

21. PORTUGAL

Fiscal consolidation and private sector deleveraging

In the spotlight of sovereign debt markets

In the first half of 2010, the economy recovered, following a severe recession that hit the country during the global economic and financial crisis. This growth spurt was due to a strong turnaround in domestic demand, in particular private and public consumption, and mildly positive contributions from external trade. Private consumption arguably benefited from low interest rates and anticipatory effects of the VAT rate increase, which has taken effect on 1 July 2010. Positive growth rates in the first half of the year merely slowed down the shedding of jobs, as investment activity remained subdued. With the continued weakness of the labour market, unemployment became more entrenched.

The recession, the subsequent deterioration in labour market conditions, and the halt in fiscal consolidation attempts observed up to early 2008 have taken a heavy toll on public finances. This spring, Portugal along with some other Member States came under increased scrutiny from sovereign debt markets, and increases in government bond yields put additional pressure on public finances. In an attempt to alleviate this pressure, the Portuguese authorities announced fiscal plans in May and September that were more ambitious than those set out in the March 2010 Stability Programme, with the new fiscal targets being underpinned by consolidation measures, part of which implemented in mid 2010.

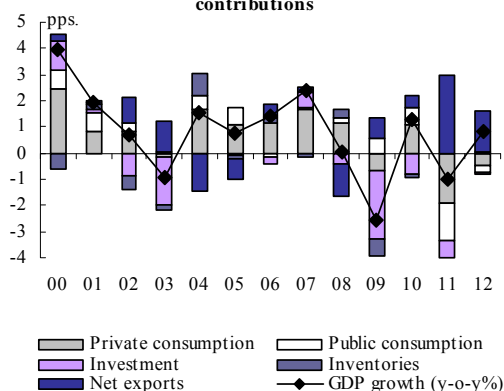
The underlying growth trend remains weak

The intensified fiscal consolidation, while having an important impact on raising confidence levels and lowering yield spreads, shapes the short-term outlook for economic growth through their immediate impact on private and public consumption expenditures. At the same time, a high level of private sector indebtedness will force households and companies to undertake balance sheet corrections. In order to attenuate the high external indebtedness, economic activity needs to be rebalanced by strengthening exports and investment activity and restraining public and private consumption.

Fiscal consolidation shapes short-term outlook

Real GDP is expected to increase by 1¼% in 2010 and to decline by about 1% in 2011. In 2012, GDP is forecast to recover at a rate of ¾%. The growth pattern in 2010 is shaped by the strong activity recorded in the first half of this year and the expected subsequent drop in GDP in the second semester due to the impact of the VAT hike and cuts in social transfers that came into effect in July. Fiscal consolidation will continue to weigh on private consumption once the new fiscal measures come into effect in January. In addition, private households are expected to continue their balance sheet repair amidst a subdued labour market outlook and tightened financial conditions. As a consequence, private consumption is expected to decrease substantially in both 2011 and 2012.

Graph II.21.1: Portugal - GDP growth and contributions



Figures for GDP components in 2010 and 2011 are distorted by the import of two submarines in 2010, which raises government consumption and imports but not aggregate GDP. In 2011, real government consumption is forecast to fall by about 6¾% in 2011 and by a further 1¼% in 2012. Gross fixed capital formation is projected to continue its longstanding downward trend until the end of 2011, weighed down by weak domestic demand and deleveraging by the corporate sector. A mild recovery in machinery and equipment investment and business construction is, however, expected for 2012 as accelerating exports are likely to require additional production capacity. Housing investment, in contrast, should continue to decline during the forecast period.

Stronger exports in line with the expected recovery in Portugal's export markets and a deceleration in imports due to the contraction in domestic demand should lead to significant reductions of the deficits in the trade and current-account balances. Servicing external liabilities will continue to absorb a significant share of income over the medium-term, mirrored in the deficit in the primary income balance, which is expected to increase from 3½% of GDP in recent years to 4% of GDP in 2012. As a result, the gap between gross domestic product and gross national income should continue to widen.

Labour market conditions weigh on wage growth...

Unemployment recorded a sharp increase when the economic and financial crisis unfolded at the end of 2008 and has since become entrenched with more than half of the unemployed now being out of work for longer than one year. At the same time, the NAIRU has increased to record levels. Labour market conditions are expected to improve only towards the end of 2012, on the back of the recovery in private investment activity. Employment is forecast to decrease in each year between 2010 and 2012. Against this background and in the wake of a reduction in nominal public sector wages, private sector wage growth is expected to be moderate in the forecast period, thereby containing unit labour costs and improving price competitiveness.

...and dampen price developments

HICP headline inflation reached 2% y-o-y in September 2010, partly as a result of the VAT hike in July. A further increase is to be expected when another VAT increase comes into effect at the beginning of 2011. HICP is forecast to increase by 1½% in 2010 and to further accelerate to 2¼% in 2011, before it falls back in 2012. After a strong increase in 2009, unit labour costs are expected to stagnate or even slightly decline in the forecast period.

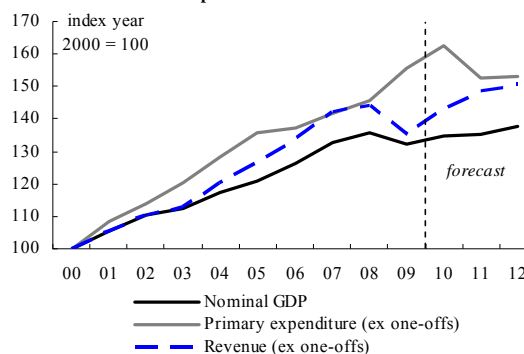
There are upside and downside risks to the forecast. On the positive side, an earlier-than-expected improvement of labour market conditions could mitigate the contractionary short-term impact of the fiscal consolidation and trigger a faster recovery of domestic demand. On the negative side, any unfavourable development would not only put public finances at immediate

risk, but higher risk premia on the bond market could also raise the funding costs of domestic banks and negatively impact on the provision of credit to the private sector.

Challenge of fiscal consolidation in a low GDP growth environment

In 2010, the government deficit is expected to be 7.3% of GDP, down from 9.3% of GDP in 2009. The lower 2010 deficit outcome is due to higher revenue, reversing the sharp falls recorded in 2009. The revenue increase partly reflects some household consumption buoyancy as well as discretionary measures taken in the middle of the year, especially a one percentage point increase in all VAT rates and, to a lesser extent, increases in direct taxes. In addition, the 2010 budgetary outcome will benefit from a one-off revenue item worth 1.5% of GDP, linked to the transfer of a private pension fund to the government sector, which takes responsibility for the payment of future pensions. This transaction reduces the 2010 deficit but is neutral in terms of fiscal sustainability insofar as the one-time payment to the government is the actuarial value of future pension payments.

Graph II.21.2: Portugal - Government revenue and expenditure and GDP



Yet, in 2010, the higher revenue-to-GDP ratio has been accompanied by a rising expenditure-to-GDP ratio. Despite some deceleration following the large increase in 2009, primary expenditure is estimated to have grown in excess of nominal GDP, with social transfers accounting for a significant part of that increase. Large non-recurrent purchases of military equipment in 2010 also contributed to the higher spending and interest expenditure edged up too.

A sizeable fiscal consolidation effort will be implemented in 2011, based on several fiscal

measures to reduce spending and increase revenue. Measures on the expenditure side include an average cut of 5% in government wages, reductions in government employment, cuts in social transfers such as unemployment benefits and family allowances, and a freeze of essentially all other social outlays. Additional measures are targeted at reining in spending in a number of other areas, including, for instance, the health sector, and transfers to state-owned enterprises or public investment. Consolidation efforts on the revenue side consist mainly of an additional rise of 2 pps. in the standard VAT rate. In addition, revenue proceeds will reflect the carry-over effect of the tax hikes of mid-2010.

In all, with such a large fiscal consolidation effort, the 2011 deficit may come to under 5% of GDP, also taking into account the fact that the fading of the large one-off revenue recorded in 2010 will limit the deficit reduction in 2011. The current fiscal outlook hinges, on the one hand, upon the assumption that the ambitious expenditure plans outlined in the 2011 Budget Law will largely materialise and, on the other hand, upon a GDP outlook which is only mildly more subdued than the contraction of 0.7% underlying the tax projections of the 2011 Budget. Thus, there are risks to this fiscal scenario. Notably, should the macroeconomic outlook turn out to be bleaker than

currently expected, fiscal prospects will be affected by lower tax revenues. Indeed, given the uncertainty on a number of external and financial variables, it cannot be excluded that the evolution of demand stays below the present scenario.

Based on unchanged policies, the government deficit is expected to remain essentially constant in 2012. Revenue is expected to continue to be affected by the weak economic momentum, while expenditure is projected to grow in excess of sluggish nominal GDP. In particular, interest spending is expected to increase rapidly. Measures put in place in earlier years to rein in spending are expected to work towards expenditure containment, but they will not yield a marked fall in the primary-spending-to-GDP ratio in a context of rather low nominal GDP growth.

Government debt is projected to attain 92% of GDP in 2012, up from 83% of GDP in 2010. The rising debt levels should lead to a rapid increase in interest spending, which is expected to be the fastest-growing spending item and a major factor hindering improvements in the government balance in the coming years.

Table II.21.1:

Main features of country forecast - PORTUGAL

	2009			Annual percentage change						
	bn EUR	Curr. prices	% GDP	92-05	2007	2008	2009	2010	2011	2012
GDP	168.1	100.0	2.2	2.2	2.4	0.0	-2.6	1.3	-1.0	0.8
Private consumption	111.9	66.6	2.4	2.4	2.5	1.8	-1.0	1.6	-2.8	-0.7
Public consumption	35.8	21.3	2.4	2.4	0.5	0.8	2.9	3.0	-6.8	-1.3
Gross fixed capital formation	32.7	19.4	2.0	2.0	2.6	-1.8	-11.9	-4.1	-3.2	-0.4
of which : equipment	10.1	6.0	3.4	3.4	7.9	3.7	-14.4	-3.0	-3.4	0.6
Exports (goods and services)	46.9	27.9	5.9	5.9	7.6	-0.3	-11.8	9.1	5.6	6.4
Imports (goods and services)	59.7	35.5	6.0	6.0	5.5	2.8	-10.9	5.8	-3.2	1.5
GNI (GDP deflator)	162.4	96.6	2.0	2.0	2.2	-0.3	-2.5	1.1	-1.2	0.7
Contribution to GDP growth :										
Domestic demand			2.6	2.6	2.3	0.9	-2.7	0.9	-4.0	-0.8
Inventories			0.2	0.2	-0.1	0.3	-0.6	-0.1	0.0	0.0
Net exports			-0.6	-0.6	0.2	-1.2	0.8	0.5	3.0	1.6
Employment			0.5	0.5	0.0	0.5	-2.6	-0.9	-0.7	-0.3
Unemployment rate (a)			5.9	5.9	8.1	7.7	9.6	10.5	11.1	11.2
Compensation of employees/head			6.0	6.0	3.6	2.7	3.6	1.7	-1.3	0.7
Unit labour costs whole economy			4.2	4.2	1.2	3.1	3.5	-0.5	-1.1	-0.4
Real unit labour costs			0.1	0.1	-1.6	1.1	3.3	-1.2	-2.3	-1.4
Savings rate of households (b)			-	-	-	7.8	11.0	10.5	9.9	10.2
GDP deflator			4.1	4.1	2.8	2.0	0.2	0.7	1.3	1.0
Harmonised index of consumer prices			3.6	3.6	2.4	2.7	-0.9	1.4	2.3	1.3
Terms of trade of goods			0.4	0.4	0.4	-2.2	5.1	-1.8	0.2	-0.4
Trade balance (c)			-10.3	-10.3	-10.9	-12.9	-10.1	-10.8	-8.5	-7.6
Current account balance (c)			-7.8	-7.8	-10.2	-12.5	-10.4	-10.7	-8.0	-6.7
Net lending(+) or borrowing(-) vis-à-vis ROW (c)			-5.6	-5.6	-8.9	-11.0	-9.3	-9.5	-6.7	-5.3
General government balance (c)			-3.9	-3.9	-2.8	-2.9	-9.3	-7.3	-4.9	-5.1
Cyclically-adjusted budget balance (c)			-4.0	-4.0	-3.1	-3.0	-8.2	-6.7	-3.8	-4.3
Structural budget balance (c)			-	-	-3.2	-3.8	-8.0	-8.3	-4.1	-4.3
General government gross debt (c)			55.0	55.0	62.7	65.3	76.1	82.8	88.8	92.4

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.