

OUTLOOK FOR THE PORTUGUESE ECONOMY: 2009-2011¹

1. INTRODUCTION

The outlook for the Portuguese economy over the projection horizon is marked by the gradual and moderate recovery of global activity, after the recent unprecedented recession which intensified at the end of 2008. In this context, the timely adoption of monetary and fiscal stimulus measures and policies aimed to support the financial system – in some cases in a coordinated way – was decisive to reduce volatility and the risk-aversion levels of economic agents, and contributed to limiting the contraction in economic activity, preventing a spiral of systemic effects potentially unfavourable for the global economy, and creating the conditions for a gradual recovery as of the second half of 2009. For 2010 and 2011 a high uncertainty and downward risks for the global economic activity remains. These risks are due to both the possible impact on demand of the unavoidable reversal of stimulus measures implemented by the authorities, and to the possible effects of the financial crisis on the equilibrium level of economic activity and on the economies' potential output growth dynamics.

A small open economy fully integrated in economic and financial terms like the Portuguese one tends to be strongly affected by these developments, wherefore prospects for economic growth in the 2009-2011 period should be interpreted in the light of this international framework. Moreover, the Portuguese economy has shown a number of structural fragilities, which have limited its potential growth

Table 1.1

PROJECTIONS OF BANCO DE PORTUGAL 2009-2011							
Rate of change, per cent							
	Weights 2008	EB winter 2009			EB autumn 2009	EB summer 2009	
		2009 ^(p)	2010 ^(p)	2011 ^(p)	2009 ^(p)	2009 ^(p)	2010 ^(p)
Gross domestic product	100.0	-2.7	0.7	1.4	-2.7	-3.5	-0.6
Private consumption	66.5	-0.9	1.0	1.6	-0.9	-1.8	-0.6
Public consumption	20.7	2.0	0.7	1.1	2.1	1.0	0.7
Gross fixed capital formation	21.7	-11.7	-3.4	0.9	-13.1	-14.3	-3.8
Domestic demand	109.6	-2.9	0.3	1.4	-3.0	-4.5	-0.7
Exports	33.0	-12.5	1.7	3.2	-13.1	-17.7	-0.9
Imports	42.5	-10.8	0.3	2.7	-11.7	-17.1	-1.2
Contribution to GDP growth (in p.p.)							
Net exports		0.5	0.4	-0.1	0.6	1.4	0.2
Domestic demand		-3.2	0.3	1.5	-3.3	-4.9	-0.7
of which: change in inventories		-0.5	0.1	0.0	-0.3	-0.8	0.2
Current+capital account (% of GDP)		-8.2	-9.8	-11.3	-8.6	-8.3	-9.6
Trade balance (% of GDP)		-6.5	-6.8	-7.0	-6.7	-6.5	-6.6
HICP		-0.9	0.7	1.6	-0.9	-0.5	1.3

Source: Banco de Portugal.

Notes: (p) - projected. The central projections for each aggregate are shown (considered to be its most likely value, depending on the range of assumptions in question). As described in Section 7, probability distributions assigned to the possible values of the aggregate may be asymmetrical. Therefore, the probability of observing a value below the central projections may be different from the probability of observing a value above the central projections.

(1) This section is based on data available up to mid-December. The assumptions underlying the international framework are based on figures up to 11 December 2009.

over the last decade, in a context of increased competition in international markets and growing integration of emerging market economies with a similar export pattern. Such fragilities are reflected on a limited growth of total factor productivity, which can hardly be disconnected to the low qualification level of the labour force. Furthermore, a low contribution of labour input to growth is likely to occur, as a result of the increasing structural unemployment, which will tend to persist in a context of weak buoyancy of demand and low labour market mobility, also conditioned by the human capital level. These fragilities, in parallel with the challenges posed by the new international financial framework stemming from the financial crisis, will tend to limit economic activity growth in the medium term. Against this background, Gross Domestic Product (GDP) is expected to increase by 0.7 per cent in 2010 and 1.4 per cent in 2011, after contracting by 2.7 per cent in 2009.

Underlying the present projection for economic activity in 2010 and 2011, on the supply side, is an increase in total factor productivity, after the fall observed in 2009. This trend reflects the usual contribution of cyclical factors during economic upturns, namely a reversion on the rate of installed capacity utilisation, as well as a more intensive use of labour force. On the demand side, the economic downturn in 2009 reflected, in addition to the continued markedly negative behaviour of investment and exports, a significant contraction of private consumption, in particular in the durables component. These developments of demand reflected, on the one hand, the significant tightening of financing conditions, which materialised in tightened credit standards applicable to new loans and an increase in risk premiums, against a background of rising default in some credit segments more exposed to cyclical conditions, notwithstanding the decline in money market interest rates. On the other hand, it reflected increased tension in financial markets, which has largely contributed to the collapse of international trade and to a sharp deterioration of economic agents' confidence. Growth of economic activity projected for 2010 and the expected acceleration for 2011 reflect a broadly based recovery of private demand components, in a context where external demand for Portuguese goods and services seems to have resumed an upward trend as of the second half of 2009. The development of domestic demand in 2010 and 2011 will likely continue to be affected by the deterioration of labour market conditions, by some persisting structural weakness, and by the uncertainty surrounding the resumption of the fiscal consolidation process.

Turning to inflation, the Harmonised Index of Consumer Prices (HICP) declined by 0.9 per cent in 2009, after an increase of 2.7 per cent in 2008. The inflation rate is expected to resume positive figures in 2010 (0.7 per cent), rising to 1.6 per cent in 2011. The cut in consumer prices in 2009 is therefore forecast to be temporary, which is confirmed by indicators of inflation expectations that point to positive, albeit low levels in 2010. Against a background of contracting global demand, the fall in prices in 2009 was strongly influenced by the sharp decline in the import deflator, reflecting, in particular, the cut in oil and non-energy commodity prices. Moreover, the relatively high growth of unit labour costs in the private sector may also have been accommodated by the significant narrowing of profit margins, due to the contracting demand in the domestic market. In a context of economic recovery at both the global and national level, the increase in consumer prices in 2010 and 2011 reflects an increase in oil prices, a rise in the import deflator of non-energy goods and a moderate increase in unit labour costs, which will tend to allow for some recovery of profit margins. This projection for the inflation rate in Portugal implies that the price growth differential *vis-à-vis* the euro area will continue to be negative in 2010, albeit to a smaller magnitude than in 2009.

The net borrowing requirements for the Portuguese economy, as measured by the combined current and capital account deficit as a percentage of GDP, declined from 10.5 per cent of GDP in 2008 to 8.2 per cent in 2009, especially reflecting favourable developments in terms of trade, which were more apparent than developments exclusively due to the significant decline in oil prices. Over the projection horizon, however, external borrowing requirements are projected to rise again to 9.8 and 11.3 per cent

of GDP in 2010 and 2011 respectively. These developments reflect in particular a slight deterioration of the goods and services account deficit and a sharp widening of the income account deficit, as a result of a further deterioration of the international investment position and a gradual interest rate increase as of mid-2009.

The current projection does not imply a revision of economic activity growth in 2009 *vis-à-vis* the figures published in the Autumn Economic Bulletin of 2009, although it shows a slight revision in the expenditure composition. Compared with the Summer Economic Bulletin of 2009, this projection implies a significant upward revision of the GDP growth rate in 2009 (+0.8 percentage points (pp.)). This revision reflects higher-than-expected growth in most components of overall demand, in parallel with a revision of imports in the same direction, which implies a substantially higher-than-forecast contribution of domestic demand (+1.6 pp.) and a lower-than-expected contribution of external trade in net terms (-0.9 pp.). The present projection for economic activity in 2010 implies an upward revision of +1.3 pp., which is due not only to the dynamic effects associated with higher-than-anticipated growth for the second half of 2009, but also to prospects of more favourable developments of global financing conditions, as well as demand conditions, in a context of gradual decline in the agents' risk-aversion level. These factors will likely contribute to higher-than-anticipated growth of both private domestic demand and exports. The current projection for inflation points to a downward revision of approximately 0.5 pp. in 2009 and 2010, chiefly reflecting a higher-than-projected fall in the import deflator of non-energy goods.

2. ASSUMPTIONS UNDERLYING THE PROJECTION EXERCISE

The current projections are based on a set of assumptions regarding the developments in the international environment of the Portuguese economy. These assumptions reflect data available up to mid-December 2009 and rely on technical hypotheses on the future developments of interest rates, exchange rates and commodity prices, as well as the performance of global economy, particularly in the euro area, and its implications for the external demand of Portuguese goods and services.

As of the second half of 2009 the situation in international financial markets eased gradually and risk *premia* declined steadily, though remaining at a level higher than the ones registered before the outbreak of the financial crisis. The current projection incorporates the maintenance of this trend of progressive normalisation of financing conditions in 2010 and 2011 and a regularisation of international trade flows, in a context of recovering world economic activity. Although these developments imply a gradual return of growth rates to levels close to those observed prior to the recent financial crisis in both economic activity and international trade flows, they imply a fall in the level of those variables, which will prevail over the projection horizon.

The current projections point to negligible revisions, when compared with those underlying the macroeconomic projections for 2009 included in the autumn 2009 issue of the Economic Bulletin. In turn, when compared with the assumptions underlying the projection published in the summer 2009 issue of the Economic Bulletin, the current external framework of the Portuguese economy includes a more favourable appraisal of external demand, reflecting a faster-than-anticipated recovery of world economic activity (Table 2.1). Moreover, the monetary stimulus and liquidity management measures implemented by a number of central banks and, in particular, by the European Central Bank, have contributed to a decline in interbank money market risk *premia*, implying a higher-than-expected decline of short-term interest rates in 2009. As regards commodity prices in US dollars, in particular of oil, futures markets implicit expectations point to an upward revision, consistent with the update of the outlook for global economic activity. The appreciation of the euro exchange rate since then, however, has contributed to mitigate the revision of commodity prices in euro terms.

Table 2.1

ASSUMPTIONS UNDERLYING THE PROJECTION EXERCISE							
		EB winter 2009			EB autumn 2009	EB summer 2009	
		2009	2010	2011	2009	2009	2010
External demand	yoy	-13.0	1.9	3.2	-13.4	-13.0	-0.5
Interest rate							
Short term	%	1.2	1.2	2.2	1.3	1.4	1.8
Long term	%	4.2	4.0	4.4	4.2	4.5	5.0
Exchange rate (+ = appreciation)							
euro effective exchange rate	yoy	0.8	2.2	0.0	0.2	0.1	0.6
Euro-dollar	aav	1.40	1.49	1.49	1.38	1.36	1.40
Oil price							
in dollars	aav	62.2	80.5	86.3	62.4	61.9	76.3
in euros	aav	44.2	53.9	57.8	45.0	45.2	54.7

Sources: BCE, Bloomberg, Thomson Reuters and Banco de Portugal calculations.

Notes: (p) - projected, yoy - year-on-year rate of change, % - per cent, aav - annual average value.

2.1. Interest rates and exchange rates

The assumptions on short-term interest rate developments are based on expectations regarding the trend of the three-month EURIBOR implied in futures contracts. Financial market participants anticipate that, after the strong fall in the first quarter of 2009 and further more moderate declines up to the end of 2009, this rate will increase gradually until the end of the projection horizon, albeit to levels clearly below the annual averages observed in 2008. Therefore, in annual average terms, the three-month EURIBOR is expected to remain at 1.2 per cent in 2010, and to increase to 2.2 per cent in 2011. Against this background, it is worth mentioning that the development of the short-term interest rates is affected by both expectations regarding the ECB intervention rates and the developments of risk *premia* implied by the money market, measured by the interest rate differential between collateralised and non-collateralised operations. This differential rose sharply in mid-2007 with the outbreak of the financial crisis and also significantly in 2008, but has reversed steadily in the course of 2009 (Chart 2.1.1). The profile of future developments of the interest rates included in the present projection implicitly assumes a slight reduction of the interbank money market risk premium in early 2010, followed by a small rise in the second half of the year, in a context of reversal of an important package of monetary stimulus measures implemented in 2009. Against the background of a gradual easing of the financial markets, this differential will likely stabilise after early 2011, albeit at levels clearly above those prevailing before the outbreak of the financial crisis.

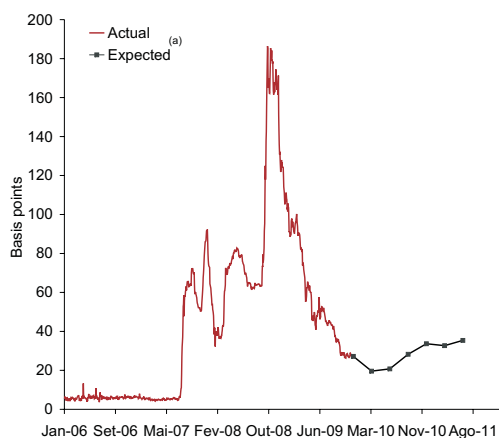
The profile underlying the present projections regarding developments in bank lending rates reflects the cost of financing of banks in wholesale markets and risk *premia* charged by banks on households and non-financial corporations using bank loans. Thus, the present projection considers that bank spreads will continue to decline over the projection horizon, although to levels above those recorded in the period immediately before the outbreak of the financial crisis.

According to implicit ten-year government bond yield data, benchmark long-term interest rates are expected to decline, in annual average terms, from 4.2 per cent in 2009 to 4 per cent in 2010. In 2011, these rates will likely increase to 4.4 per cent, which is close to the 2008 figure.

Finally, exchange rate developments rely on the technical assumption of unchanged rates at the average levels prevailing in mid-December 2009, implying an annual average appreciation of the euro ef-

Chart 2.1.1

SPREAD BETWEEN EURIBOR AND THREE-MONTH EONIA SWAPS



Sources: Bloomberg, Thomson Reuters and Banco de Portugal calculations.

Note: (a) Spread between the three-month EURIBOR implicit in futures contracts and the average expected EONIA rate (derived from the EONIA swap index) for the corresponding period.

fective exchange rate of 0.8 per cent in 2009 and 2.2 per cent in 2010, after an appreciation of 4.8 per cent in 2008 (5.1 per cent depreciation against the US dollar in 2009, followed by a 7 per cent appreciation in 2010).

2.2. International prices

After reaching an average monthly value of USD 134 per barrel in July 2008, the price of oil declined sharply in the second half of the year, particularly in the last quarter, standing at a monthly average figure of USD 42 per barrel in December. In 2009, the oil price resumed an upward trend, to stand close to USD 62 per barrel. According to expectations implied by the futures markets, oil price is likely to maintain an upward trend until the end of the projection horizon, reaching figures close to USD 87 per barrel. In annual average terms, this pattern implies a reduction of oil prices from USD 98 per barrel in 2008 to approximately USD 62 in 2009, followed by an increase to around USD 80 per barrel in 2010 and to USD 86 in 2011. Along with the assumptions already mentioned with regard to the euro/USD exchange rate, these developments are projected to imply an annual average price of €44 per barrel in 2009 (€66 in 2008), €54 in 2010 and €58 in 2011.

As regards non-energy commodity prices, available data point to an increase in food commodity prices of approximately 27 per cent in 2008, while the prices of other non-energy commodities increased by around 3 per cent. Available data on the development of these prices, implied by futures markets, points to a fall of around 12 per cent in food commodity prices and of 27 per cent in other non-energy commodities in 2009, reflecting the impact on prices of the sharp reduction in demand expectations. Prices of non-energy commodities are expected to increase further by 25 per cent in 2010 and by 4 per cent in 2011, in the context of the expected recovery in global demand and hence in demand for commodities.

2.3. International environment and external demand

In the context of a gradual unwinding of the international financial crisis, the December 2009 Eurosystem projections, published in the Monthly Bulletin of the European Central Bank, and based on data available until 20 November 2009, suggest that economic activity growth in the euro area has turned positive in the third quarter of 2009, for the first time since early 2008. In annual average terms, after growing 0.5 per cent in 2008, GDP in the euro area contracted between 3.9 and 4.1 per cent in 2009, and is expected to grow in a range between 0.1 and 1.5 per cent in 2010 and between 0.2 and 2.2 in 2011. These more favourable developments of activity reflected, at a first stage, the role played by a range of interlinked factors, among which stress is laid on the implementation of fiscal stimulus packages, restoring of average inventories levels after the destocking observed in the recent past, and international trade growth. Over the horizon, the lagged effects of monetary policy measures and the significant efforts towards a smoother functioning of the financial system have also contributed to the gradual recovery of economic activity. However, it should be pointed out that the available projections point to a pace of growth significantly slower than before the recession, due to the need to restructure the balance sheets in different sectors, which translates namely into weak growth of private consumption against a background in which prospects also indicate a low level of job creation.

Projections for consumer price developments, prepared within the same projection exercise, point to a significant reduction in euro area inflation in 2009, as measured by the annual average rate of change in the HICP, which stood at -0.4 per cent in the third quarter, but is expected to have resumed positive figures in the fourth quarter. These developments were strongly associated with base effects related to past falls in commodity prices. In this context, the annual average inflation rate, which stood at 0.3 per cent in 2009, is projected to lie in the range from 0.9 to 1.7 per cent in 2010 and from 0.8 to 2.0 per cent in 2011. The developments estimated for 2010 and 2011 reflect, on the one hand, an increase in commodity prices and in the prices of manufactured goods over the projection exercise and, on the other hand, a moderate recovery of profit margins, in a context of wage moderation and increased productivity associated with the gradual recovery of economic activity.

The external environment of the current projection implies a fall in external demand for Portuguese goods and services of around 13 per cent in 2009, after an expansion of 0.4 per cent in 2008. This strong contraction in exports is a totally atypical situation.² The current projection for the international environment indicates a gradual recovery of international trade and external demand for Portuguese goods and services after the third quarter of 2009, in a context of easing international financial market tensions, recovery of the confidence levels of economic agents and gradual increase in demand and world economic activity. These developments indicate that the external demand indicator relevant for Portugal is expected to grow by 1.9 per cent in 2010 and 3.2 per cent in 2011.

2.4. Assumptions underlying public finances and administered prices

As regards public finance projections, and as usual within the scope of the Eurosystem projection exercise, only the fiscal policy measures that have been legally approved or specified in adequate detail and with high probability of legislative approval were included. Therefore, the present projections are conditioned by the fact that the State Budget for 2010 and the update of the Stability Programme will only be published after the cut-off date of this Bulletin. As regards the fiscal stimulus measures imple-

(2) Since the start of the 1980s, in annual average terms, this indicator declined only in 1993 (-1.8 per cent). For the period prior to 1980, no data are available for the calculation of this indicator.

mented in December 2008, it was assumed they would be discontinued during the projection horizon. This assumption has affected, in particular, the public investment profile, which, in real terms, is projected to decline in 2010 and 2011. Public consumption, in turn, is forecast to decelerate sharply in 2010, in real terms, to 0.7 per cent, followed by a slight acceleration in 2011. These developments imply a stabilisation of the number of civil servants, and a significant deceleration *vis-à-vis* 2009 of intermediate consumption and social benefits in kind.

As regards public transfers from the European Union, the profile assumed in the projection horizon is affected by the assumption that the stimulus measures implemented in the context of the economic crisis will be discontinued, as an important share of those measures benefited from community financial assistance.

As to administered prices, the present projection incorporates public information, in particular on the update of actual rents and the rise in electricity prices in 2010. Other prices for which no data is available as yet are assumed to increase in line with the average growth recorded in the recent past.

3. SUPPLY

3.1. Output and sectoral developments

The current projection points to a 2.7 per cent contraction in economic activity in 2009, followed by a return to positive values, of 0.7 per cent in 2010 and 1.4 per cent in 2011 (Chart 3.1.1) (see “Section 4 Demand”). These developments are marked by the performance of private sector economic activity, as public sector GDP is likely to contract substantially less than private sector GDP in 2009 and to grow by marginally positive values in 2010 and 2011.³

In 2009 the growth differential between Portugal and the euro stood at 1.3 per cent, interrupting the negative differential observed since 2003 (Chart 3.1.2). Over the projection horizon, the differential is expected to be marginally negative in 2010 (-0.1 per cent) and somewhat positive in 2011 (0.2 per cent).⁴

At the sectoral level, the current projection comprises heterogeneous developments, with particularly sharp falls in the most sensitive sectors to cyclical fluctuations (construction and manufacturing). Following a substantial contraction in manufacturing in 2009, growth rates are projected to return to positive values in 2010 and 2011, amid a gradual recovery of world economic activity. This projection reflects the profile of both domestic and external demand for Portuguese goods and services.

Activity in the construction sector is expected to contract over the projection horizon, albeit at a gradually slower pace. This evolution is associated with systematic drops in corporate and residential investment. In 2009 these were partially offset by public investment developments, reflecting a set of fiscal stimulus measures.

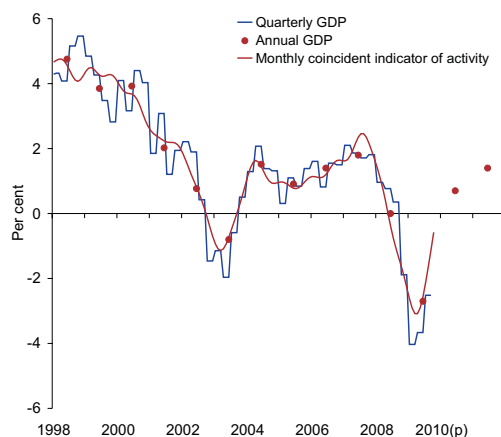
With regard to the services sector, following a slight contraction in 2009, a gradual recovery is expected over the projection horizon, reflecting developments in household consumption expenditure and tourism exports. Tourism exports are projected to grow substantially in 2011, after a sharp contraction in 2009, due to a deterioration in economic activity in advanced economies and, particularly, in the countries of origin of the majority of tourists visiting Portugal.

(3) Public sector output corresponds to general government expenditure on primary factors intended for the supply of public goods and services, particularly staff costs and fixed capital consumption. Private sector output is obtained as the difference between total output and public sector output, thus including general government intermediate consumption expenditure on goods and services produced by the private sector.

(4) Euro area figures correspond to the midpoints of projection ranges published in the December issue of the ECB *Monthly Bulletin*.

Chart 3.1.1

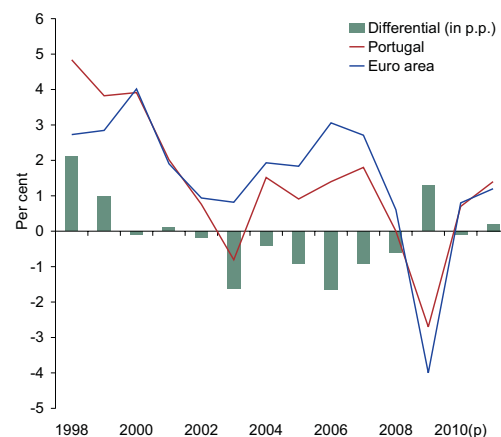
ECONOMIC ACTIVITY
Year-on-year rate of change



Sources: INE and Banco de Portugal.
Note: (p) - projected.

Chart 3.1.2

GDP IN PORTUGAL AND IN THE EURO AREA
Annual rate of change



Sources: ECB, Eurostat, INE and Banco de Portugal calculations.
Notes: (p) - projected. Euro area figures correspond to the midpoints of projection ranges published in the December issue of the ECB *Monthly Bulletin*.

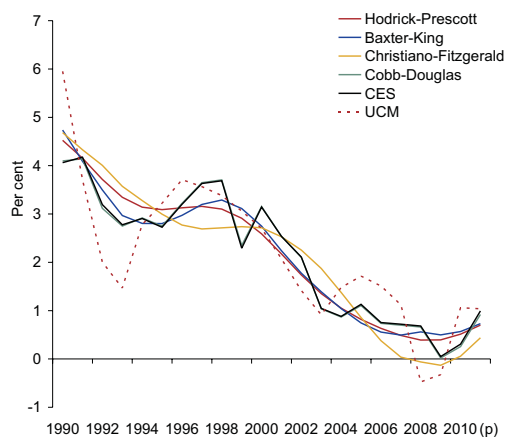
The analysis of potential output and the output gap in the current juncture is particularly difficult and is surrounded by considerable uncertainty, given that it is not yet possible to determine the effects of the economic and financial crisis on the equilibrium level of activity. This crisis may have persistent negative effects on both the level and growth rate of economy activity, in particular due to an increased obsolescence of installed capital, with an impact on long-term productivity. Moreover, the crisis may imply lower capital accumulation and rising structural unemployment, with effects on input accumulation. Finally, methods used to calculate potential output and the output gap are generally very sensitive to GDP values at the end of the estimation period. This is particularly relevant in the current climate of high uncertainty surrounding economic activity developments in the near future.

Difficulties associated with the rigorous quantitative evaluation of potential output and the output gap suggest the usefulness of various estimation methods.⁵ Overall, the methods considered point to a slowdown in potential output in 2009, while a slight acceleration is projected for 2010 and 2011 (Chart 3.1.3). In turn, the output gap is likely to stand in negative territory over the projection horizon, although considerable uncertainty persists regarding its level and trajectory, as shown by the marked dispersion in results obtained with the different methods (Chart 3.1.4).

(5) These methods correspond to the Hodrick-Prescott, Baxter-King and Christiano-Fitzgerald statistical filters and the Cobb-Douglas and Constant Elasticity of Substitution (CES) production functions presented in V. Almeida and R. Félix (2006), "Computing potential output and the output gap for the Portuguese economy", Banco de Portugal, *Economic Bulletin*-Autumn. The Unobserved Components Model (UCM) method is presented in Centeno, M., J. Maria and A. Novo (2009), "Unemployment: Supply, demand, and institutions", *The Portuguese Economy in the Context of Economic, Financial and Monetary Integration*, Economics and Research Department, Banco de Portugal.

Chart 3.1.3

POTENTIAL OUTPUT GROWTH
Annual rate of change

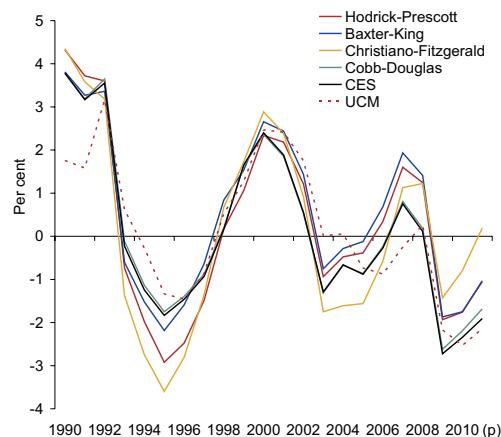


Sources: INE and Banco de Portugal.

Note: (p) - projected.

Chart 3.1.4

OUTPUT GAP
Deviation from potential output level



Sources: INE and Banco de Portugal.

Note: (p) - projected.

3.2. Employment

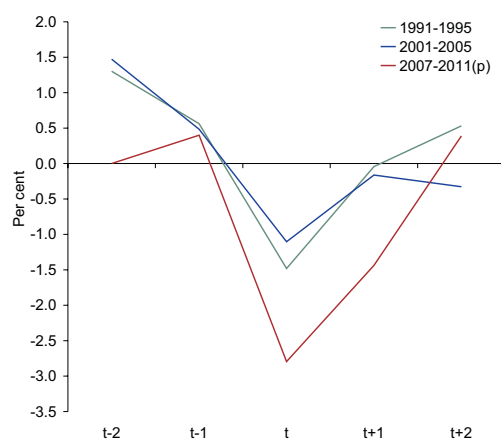
Developments in employment will be marked by the strong contraction in economic activity in 2009, which will tend to impact on the demand for labour in 2010, reflecting the usual lag between the output and employment cycles. Therefore, following a 2.8 per cent contraction in 2009, employment is projected to contract by 1.3 per cent in 2010 and to grow by 0.4 per cent in 2011. Projected developments indicate that net job destruction will be much higher during the 2007-2011 recessive period than in the previous two recessive episodes (Chart 3.2.1). In sectoral terms, projected developments in employment are marked by the behaviour of the private component, over the entire projection horizon, against a background of expected stabilisation in public sector employment, in line with the already mentioned methodological assumptions (see “Section 2 Assumptions underlying the projection exercise”).

Underlying developments in employment and economic activity in 2009 is the stagnation in apparent labour productivity, measured as output per worker, which will return to positive growth rates in 2010 and 2011. A comparison with previous recessive episodes indicates that the recovery of apparent labour productivity in 2010 will be stronger than recorded during the year following activity contraction in previous recessive periods. This reflects the contribution of cyclical factors during economic recovery stages, more specifically a reversal of capacity utilisation and the return to a more intensive use of labour inputs (Chart 3.2.2). However, the partial unwinding of these factors in 2011 is likely to lead to a slowdown in apparent productivity, which should return to figures closer to its underlying trend growth.

With regard to labour supply, the participation rate declined in 2009 and is projected to decline in 2010, but some reversal is projected for 2011. These developments are likely to partly reflect some discouragement in terms of labour market participation. Developments in the activity rate together with low working age population growth – in line with its recent behaviour and in a context of population ageing – imply a contraction in labour force in 2009 and 2010 and a rate of change of around 0.6 per cent in 2011, in contrast with average growth of around 1 per cent over the past decade.

Chart 3.2.1

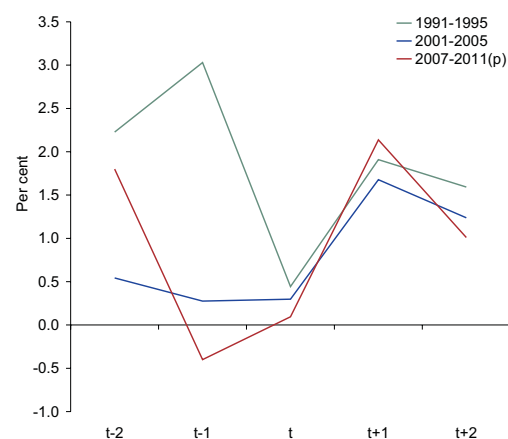
EMPLOYMENT
Comparison between recessive periods
Annual rate of change



Sources: INE and Banco de Portugal.
Note: (p) - projected.

Chart 3.2.2

APPARENT LABOUR PRODUCTIVITY
Comparison between recessive periods
Annual rate of change



Sources: INE and Banco de Portugal.
Note: (p) - projected.

3.3. Economic growth factors

Growth factors in the Portuguese economy may be analysed from a supply perspective through a growth accounting exercise, namely resorting to the Cobb-Douglas production function, which breaks GDP growth into contributions from the accumulation of inputs (labour and capital) and total productivity.⁶ Although useful to understand aggregate supply developments, this exercise presents some limitations. In particular, factor productivity is obtained residually, and therefore is not only an efficiency measure but also the result of variables not explicitly included in the growth accounting exercise (e.g. the quality of inputs or the degree of capacity utilisation).

Over the projection horizon, developments in the labour factor have the most unfavourable impact on economic activity growth, with a markedly negative contribution both in 2009 and 2010 (-1.8 and -1.0 p.p. respectively) and a marginally positive contribution in 2011. The contribution of the capital stock to economic activity growth should be virtually nil over the projection horizon (Chart 3.3.1). These developments reflect the contraction in investment recorded in 2008 and projected for 2009 and 2010.

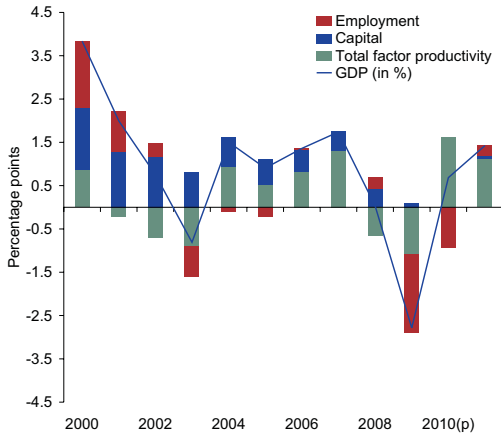
With regard to total factor productivity, following a 1.1 per cent contraction in 2009, a fast reversal is expected to ensue, with this component being the largest contributor to economic activity growth in 2010 and 2011 (1.6 and 1.1 pp.) respectively. Such developments are likely to be strongly influenced by cyclical factors. In 2009, negative developments in productivity should be partly related to a sharp decline in the utilisation rate of the capital stock (Chart 3.3.2) (which is very sensitive to cyclical economic fluctuations) as well as to labour hoarding.⁷ In 2010 and 2011, the recovery of economic activity will tend to eliminate these temporary factors, allowing for an upturn of total factor productivity.

(6) For a discussion of this methodology, see Almeida, V. and R. Félix (2006), "Computing potential output and the output gap for the Portuguese economy", Banco de Portugal, *Economic Bulletin*-Autumn.

(7) The retention of workers under these circumstances may result either from the difficulty of adjustment of employment for legal reasons, or from the strategy of some firms to avoid the destruction of specific human capital, i.e. incur in unrecoverable costs resulting from the transmission of job and firm-specific skills.

Chart 3.3.1

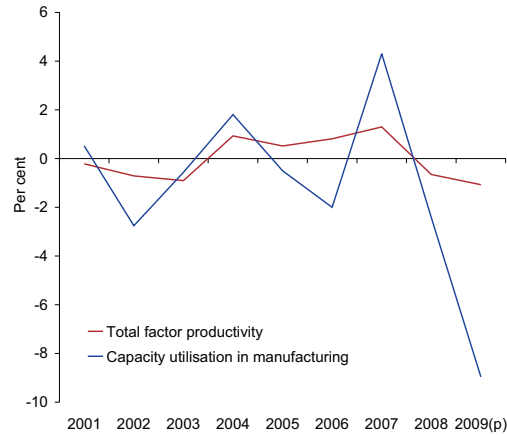
GROWTH ACCOUNTING - 2005-2011
Contribution to the annual rate of change



Sources: INE and Banco de Portugal.
Note: (p) - projected.

Chart 3.3.2

TOTAL FACTOR PRODUCTIVITY AND CAPACITY UTILISATION IN MANUFACTURING INDUSTRY
Annual rate of change

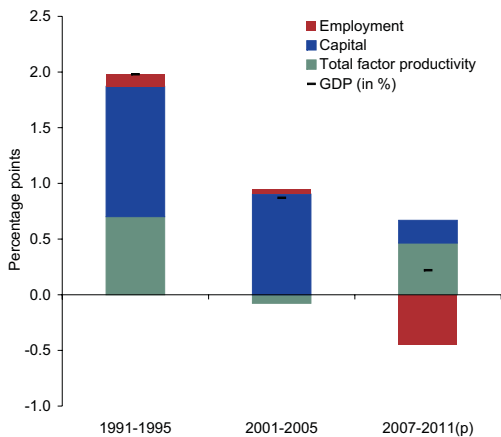


Sources: European Commission, INE and Banco de Portugal.
Note: (p) - projected.

By comparing the 2007-2011 period with the two previous recessionary periods in Portugal (1991-1995 and 2001-2005), some conclusions may be drawn regarding GDP developments and the contribution of inputs and total factor productivity to economic growth (Chart 3.3.3). Average GDP growth in the 2001-2005 period was substantially lower than in the 1991-1995 period (0.9 per cent, compared to 2.0 per cent), and a further decrease is projected in the most recent period (0.2 per cent), an indicator of the unprecedented nature of the current recessive phase. While lower output growth in 2001-2005 was mainly due to a marked decline in the contribution of total factor productivity, lower

Chart 3.3.3

COMPARISON OF GROWTH ACCOUNTING - 1991-1995, 2001-2005 AND 2007-2011
Contribution to the average rate of change



Sources: INE and Banco de Portugal.
Note: (p) - projected.

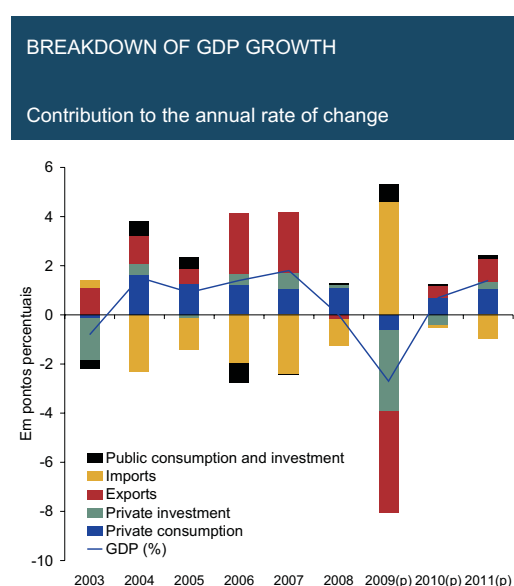
growth projected for 2007-2011 reflects a smaller contribution from inputs, particularly the capital stock. Capital stock developments may reflect the amortisation of important investment flows during the 90s, as well as a poor investment performance over the current recessive period. With regard to the labour factor, projected developments should be mainly associated with weaker private sector employment growth, in a context where structural unemployment is higher than in previous recessive episodes. Finally, developments in total factor productivity indicate that, following abnormally low growth between 2002 and 2006, in 2007-2011 average growth will return to a level closer to its historical average.

4. DEMAND

Economic activity in Portugal recorded a very significant drop in the last quarter of 2008, which extended to the first quarter of 2009. GDP has thus recorded a negative rate of change of 2.7 per cent in 2009, the most marked of recent decades. Regarding the composition of demand, this sharp drop stemmed mainly from exports and investment (both recorded a decline close to 12 per cent), reflecting the marked deterioration in demand prospects.

The assumptions underlying the current projection include a recovery of world demand and economic activity in 2010 and 2011, including in the euro area, albeit moderate (see “Section 2 Assumptions underlying the projection exercise”). Against this background, the current projection points to a slight recovery in economic activity (0.7 per cent in 2010), led by exports and private consumption (Chart 4.1). Among other factors, these developments are driven by the increase in external demand for Portuguese goods and services, the improvement in the expectations of economic agents regarding developments in their income and wealth, as well as the maintenance of interest rates at a low level. Economic recovery is expected to continue in 2011, with an estimated growth of 1.4 per cent, due to positive contributions from all domestic demand components and a virtually nil contribution from net exports.

Chart 4.1

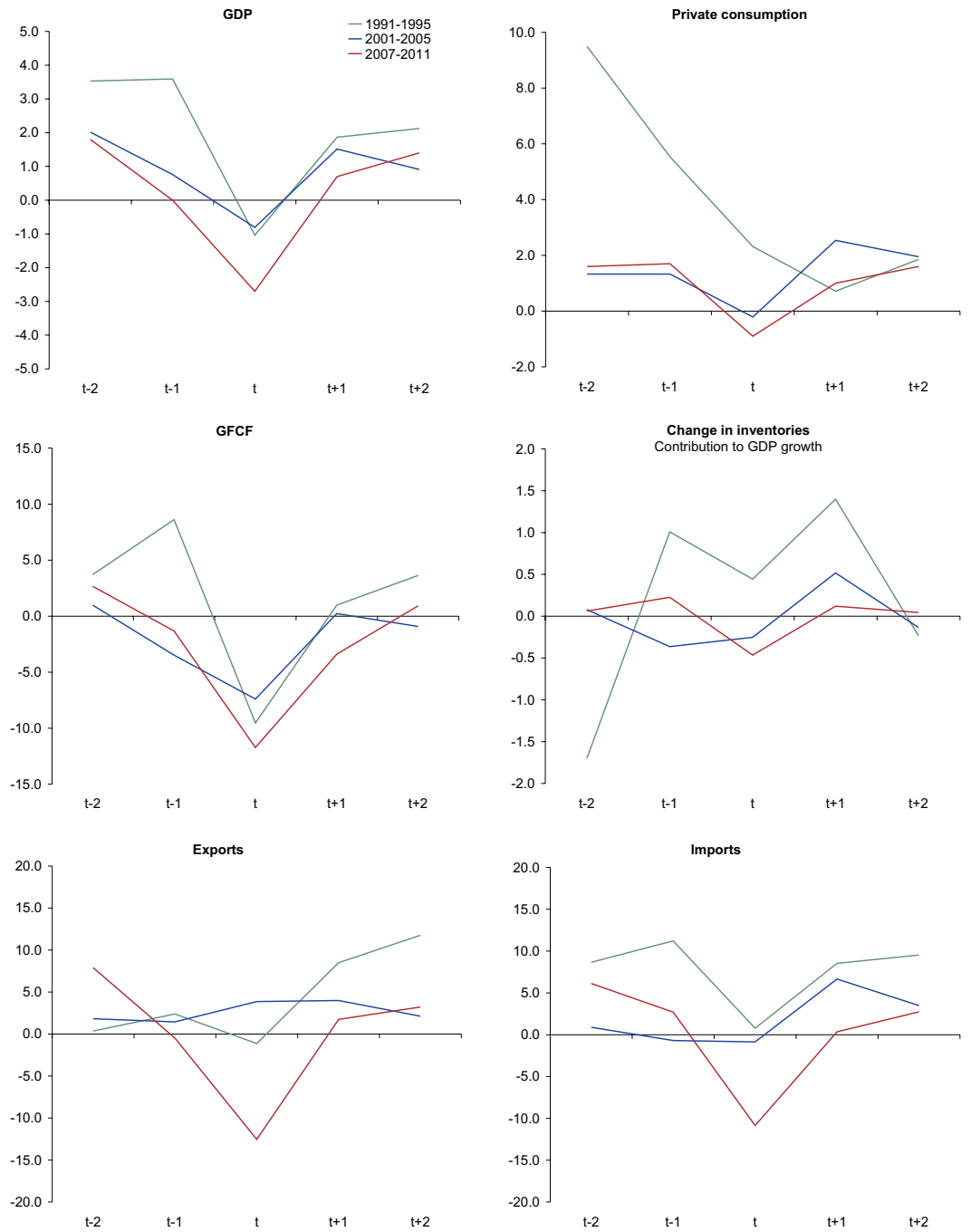


Sources: INE and Banco de Portugal.
Note: (p) - projected.

Comparing this recession with previous ones, it is possible to highlight the unprecedented size and nature of the present situation, and to draw some conclusions on the most relevant characteristics of the Portuguese economy over recent years (Chart 4.2). In the past 20 years, the Portuguese economy recorded two other recessive episodes, none of which with a GDP contraction of similar magnitude. It

Chart 4.2

DEVELOPMENTS IN GDP AND EXPENDITURE COMPONENTS IN RECESSION PERIODS
Annual rate of change, per cent



Sources: INE and Banco de Portugal.
Note: (p) - projected.

should be mentioned, however, that, unlike previous recessive episodes, the current one occurs against the backdrop of a deep international financial crisis, accompanied by a contraction in global economic activity. According to the projections for developments in final demand components, this recession comprises unprecedented drops in gross fixed capital formation (GFCF) and exports, mirroring the effects of the financial and economic crisis on investment decisions and demand expectations in the context of the collapse of international trade at the end of 2008. Over the past few years, investment developments have limited the growth potential of the economy and the path of exports has reflected the difficulties of the export sector when faced with new international competitors with low unit labour costs. In 2009, private consumption dropped more markedly than in the troughs observed in previous recessive episodes. In contrast to previous recessions, the current recession was accompanied by a sharp deterioration in labour market conditions, which is projected to continue over the projection horizon (see “Subsection 3.2 *Employment*”). This situation is expected to result in a reversal of the downward path observed in the household savings rate over the past few years, namely due to precautionary savings, against a background of a high level of household indebtedness and less favourable financing conditions than in previous recessive episodes.

4.1. Private consumption

Private consumption contracted by 0.9 per cent in 2009, following a growth rate slightly above 1.5 per cent in the two previous years. The fall in consumption occurred in a context of a rise in real disposable income, determined to a large extent by an increase in transfers to households and compensation of employees, despite the strong reduction in employment (Chart 4.1.1). Mention should also be made to the positive impact on disposable income from the strong decline in banking interest rates in the course of 2009, considering the net borrowing position of households in terms of interest-bearing assets and liabilities.

In an environment of high uncertainty, the tightening of credit standards for bank loans is estimated to have also led to the postponement of household consumption expenditures, notwithstanding a sharp drop in interest rates over the course of 2009. In fact, the tightening of financing restrictions in international markets, compared to conditions prevailing before the outbreak of the financial market turbulence, is estimated to have limited banks' ability to adjust the debt servicing of households to their payment capacity. In addition, the materialization of credit risks also gave rise to tighter credit standards by banks.

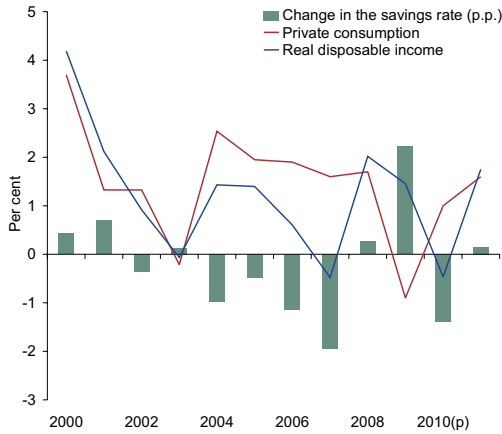
Developments in private consumption in 2009 resulted from the combination of weak growth in the consumption of non-durable goods and a very marked fall in the consumption of durable goods, reflecting the strong sensitivity of this component to the business cycle, particularly given the sharp increase in the unemployment rate and persistent tensions in international financial markets (Chart 4.1.2). Nevertheless, private consumption recovered throughout the year, in particular the consumption of durable goods, likely due to a deduction in financial market tensions, as well as the associated fall of uncertainty and recovery in consumer confidence (Chart 4.1.3).

In 2009, the decrease in private consumption is less marked than that of GDP, in line with the usually smoother developments in consumption (Chart 4.1.4). In addition, private consumption growth is expected to be similar to the euro area, taking as reference the midpoint of the projection ranges published in the (Chart 4.1.5).

The households saving rate increased significantly in 2009, adding to the slight rise of 2008 and interrupting the downward trend recorded since 2002. Developments in the household saving rate are estimated to have reflected precautionary savings due to the high uncertainty associated with the

Chart 4.1.1

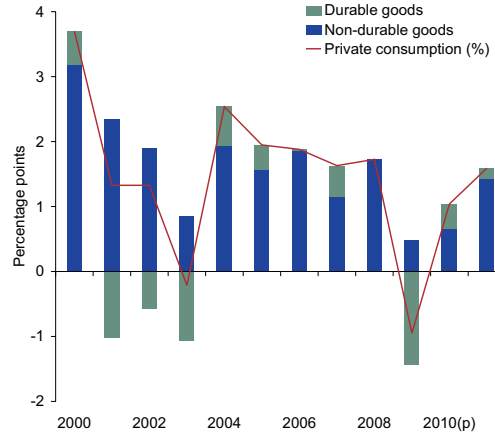
CONSUMPTION, DISPOSABLE INCOME AND SAVINGS RATE
Annual rate of change



Sources: INE and Banco de Portugal.
Notes: (p) - projected. The savings rate is calculated as a percentage of disposable income.

Chart 4.1.2

BREAKDOWN OF PRIVATE CONSUMPTION
Contribution to the rate of change



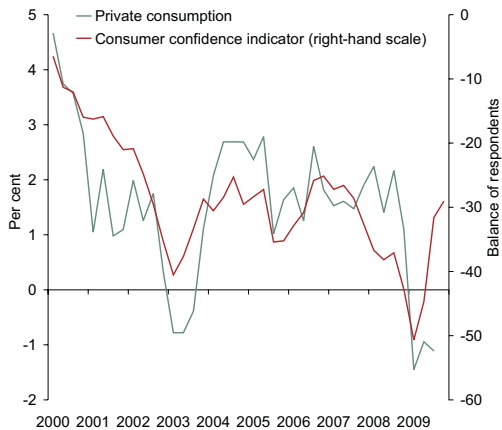
Sources: INE and Banco de Portugal.
Note: (p) - projected.

magnitude and duration of the financial crisis and its interaction with economic activity, particularly regarding wealth and income developments.

For 2010 and 2011, the current projection implies private consumption growth of 1 and 1.6 per cent, respectively. These developments represent an acceleration in private consumption, in particular in the durable goods component, which typically shows a pro-cyclical and highly volatile behaviour. Notwithstanding the limitations imposed by an unfavourable labour market situation and the gradual increase in interest rates over the projection horizon, consumption is likely to grow above disposable income, which implies a reduction in the households saving rate to levels closer to those prevailing in 2008.

Chart 4.1.3

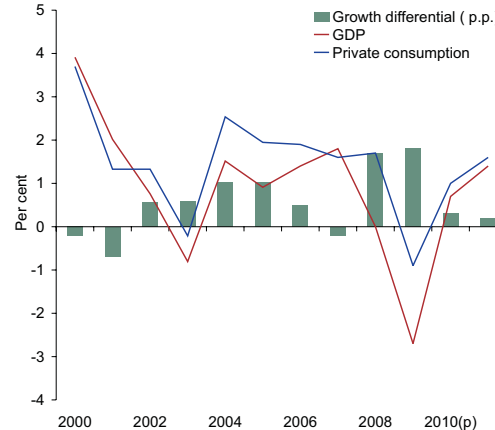
PRIVATE CONSUMPTION AND CONSUMER CONFIDENCE
Annual rate of change



Sources: European Commission, INE and Banco de Portugal.
Note: The level for the fourth quarter of 2009 is based on the assumption that monthly indicators will remain unchanged at the level of the latest figure available (November).

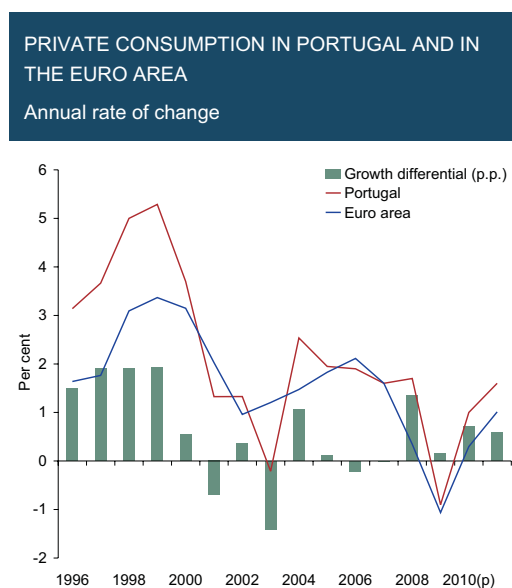
Chart 4.1.4

PRIVATE CONSUMPTION AND GDP
Annual rate of change



Sources: INE and Banco de Portugal.
Note: (p) - projected.

Chart 4.1.5



Sources: ECB, Eurostat, INE and Banco de Portugal calculations.
Notes: (p) - projected. Euro area figures correspond to the midpoint of the projection ranges published in the December issue of the ECB *Monthly Bulletin*.

Real disposable income is expected to decrease in 2010 and to accelerate in 2011, in line with the profile projected for the compensation of employees. It should also be noted that, although a gradual normalization of financing conditions is assumed over the projection horizon, credit standards are expected to remain tighter than in the period preceding the onset of the financial crisis, namely owing to risk reassessment and the associated tightening of credit standards.

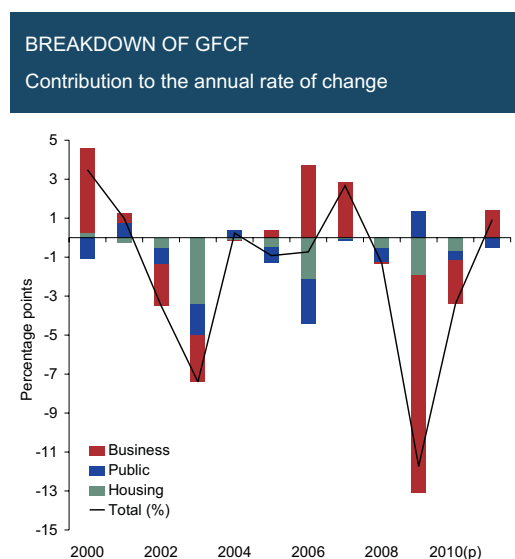
In 2010 and 2011, private consumption growth is in line with expected GDP developments, in contrast to the past few years, when, in general, positive differentials were recorded. The current projection also points to higher private consumption growth in Portugal than that projected for the euro area, as was the case in previous years, and contrasting with the typically negative differential recorded in GDP since the beginning of the decade.

4.2. Investment

GFCF projections point to a drop of around 12 per cent in 2009, after a reduction of 1.3 per cent in 2008 (Chart 4.2.1). The sharp decline in the GFCF in 2009 is likely to have been associated with the marked deterioration in the expectations of economic agents regarding the levels of demand both in the domestic market and in Portugal's export markets. This has occurred in an international environment dominated by a strong contraction in world demand, unusually high uncertainty levels and the associated increase in credit risk *premia*. Negative expectations regarding future levels of demand and the sharp drop in international trade flows are likely to have also implied a significant reduction in the level of inventories, similarly to what happened in other European countries, which resulted in an unusually negative contribution from this component to GDP growth and in a sharper fall in investment.

Regarding the intra-annual profile, after an abrupt reduction in the first quarter of 2009, GFCF showed a profile of gradually smaller falls over the course of the year. Less unfavourable developments in the second half of the year have possibly benefited from the gradual fading away of financial market instability and the associated decrease in uncertainty levels. The latter was also reflected in gradually less

Chart 4.2.1



Sources: INE and Banco de Portugal.

Note: (p) - projected.

negative levels in most confidence indicators, namely regarding production expectations in the manufacturing industry (Chart 4.2.2). In turn, GFCF also benefited from a significant interest rate reduction throughout 2009, despite tighter credit standards.⁸

The current projection points to a contraction in GFCF of 3.4 per cent in 2010 and a slight recovery, to 0.9 per cent, in 2011. These developments mirror a gradual improvement in demand prospects in the domestic and the external markets, as a result of a normalisation of financing conditions in international markets and continued low interest rate levels. Nevertheless, the current projection points to gradually rising interest rates over the projection horizon, as well as continued tighter credit standards than those prevailing before the outbreak of the financial crisis. In addition, the projected GFCF developments imply a reduction in its weight in GDP over the projection horizon, similarly to what happened in the 2001-2006 period (Chart 4.2.3).

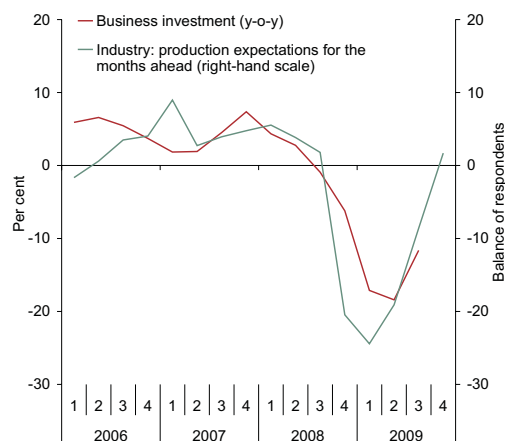
As regards GFCF sectoral developments, business investment is estimated to have decreased by around 15 per cent in 2009, decisively contributing to the reduction in the GFCF this year. According to information included in the July 2009 Investment Survey conducted by *Instituto Nacional de Estatística - INE* (Statistics Portugal), deteriorating demand prospects are likely to have played a major role in explaining business investment developments. In effect, there has been a clear increase in the number of firms reporting investment constraints compared to the 2008 survey, and, from among these, a marked increase in firms pointing to deteriorating sales prospects as the main limiting factor. In addition, there has also been an increase in the share of firms mentioning financing difficulties as a factor limiting investment, albeit to a much lesser extent.

The current projection also includes a fall of 3.1 per cent in business investment in 2010, followed by growth of 1.9 per cent in 2011, against a background where the ongoing stabilisation of the international macroeconomic and financial environment is likely to enable a gradual and moderate recovery in domestic and external demand. As a percentage of GDP, this type of investment, which should be

(8) GFCF developments during the third quarter of the year were particularly influenced by specific and temporary factors, such as the purchase of aeronautic equipment.

Chart 4.2.2

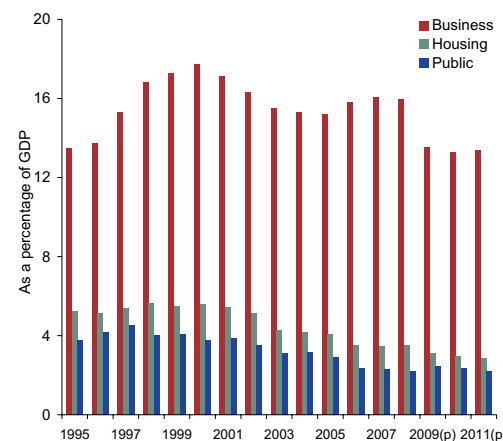
BUSINESS INVESTMENT AND INDUSTRIAL PRODUCTION EXPECTATIONS



Sources: European Commission and Banco de Portugal.
 Note: The level for the fourth quarter of 2009 is based on the assumption that monthly indicators will remain unchanged at the level of the latest figure available (November).

Chart 4.2.3

BREAKDOWN OF GFCF BY INSTITUTIONAL SECTOR



Sources: INE and Banco de Portugal.
 Note: (p) - projected.

strengthened in quality and quantity in order to ensure a sustained recovery of economic activity, is expected to stand at levels close to those recorded in the mid-1990s.

Residential investment is likely to have fallen by 12 per cent in 2009, following a contraction of 3.4 per cent in 2008. This GFCF component has shown a marked downward trend since the beginning of the decade, reaching about 50 per cent in cumulative terms. Residential investment has also been affected by the international financial crisis, given that a high percentage of this type of investment is financed with recourse to bank lending, against a background of tighter credit standards. In addition, recent developments in this component are also estimated to have been highly affected by unfavourable labour market conditions. The current projection comprises a drop of 4.1 per cent in 2010 and marginally positive growth in 2011. Developments in this GFCF component will continue to be limited by weak job creation and, as a consequence, by household income prospects, as well as dynamics linked to demographic factors.

Public investment is projected to have grown by 13.4 per cent in 2009 in real terms, a growth rate unparalleled over the past decade, which reflects the implementation of a set of fiscal stimulus measures aimed at sustaining the contraction in final demand and thus in economic activity. According to "Section 2 Assumptions underlying the projection exercise", public investment is expected to decrease by around 4 per cent in 2010 and 2011. It should be noted that these assumptions are conditioned by the fact that the State Budget for 2010 and the update of the Stability and Growth Programme will only be available after the cut-off date of this Bulletin.

4.3. External trade

In a context of a significant drop in world trade from the last quarter of 2008 onwards, particularly marked in the first quarter of 2009, the contraction in exports of goods and services significantly contributed to the recessive scenario which characterised Portuguese economic activity in 2009. In fact, after a decline of 0.5 per cent in real terms in 2008, the current projection points to an unprecedented

contraction in exports in 2009 (-12.5 per cent), resulting from a drop of a similar magnitude in the indicator of external demand for Portuguese goods and services (Chart 4.3.1).

The strong contraction in exports in 2009 is more marked fall in exports of goods (-14.2 per cent) than in other goods and services (-8.6 per cent) (Chart 4.3.2). In particular a strong contraction in exports of goods to Portugal's major trading partners was recorded since the decline in demand was stronger. As a result, exports of services regained their importance in exports as a whole, accounting for around 30 per cent of the overall exports in 2009 (Chart 4.3.3).

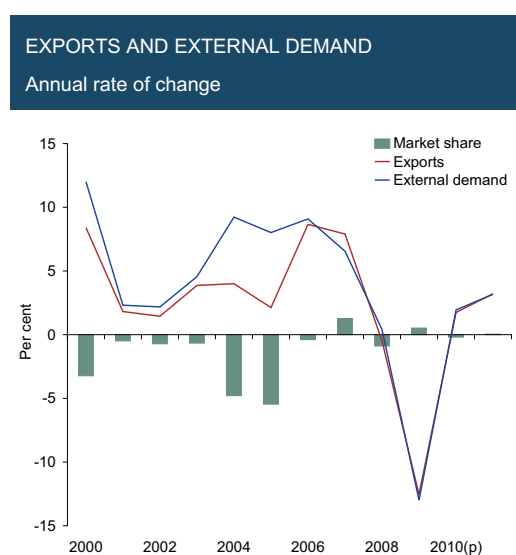
In 2010 and 2011, the indicator of external demand is projected to recorded further positive changes (see "Section 2 Assumptions underlying the projection exercise"), following the gradual normalisation of international financial market conditions and the reduction in uncertainty levels. In this context, the current projection points to growth in exports of goods and services of 1.7 and 3.2 per cent in 2010 e 2011, respectively. This trend is in line with expected developments in the external demand indicator, thus implying virtually nil change in the exports market share (Chart 4.3.1).

The pace of growth of exports of goods and services is expected to be moderate throughout 2010. This projection comprises a positive rate of change of exports of goods, while exports of services should continue to fall. The projected annual developments in exports of services are mainly determined by the markedly downward trend of the past year, given that a moderately upward trend is projected throughout 2010. In 2011, exports of goods and services are expected to accelerate, converging to average annual growth close to 3 per cent.

Regarding imports of goods and services, the current projection points to a significant contraction in 2009 (close to 11 per cent), in contrast to a positive change in the previous year (2.7 per cent). This decrease mainly derives from the marked contraction in final demand and comprises both imports of goods and services. Over the projection horizon, a gradual recovery is anticipated in imports of goods and services, in line with developments projected for weighted final demand(Chart 4.3.4). This trend is expected to result in virtually nil annual average import growth in 2010 and 2.7 per cent growth in 2011.

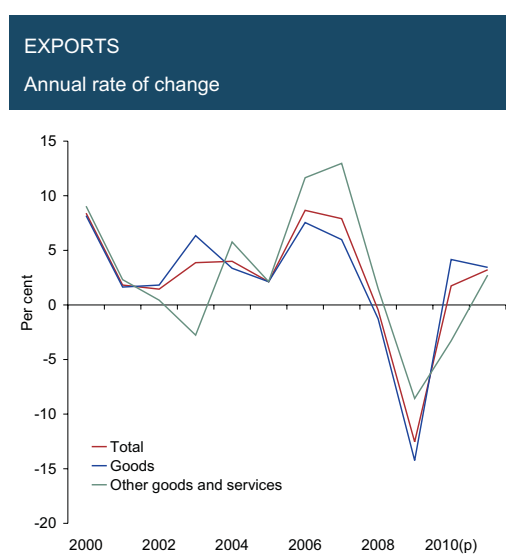
The marked fall in imports in 2009 was mainly determined by the strong contraction in demand components with higher import content: consumption of durable goods, business investment and exports of goods. At the same time, there was less inventory accumulation in 2009, a phenomenon which is gen-

Chart 4.3.1



Sources: ECB, INE and Banco de Portugal.
Note: (p) - projected.

Chart 4.3.2

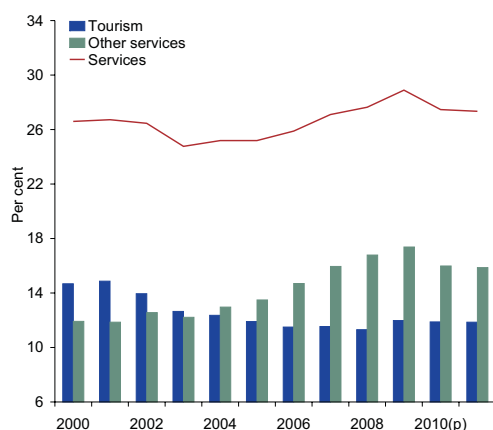


Sources: INE and Banco de Portugal.
Note: (p) - projected.

Chart 4.3.3

SHARE OF EXPORTS OF SERVICES IN OVERALL EXPORTS

Annual rate of change, on the basis of figures in real terms

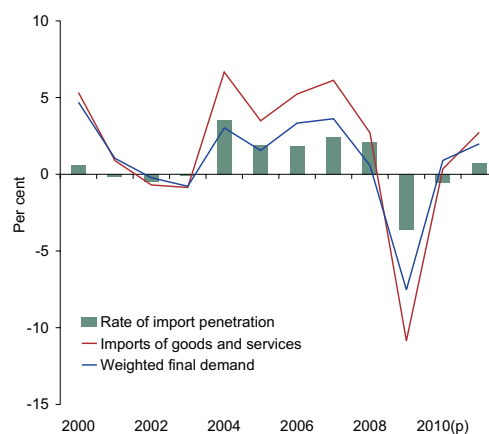


Source: Banco de Portugal.
Note: (p) - projected.

Chart 4.3.4

IMPORTS AND WEIGHTED OVERALL DEMAND

Annual rate of change



Sources: INE and Banco de Portugal.
Note: (p) - projected.

erally registered in years of marked downturn in demand. After the increase in import content over the past years, arising in part from the vertical integration of production on a global scale, there was less import penetration in 2009, as is usually the case in recessive periods of the economic cycles (Chart 4.3.4). The current projection foresees virtually nil average change of import penetration in the 2010-2011 period as a whole.

5. INFLATION

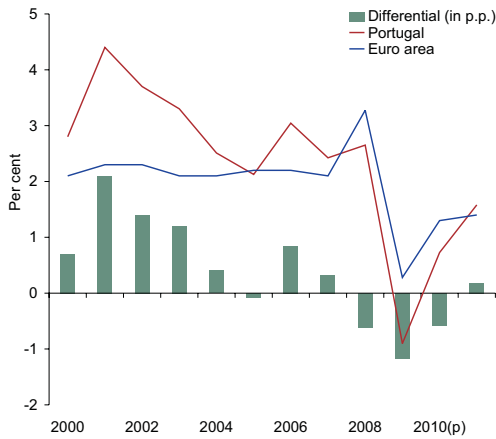
The current projection envisages a decline in consumer prices, as measured by HICP, of 0.9 per cent in 2009, while the resumption of positive growth rates is expected as from the beginning of 2010. In fact, the current projection indicates that the inflation rate will turn out to be 0.7 per cent in 2010 and 1.6 per cent in 2011 (Chart 5.1).

The decline in consumer prices in 2009 was unprecedented over the past three decades and reflected negative contributions from both the energy goods and the non-energy component, which fell 8 and 0.2 per cent respectively (Chart 5.2). These developments were associated with the large contraction in foreign and domestic demand, stemming from the recent economic and financial crisis. The fall in demand contributed to a considerable decline in commodity prices in international markets, both energy and non-energy. At the domestic level, contracting demand led to a substantial compression of profit margins, against a background of continued robust growth in unit labour costs, which portrayed a mismatch between buoyant wage developments and poor productivity increases.

In 2010, the inflation rate should return to positive levels (0.7 per cent), increasing to 1.6 per cent in 2011, against a background of recovery in global economic activity that should be reflected in price developments both abroad and in Portugal. At the international level, the recovery in economic activity is likely to induce an increase in demand for energy and non-energy commodities, leading to price hikes that will pass through to the Portuguese economy via developments in the non-energy imports deflator and oil prices. In the Portuguese economy, developments in economic activity should allow for a partial

Chart 5.1

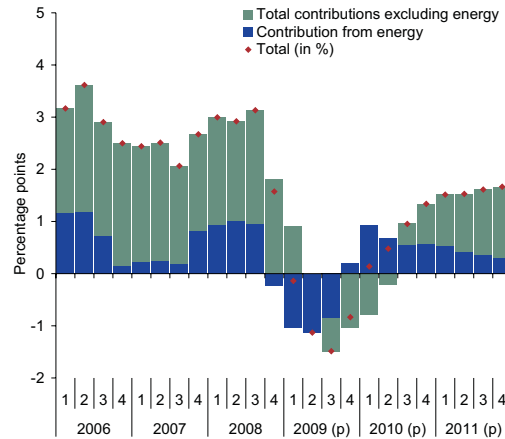
HICP IN PORTUGAL AND IN THE EURO AREA
Annual rate of change



Sources: ECB, Eurostat, INE and Banco de Portugal calculations.
Notes: (p) - projected. Euro area figures correspond to the midpoints of projection ranges published in the December issue of the ECB Monthly Bulletin.

Chart 5.2

OVERALL HICP AND CONTRIBUTION FROM ENERGY AND NON-ENERGY GOODS
Year-on-year rate of change

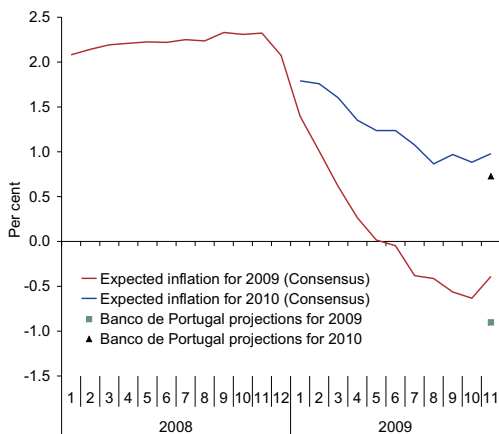


Sources: INE and Banco de Portugal calculations.
Note: (p) - projected.

recovery in profit margins in 2010, in a context of declining unit labour costs. This projected decrease stems the envisaged subdued wage growth, following the strong increase registered in 2009 and more favourable developments in productivity. In 2011 improvements in economic activity should lead to an increase in unit labour costs associated with larger wage growth than those projected for 2010.

Chart 5.3

DEVELOPMENTS IN INFLATION EXPECTATIONS FOR 2009 AND 2010 AND BANCO DE PORTUGAL PROJECTIONS FOR IHCP
Year-on-year rate of change



Sources: Consensus Economics and Banco de Portugal calculations.
Note: Monthly inflation expectations refer to the year as a whole.

Therefore, and in a context where inflation expectations of economic agents in 2010 remain anchored in positive territory (Chart 5.3), the decrease in consumer prices in 2009 should be regarded as a phenomenon of a temporary nature and not as a continued and sustained fall in prices.

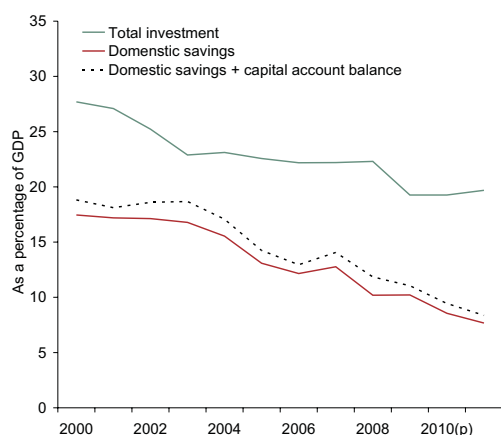
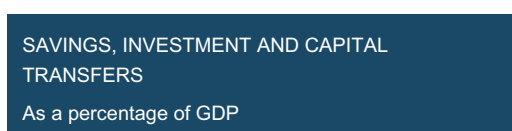
The current projections imply that the inflation differential between Portugal and the euro area will remain negative in 2010, albeit lower than in 2008 and 2009.⁹ These developments are widespread across all components of non-energy goods and contrast with the maintenance of a positive differential since the start of the euro area up to mid-2007. For 2011, the current projection envisages that this differential will be virtually nil.

6. CURRENT AND CAPITAL ACCOUNT

In the period following the 2003 recession, the Portuguese economy recorded a persistent and increasing imbalance between the domestic investment and domestic saving levels, thereby inducing an increase net external borrowing requirements of the Portuguese economy¹⁰ (Chart 6.1). Against this background, net external borrowing requirements of the Portuguese economy, as measured by the combined current and capital account balance as a percentage of GDP, have remained at a high level for a protracted period. The current projections point to a temporary decline in the borrowing requirements from 10.5 per cent of GDP in 2008 to 8.2 per cent in 2009. In fact, net external borrowing requirements are likely to increase again throughout the projection horizon, to 9.8 and 11.3 per cent of GDP, respectively in 2010 and 2011 (Chart 6.2).

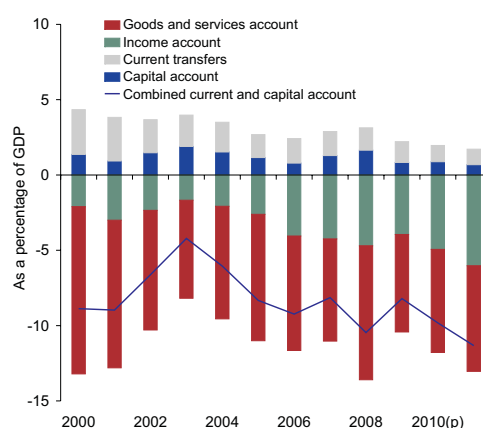
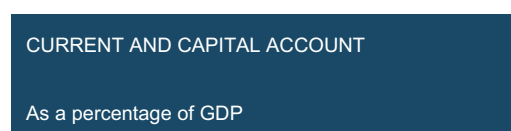
Amongst the factors contributing to the reduction in net external borrowing requirements in 2009 stand out the decline in oil prices and in interest rates. The first allowed for a substantial gain in terms of trade and consequently a significant narrowing of the energy account deficit (Chart 6.3), and the second induced a temporary inversion in the increasing profile of the income balance deficit through its effects on the debt service.

Chart 6.1



Source: Banco de Portugal.
Note: (p) - projected.

Chart 6.2



Source: Banco de Portugal.
Note: (p) - projected.

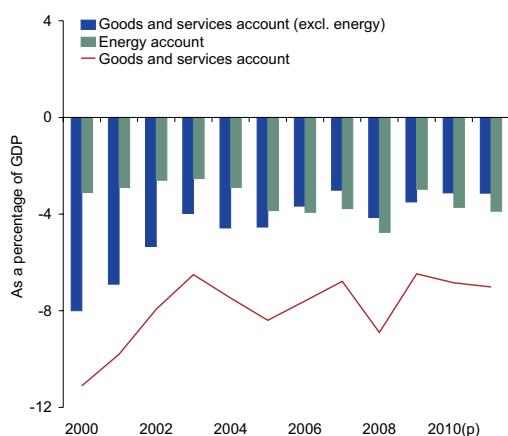
(9) Figures for the euro area correspond to the midpoints of the projection intervals published in the December issue of the *ECB Monthly Bulletin*.

(10) This gap between the levels of domestic investment and domestic saving has, however, been partially covered by the capital account surplus, as a result of capital transfers from abroad, mainly associated with the implementation of projects approved within the scope of the Community Support Frameworks.

Chart 6.3

GOODS AND SERVICES ACCOUNT AND ENERGY ACCOUNT

As a percentage of GDP



Source: Banco de Portugal.

Note: (p) - projected.

The reduction of net external borrowing requirements of the Portuguese economy in 2009 reflected the significant deterioration in general government borrowing requirements, in sharp contrast with an important reduction in the private sector's borrowing requirements. Both firms and households recorded a significant rise in the saving rate and a drop in investment. The large increase in general government borrowing requirements, in the context of a strong downturn in economic activity, mirrors both the functioning of automatic stabilisers and the discretionary fiscal stimulus measures for the economy in the meanwhile implemented by the authorities.

The current projection points to a further increase in the net external borrowing requirements in 2010 and 2011. This widening reflects, on the one hand, a slight deterioration in the goods and services account deficit and, on the other, a progressive increase in the income account deficit, stemming from the gradual and progressive rise in interest rates underlying the current projection (see "Section 2 Assumptions underlying the projection exercise") and the continuing deterioration of the international investment position of the Portuguese economy.

The large net external borrowing requirements observed throughout the past decade have resulted in a progressive deterioration in the international investment position of the Portuguese economy. The ensuing debt service has been absorbing progressively increasing resources, contributing directly to the widening of the income account deficit. This deficit, which accounted for around 2 per cent of GDP in 2000, reached around 4 per cent of GDP in 2009 and is likely to continue growing throughout the projection horizon, to stand at 6 per cent in 2011.

As mentioned, the goods and services account deficit is likely to rise somewhat over the projection horizon, which stems from the fact that the rise in average oil prices is being only partly offset by the reduction of the non-energy goods and services account deficit. Finally, in line with current assumptions for the profile of European Union transfers to Portugal (see "Section 2 Assumptions underlying the projection exercise"), the current projection envisages a slight decline in the combined surplus in the capital and current transfers accounts for 2010 and 2011.

7. UNCERTAINTY AND RISK ANALYSIS

The projections displayed in Table 1.1 correspond to the most likely figures for 2010 and 2011, conditional on the set of assumptions presented in “Section 2 Assumptions underlying the projection exercise”. The possibilities of these assumptions not materialising or the eventual occurrence of additional shocks with direct effects on the current projection warrant a quantitative assessment of risks and uncertainty, which follows in this section.

7.1. Risk and uncertainty factors

The duration, magnitude and implications of the international economic and financial crisis represent, as a whole, a prime factor for the future behaviour of the Portuguese economy. The current projection envisages the maintenance of a gradual easing of financial market tensions throughout the projection horizon. This trend reflects inter alia the impact of discretionary fiscal stimulus measures and the functioning of automatic stabilisers, which as a whole contributed to the global deterioration in general government accounts.

The deterioration in general government accounts at a global level warrants an urgent implementation of clear fiscal consolidation strategies, so as to prevent the impact of the stimulus measures from severely jeopardising future economic growth, due to persistently high debt levels, which could give rise to unsustainable dynamics in the medium to long term. Hence, further fiscal consolidation efforts, not reflected in the assumptions underlying the current projections, mean possibly lower economic dynamics in the short term, namely in the euro area, implying downward risks to external demand for Portuguese goods and services over the projection horizon. These eventual consolidation efforts may affect the projections for 2010 and in special for 2011, following the progressive deterioration in the fiscal deficits in 2009, in the context of the marked contraction in overall economic activity.

With regard to the specific case of Portugal, the economic and financial crisis also implied a marked deterioration in the general government accounts as in the other euro area countries, with a large drop in revenue and an increase in expenditure.¹¹ The underlying assumptions regarding public finances for 2010 and 2011 follow the usual rule within the scope of the Eurosystem’s projection exercise (see “Section 2 Assumptions underlying the projection exercise”). In a context of a gradual easing of international financial tensions, the need to ensure a path for the reduction of the fiscal imbalance and to restart an effective fiscal consolidation also implies downward risks to the evolution of the general government final consumption expenditure. Hence, downward risks for this variable were considered for 2011.

Finally, account was taken of downward risks as to domestic demand in Portugal in 2010 and 2011. With regard to households, there are still high levels of uncertainty surrounding their income and wealth levels, which may imply lower-than-projected growth of consumer spending and housing investment in both 2010 and 2011. In particular, the conditions prevailing in the labour market will tend to be marked by weak employment growth, which may imply a higher level of precautionary savings. Furthermore, household expenditure may also be particularly affected by both the adoption of tighter credit standards than those implied in the current projection and the persistence of higher risk *premia*,

(11) In this context, Portugal was included in the group of countries in an excessive deficit situation. In early December 2009 the ECOFIN Council adopted, within the scope of Article 126(6) of the Treaty of Lisbon (Article 104(6) of the Maastricht Treaty), decisions on the existence of excessive deficits in Austria, Belgium, the Czech Republic, Germany, Italy, the Netherlands, Portugal, Slovakia and Slovenia. France, Greece, Hungary, Ireland, Latvia, Lithuania, Malta, Poland, Romania, Spain and the United Kingdom were already in an excessive deficit situation.

arising from high household indebtedness level. Moreover, the behaviour of the Portuguese banks will always be conditioned by their financing conditions in international wholesale markets. These factors imply the continuance of downward risks to private consumption and residential investment.

As for corporations, account is also taken of the possibility of business investment expenditure falling short of the figure in the current projections. The uncertainty surrounding the sustainability of the economic recovery, in a context of low levels of the capacity utilisation rate, may give rise to increased doubts as to the future disposal of production, and may create expectations that a higher capacity utilisation rate will suffice to address possible increases in demand, thereby conditioning investment decisions over the projection horizon. In a context of eventual renewed tensions in international markets, this risk may also rise from increased difficulties in access to credit, stemming from the implementation of tighter credit standards than those considered in the current projections.

7.2. Quantification of risk factors

The effects of the above mentioned risks can be quantified by assigning subjective probabilities to its occurrence. The downward risks on external demand for Portuguese goods and services and on general government consumption will be assessed in terms of deviations from the underlying assumptions assumed, whereas specific risks to consumption and investment will be considered in terms of deviations from the projection included in Table 1.1.

With regard to risks stemming from the international background for the Portuguese economy, the following was considered: a 55 per cent probability in 2010 and a 60 per cent probability in 2011 that external demand will stand below the central projection (Table 7.2.1). In the case of general government consumption, this probability was 60 per cent in 2011. With regard to private consumption and investment, a probability of 55 per cent was assumed that such expenses would stand below the levels published in the projection, both in 2010 and 2011. As far as consumption is concerned, this quantification assumes lower-than-projected growth in the next two years, whereas for investment it assumes a larger fall in 2010 and a less marked recovery in 2011.

The effects of the subjective risks considered are quantified in Table 7.2.2. According to the methodology used, there is a 55 per cent and a 59 per cent probability that in 2010 and 2011, respectively, GDP growth will stand below the current projection.¹² The possibility of external demand falling short of the underlying assumptions indicates, in particular, a higher probability of less favourable developments in exports over the forecasting horizon. Risks to general government consumption in 2011 have a direct effect on the quantitative assessment of risks on overall economic activity. The possibility of consumption and investment falling short of the central projection reinforces such a risk and contributes to a higher than 50 per cent probability of GDP growth being below the current projection (Chart 7.2.1).

As to the inflation rate (Table 7.2.2 and Chart 7.2.2), the risks associated with the current projection are broadly balanced, and the probability of inflation standing below or above projected is virtually similar.

(12) The methodology used in this section, which replaces the former one, was published in M. Pinheiro and P. Esteves (2008), "On the Uncertainty and Risks of Macroeconomic Forecasts: Combining Judgements with Sample and Model Information", Banco de Portugal, *Working Paper* 21. The former methodology was published in A. Novo and M. Pinheiro (2003), "Uncertainty and Risk Analysis of Macroeconomic Forecasts", Banco de Portugal, *Working Paper* 19.

Table 7.2.1

SUBJECTIVE PROBABILITIES OF RISK FACTORS Per cent		
	2010	2011
Conditioning variables		
External demand	55	60
General gov. consumption	50	60
Endogenous variables		
Private consumption	55	55
GFCF	55	55

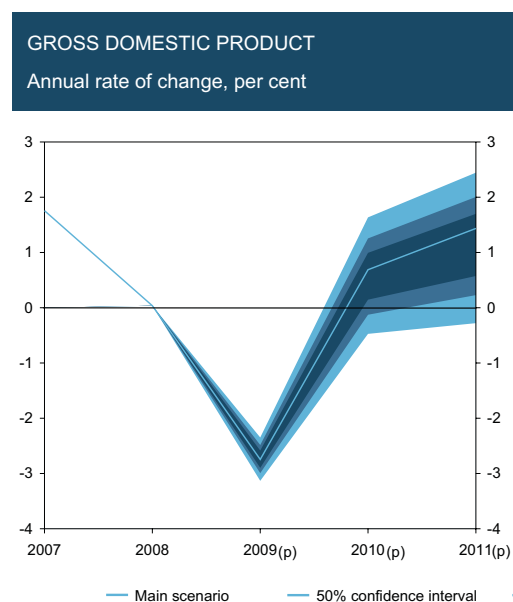
Source: Banco de Portugal.

Table 7.2.2

PROBABILITY OF AN OUTTURN BELOW THE PROJECTIONS Per cent			
	Weights 2008 (%)	2010	2011
Gross domestic product			
Private consumption	67	55	58
GFCF	22	57	59
Exports	33	52	59
Imports	43	54	62
HICP			
		49	50

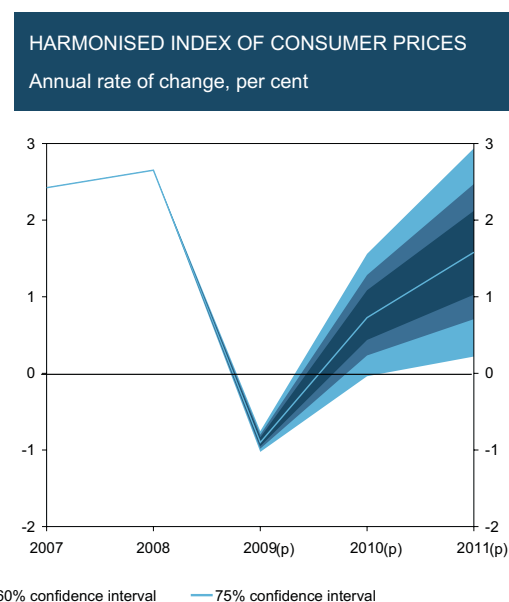
Source: Banco de Portugal.

Chart 7.2.1



Source: Banco de Portugal.
Note: (p) - projected.

Chart 7.2.2



8. CONCLUSION

The current projection for the Portuguese economy points to a recovery in economic activity, which is likely to grow at moderate pace throughout the projection horizon. This dynamics is expected to follow against the background of a progressive unwinding of the financial crisis in international markets over the projection horizon and a gradual reversal of the degree of risk aversion at a global level. These developments will pass through on to the Portuguese economy by both the recovery of external demand for Portuguese goods and services, and the improvement of financing conditions for Portuguese households and firms. These improved financing conditions stem *inter alia* from more favourable conditions in banks' access to wholesale financing markets, remaining however tighter than those prevailing in the period immediately before the outbreak of the financial crisis. Nevertheless, in the context of

the global economic and financial crisis, the Portuguese economy presented some robust features, in particular the absence of overvalued real estate market prices and the maintenance of a relatively favourable situation of the Portuguese banking system at the European level. Turning to inflation developments, in 2009 consumer prices fell in Portugal in annual average terms, reflecting demand conditions and maintaining a negative differential vis-à-vis the euro area average. The current projection envisages an increase in consumer prices from 2010 onwards, stemming from both the projected trend for import prices and some recovery in profit margins, in a context of wage moderation.

The economic recovery in Portugal faces, however, challenges that extend far beyond the conjunctural features associated with developments in financial markets and in economic activity at a global level. On the one hand, the international financial crisis may have had a negative impact on both the equilibrium level of world economic activity and the dynamics of potential output growth of the economies, which will inevitably condition demand growth prospects also in Portugal. On the other hand, throughout the last decade, the Portuguese economy has displayed a set of structural weaknesses, whose impact has been apparent in the progressive slowdown of trend output and in the interruption of the real convergence process to the average income levels recorded in the euro area. These structural weaknesses, resulting *inter alia* from a low level of labour qualification, labour and output market functioning and the judicial system, have been hampering investment with larger technological content, namely foreign direct investment, which in the past proved to be crucial in ensuring sustained growth of total factor productivity and potential output. Furthermore, the low level of human capital of working-age population limits their ability for requalification or to be relocated to sectors with brighter demand growth prospects, which will tend to translate into a greater persistence of the recent increase in structural unemployment, thereby limiting the contribution of the labour factor to output growth.

Against this background, it is of primary importance that the education and judicial systems are improved, and the recent labour legislation reforms fully implemented. Furthermore, it would be important to ensure a more effective regulation of the product market in order to increase the competition levels in the economy. Only by implementing reforms in these areas will it be possible to pave the way for a more efficient resource allocation, which seems to be an essential requirement to restore the international competitiveness of the Portuguese economy, promote the increase in productivity and the sustained job creation.

Moreover, the pursuit of a growth-oriented macroeconomic stability framework requires the presentation of a clear and credible fiscal consolidation strategy, in a medium-term perspective. Within this scope, it is relevant to rationalise public sector expenditures, to continue to increase the degree of efficiency of tax administration, as well as fully implement the rules established in the reform of the public system of social security so as to guarantee the sustainability of the fiscal situation.

Finally, the vigour of the economic recovery and job creation, in a small open economy fully integrated in economic and financial terms, is crucially dependent on its capacity to benefit from the upturn in world demand. In this context, it is vital that economic agents internalise the role of wage developments in the increase of the Portuguese economy's competitiveness and adopt a wage-setting behaviour consistent with productivity differentials *vis-à-vis* the main trading partners.

The current outlook for developments in the Portuguese economy remains surrounded with a high degree of uncertainty, with resilient downward risks to economic activity. These risks stem from the international environment *per se*, and from the uncertainty as to the possible resulting impact from their interaction with the structural weaknesses of the Portuguese economy. As regards the international environment, there is still a great deal of uncertainty surrounding the effects of the reversal of the monetary and fiscal stimulus measures adopted in 2008 and 2009 on economic activity over the projection horizon. Moreover, it is hard to put into perspective the impact of the financial crisis on the equilibrium level of economic activity and on potential output growth dynamics itself. Finally, the high indebtedness

level of the private sector, in a context of a substantial increase in public sector debt and low trend growth, may lead to less favourable financing conditions in international markets, translating into a rise in risk *premia*.