21. PORTUGAL

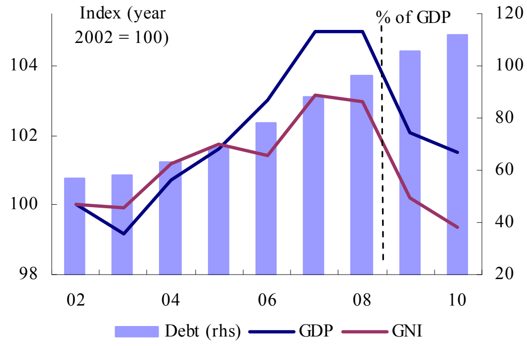
Protracted downturn

Mild upturn fades in 2008

Since the beginning of 2008, economic activity in Portugal has been weak, characterised by a sharp slowdown between the second half of 2007 and the first half of 2008. This was the result of cooling investment, notably in the construction sector, and weak exports. Private consumption remained more or less resilient for most of 2008, but decelerated towards the end of the year. In the final quarter of the year, the downturn became more acute and broad based, and activity contracted significantly. For the year of 2008 as a whole, GDP stagnated.

More fundamentally, the 2008 outturn contrasts visibly with 2007. This is due not only to the interruption in the mild GDP growth upturn (of almost 2% in 2007) but also to the worsening of macroeconomic imbalances. In particular, the contribution of the external sector to GDP growth became again negative as the rebalancing of GDP growth away from domestic demand and towards external demand clearly faded away. Accordingly, the high external deficit deteriorated further, aggravated by soaring commodity prices in 2008, augmenting the stock of external liabilities. These developments compounded the impact on the external position of a domestic demand which had been relatively dynamic for a number of earlier years and an eroded competitiveness position. The latter reflects, inter alia, sluggish productivity growth, cost and prices developments above those of Portugal's main trading partners and increased competition from emerging economies in labour-intensive goods. Looking forward, these features constrain the resilience of the economy to the ongoing crisis.

Graph 2.21.1: **Portugal - Net external debt, GDP and GNI**



Hard times to come

Against the backdrop of the financial crisis and a marked recession in trading partners, GDP is expected to fall by 3¾% in 2009. These adverse shocks are projected to have lasting effects, with activity forecast to contract further, by ¾%, in 2010.

Private consumption is expected to show a downward trend over the forecast years. This mainly reflects sluggish labour income, with the unemployment rate reaching historical highs, as well as an increase in precautionary savings in times of exceptional uncertainty. The assumed interest rate increase in 2010 will dampen disposable income in the light of the relatively high debt ratios and thus hamper household spending.

Investment is forecast to fall markedly. Against a backdrop of uncertain and gloomy demand prospects and dampened profitability, few incentives exist to add to or even replace production capacity. In addition, the coming years are expected to be characterised by the consolidation of corporate balance sheets since average credit conditions are likely to be stricter than before, which should trigger some deleveraging and limit the room for private investment. Government investment is expected to grow markedly in 2009 thanks to the fiscal package adopted in late 2008 for 2009 in the context of the EERP.

Unsurprisingly, exports are expected to be significantly affected by strongly falling external demand. Imports should also diminish sharply due to falling final domestic demand. Overall, the contribution of the external sector to GDP growth is expected to turn positive over the forecast period. The balance of goods should improve somewhat in 2009 mainly thanks to plummeting commodities prices. Nevertheless, in the light of the assumed interest rate increases in 2010, the burden of servicing the high external debt should rebound upwards, thus aggravating the primary income deficit and hindering the narrowing of the external deficit or borrowing needs.

Crisis takes a toll on the labour market and curbs inflationary pressures

Lower levels of activity will translate into lower levels of employment and the unemployment rate could reach some 10% in 2010. Wage moderation is expected to follow these developments.

Inflation is projected to ease significantly in 2009 up to the point of turning even slightly negative thanks to a dramatic fall in energy and commodities prices. The non-energy component of inflation is set to cool, with the retrenchment of aggregate demand.

Public finances set to deteriorate significantly

In 2008, the general government deficit represented 2.6% of GDP, unchanged from 2007. The 2008 outturn benefited from deficit-reducing one-off measures worth over ¾% of GDP (similar measures yielded 0.1% of GDP in 2007). Here as well, 2008 contrasts clearly with 2007, when a marked reduction of the government deficit was recorded. In 2008, on the revenue side, tax inflows decelerated significantly, whereas on the spending side, the underlying growth rate was little changed from previous year, with the much lower nominal GDP growth rate leading to an increase in the expenditure-to-GDP ratio.

A significant deterioration of the fiscal balance is projected over the forecast period, with the government deficit expected to reach 6½% of GDP in 2009. This is the result of the heavy toll imposed on public finances by the downturn, as well as a number of discretionary measures, including the fiscal impulse package implemented for 2009 in the context of the EERP, which involves an estimated fiscal cost of 0.8% of GDP (complemented in a balance-neutral way by 0.5% from EU funds). The package mainly targets an increase in public investment, reductions in social contributions and increases in subsidies to corporations and transfers to households. Despite the discontinuation of the fiscal package in 2010, no improvement in the fiscal position is expected for that year on a no-policy change scenario. This is the result of the continued recessionary environment and a marked growth in interest expenditure.

The government debt ratio is projected to grow over 81% of GDP by 2010 due to high government deficits and stagnating nominal GDP. Possible operations to support the financial sector may put additional upward pressure on the debt ratio.

Table 2.21.1:

Main features of country forecast - PORTUGAL

		2007		Annual percentage change						
		bn Euro Curr. prices	% GDP	92-04	2005	2006	2007	2008	2009	2010
GDP at previous year prices		163.2	100.0	2.1	0.9	1.4	1.9	0.0	-3.7	-0.8
Private consumption		106.0	65.0	2.6	2.0	1.9	1.6	1.6	-1.3	-0.4
Public consumption		33.1	20.3	2.5	3.2	-1.4	0.0	0.5	0.6	0.2
Gross fixed capital formation		35.6	21.8	2.9	-0.9	-0.7	3.2	-1.1	-14.4	-8.0
of which : equipment		12.1	7.4	3.2	1.0	6.6	8.0	3.9	-17.2	-8.6
Exports (goods and services)		53.3	32.7	4.6	2.0	8.7	7.5	-0.5	-11.7	-0.1
Imports (goods and services)		65.3	40.0	5.5	3.5	5.1	5.6	2.1	-10.0	-2.3
GNI at previous year prices (GDP deflator)		157.0	96.2	2.1	0.5	-0.3	1.7	-0.2	-3.6	-1.1
Contribution to GDP growth :	Domestic demand			2.7	1.7	0.8	1.8	0.9	-3.9	-1.7
	Stockbuilding			0.1	-0.1	0.1	0.0	0.2	-0.2	0.1
	Foreign balance			-0.7	-0.7	0.6	0.1	-1.0	0.4	0.8
Employment				0.5	-0.3	0.5	0.0	0.4	-1.4	-0.6
Unemployment rate (a)				5.6	7.7	7.8	8.1	7.7	9.1	9.8
Compensation of employees/head				6.0	4.7	2.1	3.3	3.1	-0.6	2.1
Unit labour costs whole economy				4.3	3.4	1.3	1.4	3.6	1.7	2.3
Real unit labour costs				-0.3	0.8	-1.5	-1.6	1.7	-0.5	0.7
Savings rate of households (b)				-	-	8.1	6.2	6.5	10.2	10.6
GDP deflator				4.5	2.5	2.8	3.0	1.8	2.2	1.6
Harmonised index of consumer prices				3.8	2.1	3.0	2.4	2.7	-0.3	1.7
Terms of trade of goods				0.1	-1.2	0.4	1.5	-2.6	4.9	-0.1
Trade balance (c)				-9.6	-10.3	-10.1	-9.9	-11.9	-9.7	-9.1
Current account balance (c)				-6.3	-9.8	-10.4	-9.7	-11.9	-9.8	-9.5
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-4.0	-8.3	-9.3	-8.4	-10.2	-7.5	-7.4
General government balance (c)				-3.8	-6.1	-3.9	-2.6	-2.6	-6.5	-6.7
Cyclically-adjusted budget balance (c)				-3.8	-5.7	-3.8	-3.2	-3.0	-5.3	-5.1
Structural budget balance (c)				-	-5.5	-3.8	-3.3	-3.8	-5.5	-5.1
General government gross debt (c)				55.5	63.6	64.7	63.5	66.4	75.4	81.5

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