely in the residential component. The data set out in the *Confidencial Imobiliário* index shows that since the beginning of the current decade, the average annual rate of change of prices in the Portuguese residential market was 3 per cent in nominal terms and close to nil in real terms. This being the case, the possibility of some price adjustment in this market should not be excluded. This could derive from the environment of economic and financial crisis, conditioning demand for property assets via expectations (on the evolution of income and actual property market prices) and fewer bank financing facilities for this type of investment. Here mention should be made of the National Statistical Office (*INE*) survey on bank valuations in the housing market (the *Inquérito à Avaliação Bancária na Habitação*). It indicates that the average banking valuations on house prices have recorded progressively negative year-on-year rates of change since the end of 2007, reaching -6.3 per cent at the end of 2008, (-5.8 per cent at the end of the first quarter of 2009). It should, however, be noted that as bank valuation indicators, these values are influenced by the increased restrictions on banks' credit supply. The *Confidencial Imobiliário* index, in turn, recorded a year-on-year rate of change of 1.1 per cent in March of 2009. The price rate of change for new properties was, in that month, of 3.0 per cent, clearly different from the rate of change for used property, of -0.2 per cent.⁵

(5) Remember that this index is computed based on offer prices and is weighted according to region and state of usage of the property. However, the quality adjustment in calculating the index does not allow a complete control of changes in this parameter. On methodology information see "Índice Confidencial Imobiliário: procedimentos metodológicos" by Isabel Fonseca and Ricardo Guimarães, in the *Imobiliária Portuguesa - Confidencial Imobiliário* Newsletter of October 2006.

2.2. Fiscal policy ⁶

In 2008, the evolution of public finances in the euro area Member-states was already affected by the economic crisis, in particular in the last months of the year. In Portugal, recent budgetary developments did not differ substantially from those observed in this group of countries. Thus, the general government deficit in national accounts stood at 2.6 per cent of GDP, the same value as in 2007 (Table 2.2.1). This outcome allowed Portugal to respect, for the second year in a row, the reference value of 3 per cent of GDP for the actual deficit defined in the Stability and Growth Pact. The 2008 outturn was, however, marked by a very significant amount of temporary measures that, according to the definition used in the Eurosystem, accounted for 1.1 per cent of GDP.⁷ Therefore, according to Banco de Portugal estimates, the structural deficit, i.e. cyclically adjusted and excluding the effect of temporary measures, reached 4.7 per cent of trend GDP in 2008, showing a deterioration of 1.4 p.p. *vis-à-vis* 2007. This value is close to the 2002 and 2003 levels and very distant from the medium term fiscal objective for the structural deficit which, in the last update of the Stability Programme, continued to be set at 0.5 per cent of GDP. In the euro area as a whole, the evolution of the structural deficit was equally unfavourable and reached a magnitude similar to the one estimated for Portugal.

Macroeconomic developments had some positive impact on the fiscal position in 2008, despite the strong economic activity deceleration that led to the stabilisation of the output gap (Chart 2.2.1). In fact, the composition of economic growth was favourable to public accounts, as private consumption and, in particular, private sector's wage bill grew above their respective trends, according to the provisional information already released. As interest expenditure as a ratio to GDP increased only slightly, fiscal policy in 2008 was clearly expansionary. Indeed, the worsening of the structural primary balance by 1.3 p.p. of trend GDP was the strongest, in annual terms, since the beginning of the Economic and Monetary Union's (EMU) third stage, offsetting a significant part of the consolidation achieved in 2006 and 2007.

The deterioration of the fiscal position predominantly reflects the rise in structural primary current expenditure as a percentage of trend GDP (Table 2.2.1 and Chart 2.2.2). In fact, after a quasi-stabilisation in the two preceding years, this item returned, in 2008, to the increasing trend recorded since the mid-90s. Pensions and intermediate consumption spending, similarly to what was observed in previous years, continued to be the components of expenditure that mostly contributed to this outcome (Chart 2.2.3). It should be noted, however, that pension spending already decelerated slightly in 2008, especially in the public employees' subsystem (*Caixa Geral de Aposentações*). It is worth highlighting that the reform of the public pension systems has a limited fiscal impact in the short term but will contribute considerably to the sustainability of public finances, by reducing the expected growth of age-related expenditure over the long term. The evolution of compensation of employees partially compensated these developments in 2006 and 2007, but the same did not happen in 2008, which might be related, essentially, to a higher update of the wage scale and to an apparently smaller net reduction in the number of employees. Additionally, note that the 2006 and 2007 outturn benefited from the freezing in automatic progressions in careers and the 2008 promotions may still not be representative of what will be the steady-state according to the new rules. In this context, full implementation of the public administration reform, namely through restructuring of services and contracts, careers and salary regimes, will be crucial to assure a sustainable evolution of compensation of employees in the next years.

(6) For a detailed analysis of fiscal developments in 2008, see "Chapter 6 Public Finances", of this Report.

(7) Revenues classified as temporary measures in 2008 resulted from concessions for hydroelectric production and motorway exploitation.

Table 2.2.1

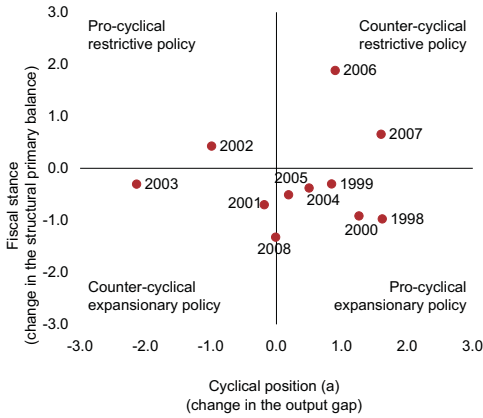
MAIN FISCAL INDICATORS												
As a percentage of GDP												
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	Change 2007-2008 ^(c)
Overall balance	-3.4	-2.8	-2.9	-4.3	-2.8	-2.9	-3.4	-6.1	-3.9	-2.6	-2.6	0.0
Primary balance	-0.2	0.2	0.2	-1.3	0.0	-0.2	-0.7	-3.5	-1.2	0.2	0.3	0.1
Temporary measures	0.0	0.0	0.3	0.0	1.3	2.4	2.1	-0.1	0.0	0.1	1.1	1.0
Structural overall balance ^(a)	-3.5	-3.6	-4.7	-5.3	-4.6	-4.7	-5.0	-5.5	-3.8	-3.3	-4.7	-1.4
Structural primary balance ^(a)	-0.3	-0.6	-1.5	-2.2	-1.8	-2.0	-2.4	-2.9	-1.1	-0.4	-1.8	-1.4
Structural total revenue ^(a)	39.4	40.1	40.0	40.2	40.7	40.2	41.0	41.6	42.6	43.5	43.3	-0.2
Structural tax burden ^{(a),(b)}	33.4	33.7	34.1	34.2	34.4	34.3	35.0	36.1	36.9	37.8	37.4	-0.3
Structural primary expenditure ^(a)	39.6	40.7	41.5	42.4	42.4	42.2	43.4	44.6	43.6	44.0	45.1	1.1
Structural primary current expenditure ^(a)	33.7	34.9	36.1	36.9	37.6	38.0	39.0	40.3	40.2	40.3	41.2	0.9
Public debt	52.1	51.4	50.5	52.9	55.6	56.9	58.3	63.6	64.7	63.5	66.4	2.9

Sources: INE and Banco de Portugal.

Notes: (a) The structural values are cyclically adjusted, exclude the impact of temporary measures and are presented as a percentage of trend GDP. The cyclical components and temporary measures are assessed by Banco de Portugal according to the methodologies used in the Eurosystem. (b) Defined as the sum of receipts from taxes on income and wealth, taxes on production and imports and social contributions. (c) The changes do not correspond necessarily to the differences in ratios to GDP due to rounding.

Chart 2.2.1

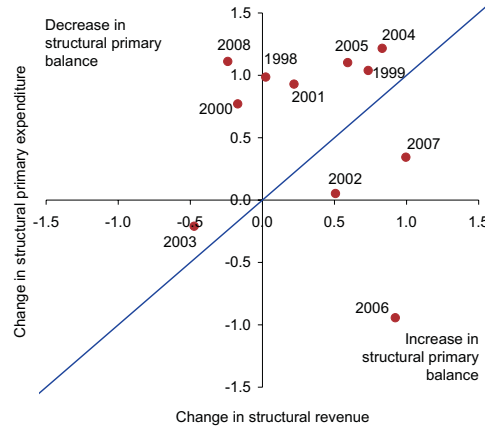
FISCAL POLICY AND CYCLICAL POSITION



Sources: INE and Banco de Portugal.
 Note: (a) The economy's cyclical position is assessed by the change in the output gap, which corresponds to the difference between GDP and trend GDP growth rates.

Chart 2.2.2

CHANGES IN STRUCTURAL REVENUE AND PRIMARY EXPENDITURE
 As a percentage of trend GDP

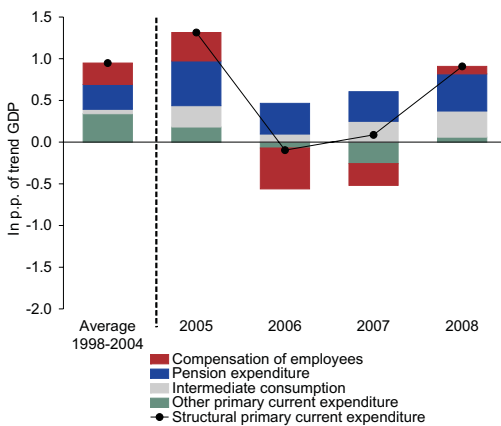


Sources: INE and Banco de Portugal.

The decline of the structural tax burden as a ratio to trend GDP also contributed, though to a lesser extent, to the worsening of the fiscal position in 2008 (Table 2.2.1). This evolution contrasts clearly with the recent past, as this variable recorded increases in almost every year since the outset of the single currency. Chart 2.2.4 shows the breakdown of the change in the structural tax burden into its several explanatory factors. As can be seen, the ratio of the structural tax burden to trend GDP in 2008 decreased, despite the positive effect caused by the above-mentioned evolution of the different macro-

Chart 2.2.3

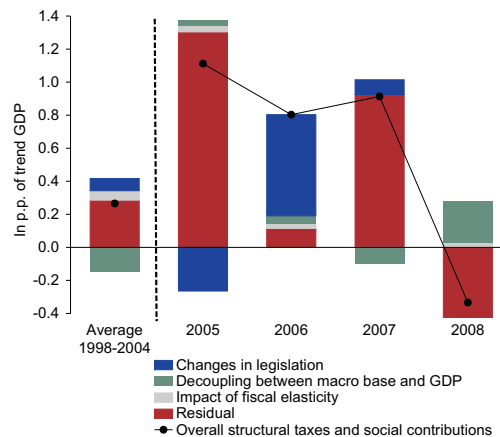
CONTRIBUTIONS TO THE CHANGE IN STRUCTURAL PRIMARY CURRENT EXPENDITURE^(a)



Sources: INE and Banco de Portugal.
 Note: (a) The composition of primary current expenditure is adjusted for the effects of successive transformations of public hospitals into corporations in the 2002-2008 period.

Chart 2.2.4

CONTRIBUTIONS TO THE CHANGE IN STRUCTURAL TAXES AND SOCIAL CONTRIBUTIONS^(a)



Sources: INE and Banco de Portugal.
 Note: (a) For further details on the methodology used to calculate these contributions see Kremer et al. (2006), "A disaggregated framework for the analysis of structural developments in public finances", ECB Working paper no. 579; Braz, C. (2006), "The calculation of cyclically adjusted balances at Banco de Portugal: an update", Banco de Portugal, *Economic Bulletin*-Winter.

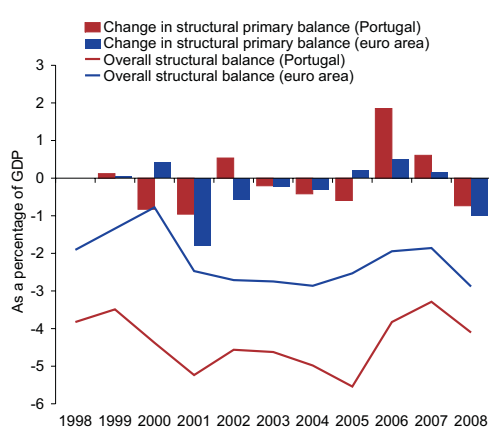
economic bases and their elasticities. Therefore, the decline is justified by the impact of changes in legislation, especially those regarding taxes on production and imports,⁸ and a negative residual effect not explained by the previous factors. It is worth highlighting the reversal of the sign of the residual component, which, in previous years, had reached large positive values, mainly associated to improvements in the effectiveness of the collection of taxes and social contributions. It should be noted that this outcome was a consequence of the stepping up of administrative procedures, having as such a permanent nature, but also stemmed from the collection of overdue amounts, which will tend to vanish in time. In 2008, the negative residual does not seem yet to result from the decrease in this transitory part of effectiveness gains, once it is essentially associated to the specific behaviour of some taxes on production and imports. Over the last years, the higher than expected growth in tax revenues, given the evolution of its macroeconomic bases and respective elasticities, happened not only in Portugal but also in other Member-states, despite the fact that the magnitudes and explanatory factors involved differ considerably from country to country. Given the limitations of the cyclically adjusted methodologies, these residuals are implicitly considered as structural, regardless of effectively having a permanent or a transitory nature. In this context, it is foreseeable that in the following years they will contribute to the deterioration of the structural balances as obtained with these methodologies, given the strong expected deceleration in economic activity.

Recent fiscal developments in Portugal did not differ substantially from those in other countries of the euro area (Chart 2.2.5). It is worth noting that the statement is also valid for the evolution of the tax burden and primary current expenditure cyclically adjusted ratios to GDP (Chart 2.2.6).

In what regards the Portuguese public debt ratio, in 2008 there was a return to the increasing trend recorded since 2001, and only interrupted in the previous year (Chart 2.2.7). Since 2001 and until the end of 2008, the debt ratio rose approximately 16 p.p., of which 2.9 p.p. in the last year. In 2008, this evolution reflects essentially the impact of the deceleration of economic activity and deficit-debt adjust-

Chart 2.2.5

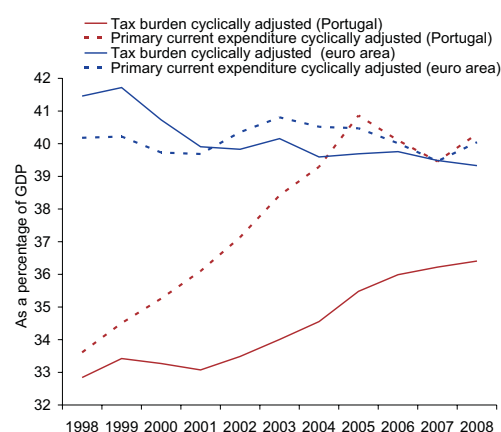
STRUCTURAL PRIMARY BALANCES IN PORTUGAL AND THE EURO AREA



Sources: European Commission and Banco de Portugal.
Note: Structural values are cyclically adjusted and, in the case of Portugal, they also exclude temporary measures. Since the European Commission cyclically adjustment methodology is used, the values may differ from those included in the remainder of the section for Portugal, which are based on the methodology followed by the Eurosystem.

Chart 2.2.6

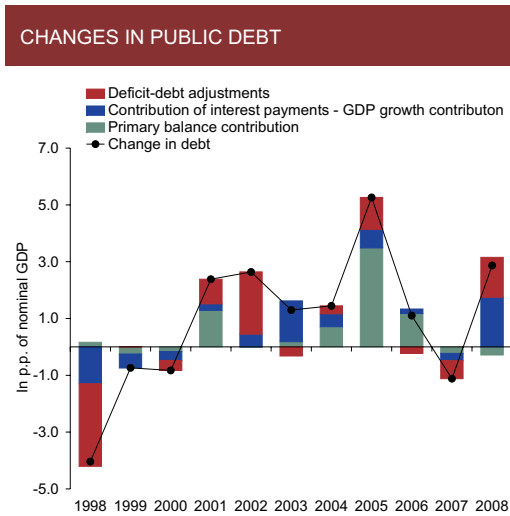
TAX REVENUE^(a) AND PRIMARY CURRENT EXPENDITURE IN PORTUGAL AND THE EURO AREA



Sources: European Commission and Banco de Portugal.
Note: (a) According to the definition used by the European Commission, it includes taxes on production and imports transferred to the community budget and excludes imputed contributions. In the case of Portugal it also excludes the impact of temporary measures. Since the European Commission cyclically adjustment methodology is used, the values may differ from those included in the remainder of the section for Portugal, which are based on the methodology followed by the Eurosystem.

(8) In particular, the effect of the reduction of the standard VAT rate, from 21 to 20 per cent, by mid-year.

Chart 2.2.7



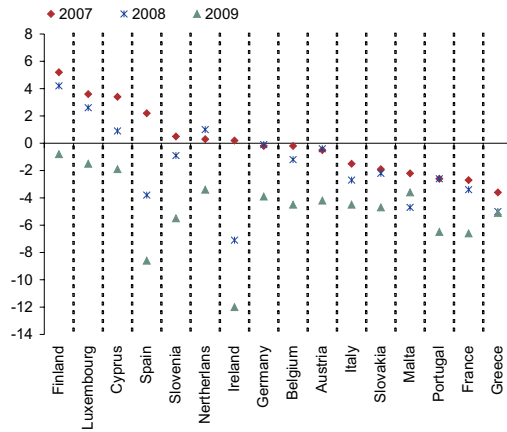
Sources: INE and Banco de Portugal.

ments, which showed a considerable magnitude, contributing to the increase in the debt ratio. It is worth mentioning that the latter have been influenced by the settlement of general government debts to non-financial corporations, which was important not only to increase their liquidity but also to eliminate the distortion caused by the transfer to the private sector of part of the burden related with the financing of the public deficit. According to the available information, the measures adopted in the context of the current crisis aiming at the stabilisation of the financial system had only a minor reducing impact on the deficit and debt through the fees related with government guaranteed loans (see “Box 2.1 Measures taken by the Portuguese authorities relating to the financial system during the international financial crisis”, 2008 Financial Stability Report).

Recent prospects for 2009 point to a very significant deterioration of the fiscal balance in the majority of euro area countries, including Portugal (Charts 2.2.8 and 2.2.9). Indeed, already in 2008 five euro area countries (Spain, France, Greece, Ireland and Malta) exceeded the reference value for the deficit in the context of the Stability and Growth Pact and the respective excessive deficit procedures were launched. According to the European Commission’s Spring Economic Forecasts, in 2009, the number of EU countries presenting deficits above 3 per cent of GDP should be extended to 20, including 13 euro area members (the exceptions are Cyprus, Luxembourg and Finland, in the euro area, and Bulgaria, Denmark, Estonia and Sweden, outside the euro area). The worsening of fiscal positions should occur as a result of both the functioning of automatic stabilisers - in a context of strong economic activity deceleration – and the fiscal stimulus measures adopted in several countries in order to mitigate the economic effects of the crisis. The fiscal measures implemented over the last months are numerous and much diversified in terms of the instruments used. Their identification is in some cases difficult as its release to the public was gradual and not in a single package (see “Box 1.5 Fiscal policy in the context of the economic and financial crisis”, of this Report). In the case of Portugal, the measures were focussed on public investment, assistance to companies and exports, as well as support to employment and social protection. They generically come under the European Commission guidelines presented by the European Economic Recovery Plan, agreed in December 2008. According to official estimates, the impact of these measures on the deficit will reach 1.2 per cent of GDP in 2009, of which 0.8 per cent resulting from the package approved in December and 0.4 per cent from several measures adopted since mid-2008.

Chart 2.2.8

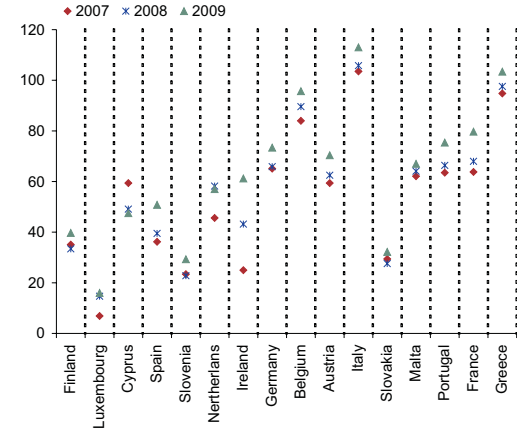
FISCAL BALANCE IN PORTUGAL AND THE EURO AREA
As a percentage of GDP



Source: European Commission.

Chart 2.2.9

PUBLIC DEBT IN PORTUGAL AND THE EURO AREA
As a percentage of GDP



Source: European Commission.

The correction of fiscal imbalances in the medium term is crucial in order to ensure the sustainability of public finances. At the current juncture, unsustainability risks can have particularly adverse effects, given the potential negative effects on the financing conditions of the economy. In this sense, the unwinding of the stimulus measures adopted by the different countries must be guaranteed, as soon as the macroeconomic conditions allow it. In the specific case of Portugal, the high structural deficit in 2008 and the prospects of a strong deterioration in 2009 (by 1.7 p.p. of GDP, according to the European Commission projections) suggest, additionally, the need to adopt an exit strategy, ensuring the return to a fiscal consolidation path. As for future prospects regarding the evolution of public expenditure, it is crucial a consistent implementation of the reform of pension systems, allowing an effective materialization of the projected savings in the medium and long term (see “Box 2.1 Update of projections of age-related public expenditure: Portugal in the EU context”, of this Report).