Economic activity is projected to fall sharply in 2020 due to the impact of the COVID-19 pandemic. The economy is expected to rebound strongly after the initial shock but in some sectors, particularly tourism, the aftershocks are expected to linger. The labour market is projected to suffer both temporary and medium-term setbacks. The pandemic is expected to take a temporary toll on public finances, which will be called to provide significant stabilisation in 2020 before improving again in 2021.

**Economic outlook changes abruptly**

Portugal’s economy had been performing strongly up until the end of February 2020, but the economic situation changed dramatically in March when the COVID-19 pandemic hit. Authorities announced containment measures on 12 March and a state of emergency on 18 March with further restrictions on mobility. Many businesses suspended operations with tourism being the hardest hit. The Commission’s economic sentiment indicator deteriorated strongly in March. Service providers reported the largest decline, while construction firms were the least affected. All in all, after growing by 2.2% in 2019, the economy is now projected to contract by 6¾% in 2020 and to rebound by 5¾% in 2021. As a result, GDP is projected to remain below its 2019 levels well into 2021. Risks are tilted to the downside, given Portugal’s reliance on foreign tourism.

Domestic demand is expected to contract substantially in 2020. Private consumption is projected to drop at a slightly lower rate than GDP as policy measures partly offset household income losses. Investment in equipment is expected to be the hardest hit due to lingering uncertainty and disruptions to global supply chains. At the same time, investment in construction is expected to be more resilient, benefitting from the cycle and the newly introduced flexibility in EU funds.

Both exports and imports are projected to drop at double digit rates in 2020 and to recover substantially in 2021. Exports are set to decrease relatively more, in light of the sizeable revenues Portugal typically earns from foreign tourists (about 8.7% of GDP in 2019) and targeted social distancing measures affecting services over the second half of 2020. Still, the strong drop in equipment investment and durable goods consumption weighs down on imports and should partly offset the fall in exports. In nominal terms, the trade balance is also expected to benefit from the drop in oil prices keeping the overall current account at a relatively small deficit.

**Unemployment set to rise sharply in 2020**

The sudden drop in economic activity in March 2020 led to a significant increase in unemployment registrations, despite the significant job-support measures enacted. Many of the job cuts are likely to be temporary, but the expected slow recovery in tourism and related services is likely to have a negative impact on labour demand over a longer period. The unemployment rate is therefore set to rise from 6.5% in 2019 to about 9½% in 2020 before improving to around 7½% in 2021. Labour income will also be affected by reduced working hours in 2020, which imply lower productivity per employee.

**Inflation to remain low**

In 2019, annual headline inflation remained low at 0.3%, mainly driven by a significant decline in energy prices. The negative contribution of energy prices is expected to be even more pronounced in 2020. At the same time, the government’s containment measures and the subsequent limits to the supply of labour and production capacities may generate inflationary pressures in certain goods, such as food and healthcare products. However, downward pressures are expected to prevail and
inflation is set to be slightly negative in 2020. Owing to the economic recovery in 2021, inflation is projected to pick up modestly to 1.2%.

**Public finances to worsen in view of COVID-19**

The general government headline balance turned into a surplus of 0.2% of GDP in 2019, helped by strong revenue performance (especially in social contributions and indirect taxes) and continuously decreasing interest expenditure. Excluding the impact of a further activation of the Novo Banco contingent capital mechanism (of 0.5% of GDP last year) and other one-offs, the general government balance would have reached a surplus of 0.8% of GDP in 2019.

It is expected that the economic and social consequences of the COVID-19 pandemic will cause a sizeable deterioration in the general government balance in 2020, reflecting the operation of the automatic stabilisers and the need for significant fiscal policy support. The government adopted fiscal policy measures to reinforce the response capacity of the health system, protect jobs, provide social support and safeguard firms’ liquidity, with an estimated overall direct budgetary cost of around 2½% of GDP. As a result, a general government deficit of 6½ of GDP is projected this year. This deterioration is driven by increases in most expenditure items (particularly subsidies and social transfers), as well as decreases in current revenue reflecting a strong contraction in the relevant tax bases.

Under a no-policy-change assumption, the deficit is projected to decrease swiftly in 2021, on the back of the expected economic recovery and the phasing-out of fiscal policy measures taken to tackle the pandemic. Risks to the budgetary forecast are tilted to the downside, linked to uncertainties surrounding the country’s epidemic curve and the persistence of its economic and social effects, as well as the surge in public contingent liabilities on top of non-negligible pre-existing levels partly related to potential further fiscal impacts of additional bank support measures.

The general government debt ratio continued to decline to 117.7% of GDP in 2019. It is now set to increase to 131½% of GDP in 2020 before resuming its decreasing path in 2021, when it is set to drop to 124½% of GDP.