16. PORTUGAL

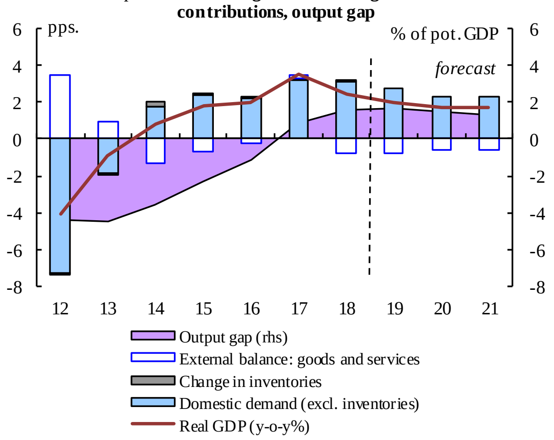
Buoyant investment supports growth

Economic growth is expected to moderate from 2.4% in 2018 to 2.0% in 2019 and 1.7% in both 2020 and 2021, driven by buoyant investment but weighed down by foreign trade. The general government headline balance and debt-to-GDP ratio are expected to continue benefiting from economic growth and favourable financing conditions. The structural balance is forecast to slightly improve in 2019 and remain broadly unchanged thereafter.

Growth surprises on the upside

Economic growth exceeded expectations in the first half of 2019 despite the weak external environment. GDP rose by 0.6% (q-o-q) in each of the first two quarters of the year, setting up a more favourable outlook for the whole year. The expected pace of moderation forecast in the summer, however, still looks likely, although it would now begin from a higher base. Taking into account the recent weakness in high frequency indicators and a further deterioration in external demand, GDP growth in Portugal is now forecast to moderate further from 2.4% in 2018 to 2.0% in 2019 and 1.7% in both 2020 and 2021.

Graph II.16.1: **Portugal - Real GDP growth and contributions, output gap**



Domestic demand is expected to remain a strong contributor to growth in 2019 due to a substantial rebound in investment in the first quarter of the year. Both private consumption and investment are projected to remain the major growth drivers in 2020-2021, albeit at a diminishing pace. The expected moderation in private consumption is linked to the recent slowdown in job creation. Investment is facing a decline in business sentiment, particularly in the industrial sector, but looks set to benefit from the absorption of EU funding over the forecast horizon. On the supply side, the strong performance in services and construction should continue to offset the weak industrial performance.

Imports outpace exports

In 2019, imports are projected to increase much faster than exports for the second year in a row. This is mainly due to strong investment demand and is set to continue over the forecast horizon, triggering a significant deterioration in the country's external balance. The current account balance has been revised upwards for the last several years, but is set to worsen from a surplus of 0.1% of GDP in 2018 to a deficit of around 1% by 2021. This reflects a significant widening in the deficit for trade in goods, which is set to be only partly offset by primary and secondary income where the net flows are expected to benefit from lower interest payments to foreign creditors and higher receipts from EU structural funds. Trade in services is set to retain a stable surplus of around 8% of GDP throughout the whole forecast period, thanks to the strong performance in tourism.

Employment growth slows

Employment growth has slowed down and wage growth picked-up since the beginning of 2019, as the slack in the labour market has declined substantially. This is expected to have a positive impact on labour productivity and to slightly weaken the growth in unit labour costs over the forecast horizon. The unemployment rate is forecast to decrease at a moderate pace to 5.6% by 2021 with services and construction being the major contributors to job creation.

Inflation drops substantially

Annual HICP inflation dropped from 1.2% in 2018 to -0.3% in the third quarter of 2019. The downturn reflects a significant decline in energy prices, including different regulatory components of electricity tariffs, as well as lower prices of other administrative services such as public transport and telecommunications. In addition, core inflation has been contained by a continuous decline in the prices of industrial goods and a temporary drop in accommodation prices. Inflation is forecast to reach an annual average of 0.3% in 2019 and to increase somewhat in the coming years with core inflation staying slightly above the headline rate.

Public finances benefit from resilient domestic demand and favourable financing conditions

The general government headline deficit is projected to decrease to 0.1% of GDP in 2019, helped by still buoyant cyclical revenue, decreasing interest expenditure and lower-than-budgeted public investment. It is, however, negatively impacted by a further activation of the Novo Banco contingent capital mechanism (0.6% of GDP). Excluding this and other one-offs, the government balance is set to reach a surplus of 0.5% of GDP. As a result, the structural balance is projected to improve by about ¼% of GDP in 2019, while the structural primary balance is expected to remain broadly unchanged.

Under a no-policy-change assumption, and in the absence of a fully-fledged Draft Budgetary Plan for 2020 (due to the recent general elections), the headline balance is projected to improve to 0.0% of GDP in 2020. At the same time, the headline balance net of one-offs (mainly a further deficit-increasing impact of 0.3% of GDP from the Novo Banco contingent capital mechanism) is set to remain broadly unchanged at a surplus of 0.4% of GDP. As the deficit-increasing carry-over impact of past discretionary fiscal policy measures is projected to be roughly offset by further savings in interest expenditure, the structural balance is projected to remain broadly stable in 2020. The headline balance is set to improve to 0.6% of GDP in 2021 while the structural balance is set to remain broadly unchanged. The structural primary balance is forecast to worsen by about ½% of GDP over the forecast horizon. Risks are tilted to the downside, linked to uncertainties surrounding the macroeconomic outlook and the potential further impact of bank support measures.

The public debt-to-GDP ratio is set to continue declining from 122.2% in 2018 to 119.5% in 2019, 117.1% in 2020 and 113.7% in 2021, mainly due to continuous primary surpluses and favourable growth–interest rate differentials.

Table II.16.1:

Main features of country forecast - PORTUGAL

	2018		Annual percentage change						
bn EUR	Curr. prices	% GDP	00-15	2016	2017	2018	2019	2020	2021
GDP	203.9	100.0	0.4	2.0	3.5	2.4	**2.0**	**1.7**	**1.7**
Private Consumption	132.2	64.8	0.6	2.6	2.1	3.1	**2.3**	**2.0**	**1.9**
Public Consumption	34.6	17.0	0.7	0.8	0.2	0.9	**0.8**	**0.8**	**0.8**
Gross fixed capital formation	35.8	17.6	-2.5	2.5	11.5	5.8	**6.5**	**4.8**	**5.0**
of which: equipment	11.7	5.7	-0.7	8.0	12.4	7.5	**6.5**	**5.6**	**6.0**
Exports (goods and services)	88.7	43.5	4.1	4.4	8.4	3.8	**2.7**	**2.7**	**2.8**
Imports (goods and services)	88.6	43.4	2.2	5.0	8.1	5.8	**4.6**	**3.9**	**4.0**
GNI (GDP deflator)	199.4	97.8	0.3	2.3	3.6	2.6	**2.1**	**1.9**	**1.9**
Contribution to GDP growth: Domestic demand			0.0	2.2	3.2	3.1	**2.8**	**2.3**	**2.3**
Inventories			-0.1	0.0	0.1	0.1	**0.0**	**0.0**	**0.0**
Net exports			0.5	-0.2	0.2	-0.8	**-0.8**	**-0.6**	**-0.6**
Employment			-0.5	1.6	3.3	2.3	**1.0**	**0.5**	**0.5**
Unemployment rate (a)			10.1	11.2	9.0	7.0	**6.3**	**5.9**	**5.6**
Compensation of employees / head			2.1	1.2	2.3	2.5	**3.2**	**2.8**	**2.8**
Unit labour costs whole economy			1.2	0.8	2.1	2.4	**2.2**	**1.7**	**1.6**
Real unit labour cost			-0.9	-0.9	0.6	0.8	**0.8**	**0.1**	**-0.1**
Saving rate of households (b)			9.8	7.0	6.6	6.5	**6.6**	**6.7**	**6.7**
GDP deflator			2.1	1.7	1.5	1.6	**1.4**	**1.5**	**1.6**
Harmonised index of consumer prices			2.1	0.6	1.6	1.2	**0.3**	**1.1**	**1.4**
Terms of trade goods			0.2	0.9	-1.1	-0.3	**0.0**	**-0.2**	**-0.2**
Trade balance (goods) (c)			-9.8	-5.5	-7.0	-7.9	**-8.7**	**-9.3**	**-9.9**
Current-account balance (c)			-7.0	0.6	1.0	0.1	**-0.4**	**-0.7**	**-1.0**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-5.5	1.5	1.8	1.2	**0.8**	**0.6**	**0.3**
General government balance (c)			-5.8	-1.9	-3.0	-0.4	**-0.1**	**0.0**	**0.6**
Cyclically-adjusted budget balance (d)			-5.3	-1.3	-3.4	-1.3	**-1.0**	**-0.8**	**-0.1**
Structural budget balance (d)			-	-1.7	-1.4	-0.6	**-0.4**	**-0.4**	**-0.4**
General government gross debt (c)			89.0	131.5	126.0	122.2	**119.5**	**117.1**	**113.7**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.