22. PORTUGAL

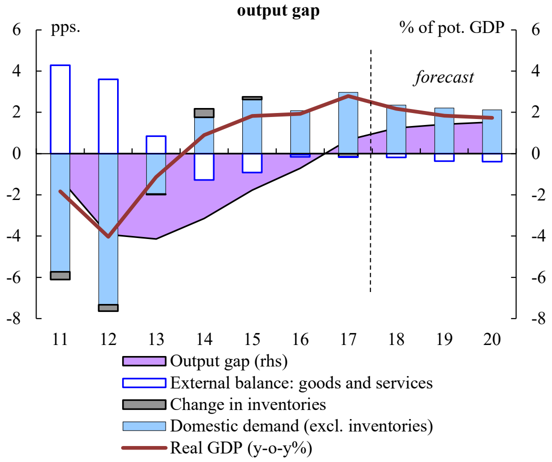
Slower growth in the face of external challenges

Domestic demand remains strong but GDP growth in Portugal is expected to slow down in 2019 and 2020 as net exports weaken. Job creation is also set to weaken amid some improvement in labour productivity. The general government deficit is expected to remain below 1% over the forecast horizon while the structural balance, following some improvement in 2018, is forecast to remain broadly stable thereafter. The gross public debt-to-GDP ratio is set to continue decreasing to around 117% by 2020.

Economic growth to ease in coming years

Real GDP in Portugal rose by 2.3% (y-o-y) over the first half of 2018, mainly driven by strong domestic demand and in line with the summer interim forecast. The Commission's Economic Sentiment Indicator eased further in the third quarter but still remains above its long-term average. Industrial production and foreign trade confirmed the soft patch, while retail trade remained robust. GDP growth is forecast to moderate somewhat in the second half of the year mainly because of the slowdown in external demand. Overall, GDP is now forecast to grow by 2.2% this year, down from 2.8% in 2017.

Graph II.22.1: **Portugal - Real GDP growth and contributions, output gap**



The moderation in job creation points to some slowdown in household demand, which would be only partly offset by the expected increase in wage growth. Private consumption growth is therefore forecast to weaken slightly in 2019 and 2020. The household saving rate, which deteriorated in 2018-Q2 amid further improvements in the financial situation of households and still very low interest rates, is expected to remain stable. Investment is set to rebound in 2019, as the implementation of certain projects supported by EU structural funds scheduled for 2018 were postponed. Net external trade is expected to continue to weigh on growth, reflecting weaker export demand and strong import growth in line with final demand. GDP growth is forecast to slow to 1.8% in 2019 and to 1.7% in 2020. Risks to the forecast appear broadly balanced as the uncertainty in external markets could be compensated by a more positive performance in domestic demand.

External balance worsens

The external balance has deteriorated somewhat since the start of the year, influenced by weaker-than-expected exports of goods and a slowdown in tourism. Oil prices have also adversely affected terms of trade and thus the nominal trade balance. Imports are set to continue outperforming exports, resulting in some deterioration in the current account balance. Larger dividend payments to foreign shareholders put additional pressure on the current account while the projected increase in absorption of EU structural funds and lower interest costs for domestic borrowers are having a positive impact.

Employment growth moderates

Employment growth moderated somewhat in the summer months of 2018 and monthly unemployment stabilised at rates close to the euro area average. Employment growth is projected to moderate further, reflecting increasing signs of supply constraints in some market segments and the maturing economic cycle. Accordingly, the average annual rate of unemployment is set to decrease at a slower pace to 6.3% in 2019 and 5.9% in 2020. This is set to spur labour productivity while wages are projected to gradually accelerate, supported by the unfreezing of career progressions in the public sector and a reduction in labour market slack.

Inflation remains low

Despite the increase in energy prices, the annual rate of inflation is forecast to remain relatively low at 1.5% in 2018 before creeping up to 1.6% in 2019 and 2020. Apart from the impact of energy markets, inflation experienced significant volatility in 2018 driven by accommodation prices, due to calendar effects as well as methodological changes affecting the time horizon of hotel bookings. Core inflation remained below the overall average in 2018 but the situation is expected to gradually reverse over the forecast period, as service prices are expected to pick up in line with more dynamic wage developments. House prices meanwhile rose by 11.2% (y-o-y) in the second quarter of 2018 but are set to slow down over the forecast horizon due to moderate supply growth.

Public finances benefitting from domestic demand and lower interest expenditure

The general government headline deficit is projected to decrease to 0.7% of GDP in 2018, helped by higher cyclical-related revenue, decreasing interest expenditure and lower-than-budgeted public investment but negatively impacted by the activation of the Novo Banco contingent capital mechanism (0.4% of GDP). Excluding this and other one-off operations, the deficit net of one-offs is set to improve to 0.3% of GDP. The structural balance is projected to improve by about ¼ pps. of GDP. The headline deficit is set to decrease to 0.6% of GDP in 2019 while the deficit net of one-offs is set to improve to 0.2% of GDP. As the impact of discretionary measures, savings in interest expenditure and higher property income is expected to be broadly neutral in 2019, the structural balance is projected to remain broadly stable. Under a no-policy-change assumption, the headline deficit is set to improve to 0.2% of GDP in 2020 while the structural balance is set to remain broadly unchanged. The structural primary balance is forecast to worsen by about ¼ pps. of GDP over the forecast horizon. Risks to the fiscal outlook are tilted to the downside, linked to uncertainties surrounding the macroeconomic outlook and the potential further deficit-increasing impact of banking support measures.

After falling by 4.5 pps. to 124.8% in 2017, the gross public debt-to-GDP ratio is forecast to further decline to 121.5% in 2018, 119.2% in 2019 and 116.8% in 2020, mainly due to primary budget surpluses and high nominal GDP growth.

Table II.22.1:

Main features of country forecast - PORTUGAL

		2017			Annual percentage change					
		bn EUR Curr. prices	% GDP	99-14	2015	2016	2017	2018	2019	2020
GDP		194.6	100.0	0.5	1.8	1.9	2.8	**2.2**	**1.8**	**1.7**
Private Consumption		126.2	64.8	0.7	2.3	2.4	2.3	**2.3**	**2.0**	**1.8**
Public Consumption		34.0	17.5	0.8	1.3	0.8	0.2	**0.9**	**0.7**	**0.5**
Gross fixed capital formation		32.3	16.6	-2.5	5.8	2.3	9.2	**4.4**	**4.7**	**5.1**
of which: equipment		11.1	5.7	-0.9	10.4	7.5	13.5	**7.0**	**7.8**	**8.5**
Exports (goods and services)		83.1	42.7	4.0	6.1	4.4	7.8	**5.5**	**4.3**	**3.6**
Imports (goods and services)		81.5	41.9	2.3	8.5	4.7	8.1	**6.0**	**5.2**	**4.4**
GNI (GDP deflator)		190.4	97.8	0.5	0.7	2.4	2.9	**2.2**	**2.0**	**1.9**
Contribution to GDP growth:	Domestic demand			0.2	2.6	2.1	3.0	**2.4**	**2.2**	**2.1**
	Inventories			0.0	0.1	-0.1	0.0	**0.0**	**0.0**	**0.0**
	Net exports			0.4	-0.9	-0.1	0.0	**-0.2**	**-0.4**	**-0.4**
Employment				-0.5	1.4	1.6	3.3	**2.2**	**1.3**	**0.8**
Unemployment rate (a)				9.7	12.6	11.2	9.0	**7.1**	**6.3**	**5.9**
Compensation of employees / head				2.4	0.4	1.7	1.6	**1.8**	**2.1**	**2.1**
Unit labour costs whole economy				1.4	0.0	1.4	2.1	**1.8**	**1.6**	**1.2**
Real unit labour cost				-0.8	-2.0	-0.3	0.5	**0.4**	**0.1**	**-0.4**
Saving rate of households (b)				8.9	5.3	5.0	4.7	**4.6**	**4.7**	**4.6**
GDP deflator				2.2	2.0	1.8	1.5	**1.4**	**1.5**	**1.5**
Harmonised index of consumer prices				2.3	0.5	0.6	1.6	**1.5**	**1.6**	**1.6**
Terms of trade goods				0.0	2.7	1.0	-0.9	**-0.3**	**0.2**	**0.2**
Trade balance (goods) (c)				-9.7	-4.5	-4.3	-5.4	**-6.0**	**-6.5**	**-6.9**
Current-account balance (c)				-7.9	-0.9	0.1	0.2	**0.0**	**-0.1**	**-0.1**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-6.3	0.3	1.0	1.1	**0.9**	**0.8**	**0.8**
General government balance (c)				-5.5	-4.4	-2.0	-3.0	**-0.7**	**-0.6**	**-0.2**
Cyclically-adjusted budget balance (d)				-5.2	-3.5	-1.6	-3.3	**-1.4**	**-1.3**	**-1.0**
Structural budget balance (d)				-	-2.3	-2.1	-1.3	**-0.9**	**-0.9**	**-1.0**
General government gross debt (c)				80.3	128.8	129.2	124.8	**121.5**	**119.2**	**116.8**

(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.