21. PORTUGAL

Gradual and shallow recovery

Impact of the crisis and policy response in 2009

Since the early 2000s, Portugal has been recording weak economic growth below the euro-area average. This has been characterised by persistently low productivity, eroded competitiveness, rising unemployment and a sizeable external deficit. The current crisis has exacerbated these weaknesses and some of those imbalances are being corrected only slowly and partially. Under the impact of the international crisis, GDP began to fall already in late 2008, reversing the earlier mild upward trend. Annual GDP stagnated. In 2009, GDP is projected to contract by nearly 3%, with all its components falling, barring government consumption. Exports, imports and investment are contracting most, by over double-digit figures, while the fall in private consumption is relatively contained.

The policy response to the crisis has consisted mainly of the implementation of discretionary measures to stimulate the economy, together with the pursuit of structural reforms. The fiscal stimulus – focused on public investment, social protection and support to employment, investment and exports by the private sector – has amounted to about 1¼% of GDP in 2009. Some other fiscal measures include support to households and firms as well as a cut of one point in the standard VAT rate already in mid-2008. At the same time, while the direct impact of the financial crisis on the Portuguese banking sector has been relatively contained, a series of measures have been implemented to strengthen financial stability. Against this backdrop, the challenge is to put the Portuguese economy on a footing of higher and sustained long-term GDP growth, while restoring competitiveness. These are necessary conditions for a sustained reduction of the large external deficit.

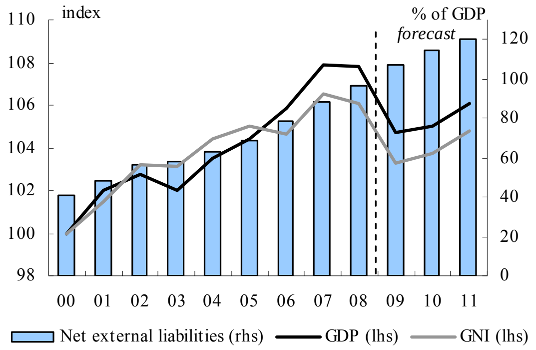
Mild recovery over the forecast period

The current outlook is one of stagnation of economic activity in 2010, to be followed by a moderated upswing in 2011, with GDP growing by 1%. Domestic demand is projected to essentially stagnate in 2010, mirroring a mild recovery of private consumption and still shrinking investment. However, growth in investment is set to turn moderately positive, thus pushing domestic demand to increase more significantly in 2010.

Sluggish labour income, with the unemployment rate reaching historical highs is expected to lead private consumption to be relatively weak in 2011. In addition, after a trough in interest rates, the burden of servicing the relatively high level of household debt will dampen disposable income. At the same time, access to credit remains more difficult than in the past as the result of tighter credit conditions imposed by financial institutions, in the context of high household indebtedness. The saving rate of households is expected to remain at around 8% of gross disposable income, higher than the rates recorded in recent years.

Investment is projected to keep falling in 2010 and to recover mildly in 2011. Against still weak demand prospects and dampened profitability, few incentives will exist for investment. In addition, the coming years are expected to be characterised by the consolidation of corporate balance sheets as average credit conditions are likely to be stricter than before, which will trigger some deleveraging and limit the room for private investment.

Graph II.21.1: **Portugal - Net external liabilities, GDP and GNI**



The present outlook for domestic demand is subject to a number of interrelated uncertainties. On the one hand, the recent fall in interest rates could relieve debt service burdens for both households and corporations still well into 2010. And the record low inflation rates could underpin real disposable income growth more than assumed in the current outlook. On the other hand, subdued employment prospects, and especially the possibility of a rise in long-term unemployment, might damage confidence and lead to a further rise in household savings. Last but not least, given the large borrowing needs of the Portuguese economy, mirroring the large external deficit, the pace of domestic spending and savings will crucially depend on the financial conditions that prevail in the future.

Exports are projected to follow the external demand recovery, which is expected to be shallow given the rather bleak outlook for imports by the country's main trading partners, notably Spain, which accounts for around a quarter of Portuguese exports. In addition, an expected deterioration in competitiveness will limit the rebound in exports in the medium term. The contraction in imports is expected to be smaller in 2010. Imports are expected to grow in 2011, largely following the path of final demand. All in all, the contribution of net exports to GDP growth is forecast to remain positive, while declining in both 2010 and 2011.

Unemployment continues to raise challenges for labour market functioning

The crisis keeps weighing on employment, which is projected to shrink by nearly ½% in 2010, after a significant contraction of 2¼% this year. In 2010 and 2011, the unemployment rate may reach some 9¼%, the highest rate in decades. Yet the increase in the unemployment rate is expected to be dampened by the fall in labour participation. Wage moderation is expected to follow but only in a gradual way.

External deficit remains large...

With the crisis the current account deficit is set to fall from 12% of GDP in 2008 to 10% of GDP in 2009. But the correction is not expected to continue over the medium term. The trade balance, affected by a weak exports performance and a rebound in commodities prices, is expected to hinder any further improvements in 2010 and 2011. Overall, this unsustainable external deficit path highlights the insufficiency of the domestic savings and the competitiveness position.

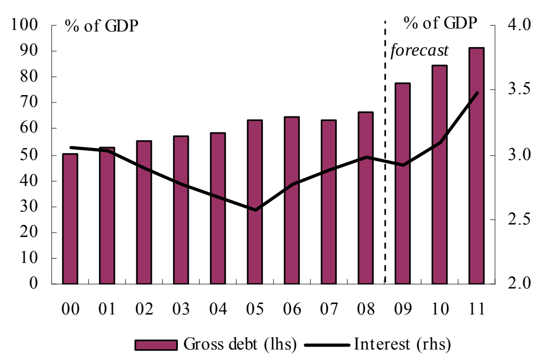
The long period of large external deficits has added to net external liabilities that have now reached 100% of GDP. The servicing of these liabilities will continue to absorb a non-negligible share of income over the medium term, mirrored in the deficit in the primary income balance. The primary income deficit is already a major component of the current account as well as an element of rigidity in the narrowing of the overall external deficit. As a result, the gap between the gross domestic product and gross national income remains large.

...while productivity growth remains sluggish...

Thus, addressing the external imbalance hinges upon a sustained recovery in the trade balance, which depends on the competitive position of the country. Productivity growth in Portugal has been sluggish during the last decade, partly on account of labour market rigidities such as high employment protection and insufficient human capital accumulation. These weaknesses have led to a further widening of the large productivity gap with respect to the euro-area. Measured productivity is projected to grow by just over ¾% on average in 2010/2011, thus remaining below the euro-area average. From a longer term perspective, the challenge is to lift productivity growth in a sustained way, which will support competitiveness as well as boosting potential GDP growth.

Cost competitiveness developments also reflect inadequate wage and price behaviour, including also the weak response of wages to productivity and labour market developments. After growing strongly in 2009, nominal compensation per employee is projected to decelerate to 2% in 2010 and 2011, above productivity growth. Furthermore, combined productivity and wage developments are expected to lead to higher unit labour costs growth than in most of the country's main trading partners, thereby hampering the potential of the external sector to contribute more to the recovery in overall economic activity.

Graph II.21.2: **Portugal - Government debt**



After a fall in the price level in 2009, inflation is projected to return to positive territory reaching

1¼% in 2010 and 2011. Whereas, the prices of oil and other commodities have been a key driver of the negative inflation rate in 2009, they may create some inflationary pressures in 2010 and 2011. However, sluggish demand prospects are an offsetting factor. After a negative inflation differential with the euro area in 2008 and 2009, the gap may turn positive again in the years ahead.

...and public finances deteriorate

Public finances are strongly affected by the fall in economic activity. In 2009, the government deficit is expected to be 8% of GDP in 2009, after recording 2.7% of GDP in 2008.

Fiscal slippages in 2009 reflect the severity of the economic downturn. Notably, sharp falls in tax revenue are being recorded and, at the same time, a rocketing expenditure-to-GDP ratio is expected given the fall in nominal GDP coupled with a marginal acceleration in underlying spending. The upswing in spending is the result of higher increases in nominal government wages and social benefits outlays when compared with earlier years, as well as of the customary anti-cyclical behaviour of a number of social transfers. In addition, discretionary measures taken largely in response to the downturn and amounting to around 1½% of GDP in 2009 are weighing further on the budgetary position.

On the basis of unchanged policies, the government deficit is expected to remain largely stable in 2010 and to rise to 8¾% of GDP in 2011. Although the assumed reversal in 2010 of most of the 2009 temporary fiscal expansion measures, as announced in the January 2009 update of the Stability Programme, will relieve some pressure from public finances, the sluggish pace of economic activity will not help narrow the fiscal imbalance. It is not only government revenue that is hurt by the downturn: expenditure too is expected to grow in excess of the sluggish nominal GDP over the entire forecast period.

With high deficits and continued low GDP growth, government debt is rising rapidly, and may reach as much as 91% of GDP in 2011, up from 66% of GDP in 2008. High government debt ratios, coupled with an assumed rebound in interest rates, should lead to a fast increase in interest spending, which is already a major force behind the projected deficit increase in 2011.

Table II.21.1:

Main features of country forecast - PORTUGAL

		2008			Annual percentage change					
	bn Euro	Curr. prices	% GDP	92-05	2006	2007	2008	2009	2010	2011
GDP		166.4	100.0	2.2	1.4	1.9	0.0	-2.9	0.3	1.0
Private consumption		110.7	66.5	2.5	1.9	1.6	1.7	-0.9	0.6	0.7
Public consumption		34.5	20.7	2.7	-1.4	0.0	0.7	1.7	0.7	0.7
Gross fixed capital formation		36.1	21.7	2.2	-0.7	3.1	-0.7	-15.2	-4.1	1.1
of which : equipment		12.2	7.3	3.0	6.6	8.1	4.6	-21.7	-6.8	0.6
Exports (goods and services)		54.9	33.0	5.3	8.7	7.8	-0.5	-14.0	0.7	3.3
Imports (goods and services)		70.8	42.5	5.8	5.1	6.1	2.7	-13.7	-0.2	2.2
GNI (GDP deflator)		159.7	96.0	2.1	-0.3	1.7	-0.4	-2.7	0.4	1.1
Contribution to GDP growth :	Domestic demand			2.7	0.8	1.8	1.1	-3.5	-0.2	0.8
	Stockbuilding			0.2	0.1	0.1	0.3	-0.6	0.3	0.1
	Foreign balance			-0.7	0.6	0.0	-1.2	1.2	0.3	0.1
Employment				0.5	0.5	0.0	0.4	-2.3	-0.4	0.1
Unemployment rate (a)				5.8	7.8	8.1	7.7	9.0	9.0	8.9
Compensation of employees/head				6.3	2.1	3.4	3.1	4.7	2.0	2.0
Unit labour costs whole economy				4.5	1.3	1.4	3.6	5.4	1.2	1.0
Real unit labour costs				0.3	-1.5	-1.5	1.5	4.9	0.4	-0.6
Savings rate of households (b)				-	-	6.1	6.4	8.6	7.8	7.8
GDP deflator				4.2	2.8	3.0	2.1	0.5	0.8	1.6
Harmonised index of consumer prices				3.7	3.0	2.4	2.7	-1.0	1.3	1.4
Terms of trade of goods				0.4	0.4	1.5	-2.3	2.2	-1.4	-0.2
Trade balance (c)				-9.9	-10.1	-10.1	-12.1	-9.5	-9.7	-9.7
Current account balance (c)				-7.4	-10.4	-9.8	-12.1	-10.2	-10.2	-10.2
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-5.1	-9.3	-8.5	-10.3	-8.5	-8.6	-8.6
General government balance (c)				-4.0	-3.9	-2.6	-2.7	-8.0	-8.0	-8.7
Cyclically-adjusted budget balance (c)				-4.0	-3.6	-2.8	-2.6	-6.6	-6.7	-7.5
Structural budget balance (c)				-	-3.6	-3.0	-3.5	-6.6	-6.7	-7.5
General government gross debt (c)				56.1	64.7	63.6	66.3	77.4	84.6	91.1

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