

PROJECTIONS FOR THE PORTUGUESE ECONOMY: 2012-2013

The developments of the Portuguese economy in 2011 were decisively marked by the interruption of access to market financing and by the start of the implementation of the Economic and Financial Assistance Programme (EFAP), which is also the main reference for the medium-term outlook analysis.

The EFAP provides a stable financing framework for the 2011-2014 period and a strategy for both the adjustment of macroeconomic imbalances in the Portuguese economy and the increase in its growth potential, based on three pillars: lasting fiscal consolidation, financial system stability and structural transformation of the Portuguese economy. These pillars are fundamental to prevent the abrupt and disorderly adjustment that would occur in the absence of financing, and to create sustainable growth conditions in the Portuguese economy and convergence with average per capita income levels in the euro area.

In 2011, this adjustment process of accumulated imbalances in the Portuguese economy translated into a 1.6 per cent decline in Gross Domestic Product (GDP). GDP developments reflect a contraction in all domestic demand components, partly offset by robust growth in exports of goods and services. The current projections for 2012-2013 suggest a continuation of this process, with a contraction of economic activity of 3.4 per cent in 2012, followed by stagnation in 2013 (Table 1). Domestic demand is projected to continue to decline in the current year, reflecting in particular a more pronounced downturn in private consumption, in a context of strong deterioration of households' disposable income. In turn, the contribution of exports will continue to be important to sustain activity, in spite of the projected significant slowdown *vis-à-vis* robust growth in 2011, as a result of a marked deterioration of external demand prospects. Balance-sheet adjustments in the public and private sectors have translated into declining external imbalances, reflected in a significant improvement in the current and capital account balance in 2011, which is projected to continue into forthcoming years.

Table 1

PROJECTIONS OF BANCO DE PORTUGAL: 2012-2013 ANNUAL RATE OF CHANGE, PER CENT							
	Weights 2011	EB Spring 2012			EB Winter 2011		
		2011	2012 ^(p)	2013 ^(p)	2011 ^(p)	2012 ^(p)	2013 ^(p)
Gross Domestic Product	100.0	-1.6	-3.4	0.0	-1.6	-3.1	0.3
Private consumption	66.3	-3.9	-7.3	-1.9	-3.6	-6.0	-1.8
Public consumption	20.2	-3.9	-1.7	-1.2	-3.2	-2.9	-1.4
Gross Fixed Capital Formation	18.0	-11.4	-12.0	-1.7	-11.2	-12.8	-1.8
Domestic demand	103.9	-5.7	-6.2	-1.6	-5.2	-6.6	-1.6
Exports	35.5	7.4	2.7	4.4	7.3	4.1	5.8
Imports	39.3	-5.5	-5.6	0.0	-4.3	-6.3	0.7
Contribution to GDP growth (in p.p.)							
Net exports		4.6	3.1	1.6	4.1	3.9	1.9
Domestic demand		-6.2	-6.5	-1.7	-5.6	-6.7	-1.5
<i>of which</i> : change in inventories		-0.5	0.8	0.1	-0.3	0.1	0.2
Current plus capital account (% of GDP)		-5.2	-2.8	-0.4	-6.8	-1.6	0.8
Trade Balance (% of GDP)		-3.2	-1.0	1.0	-3.7	0.3	2.4
Harmonised Index of Consumer Prices		3.6	3.2	0.9	3.6	3.2	1.0

Sources: INE and Banco de Portugal.

Notes: (p) - projected. For each aggregate, this table shows the projection corresponding to the most likely value, conditional on the set of assumptions considered, and based on information available up to early March 2012.

Slowdown of external demand in 2012, and maintenance of money-market short-term interest rates at low levels

Underlying the current projections is a range of assumptions regarding the Portuguese economy's external context, developments in public finances, and the domestic financing conditions of the economy (Table 2).

As regards international trade developments, the current assumptions reflect recent information published by the European Central Bank in the March 2012 issue of its Monthly Bulletin. This suggests a slowdown in overall activity growth in 2012. In particular, growth prospects in advanced economies, including the euro area, will probably remain subdued due to persisting tensions associated with the sovereign debt crisis, as well as by the impact of fiscal consolidation measures and the deleveraging process in the private sector. In this context, external demand for Portuguese goods and services is expected to slow down temporarily in 2012. In 2013 it is expected to show a pace of growth similar to that recorded in 2011. These assumptions imply a downward revision of external demand growth from the one published in the previous Economic Bulletin.

The exchange rate assumptions, which imply that they remain constant at the average levels observed in the two weeks prior to the cut-off date, entail a nominal depreciation of the euro in 2012, both in effective terms and *vis-à-vis* the US dollar. These assumptions imply an unchanged EUR-USD exchange rate profile when compared to the winter issue of the Economic Bulletin.¹

As regards the oil price in US dollars, the information implied in futures markets points to a temporary rise in 2012, whereas in 2013 it is expected to stand close to the level recorded in 2011. This profile contrasts with the downward trend in the oil price underlying the previous Economic Bulletin and is associated with intensifying geopolitical tensions.

As regards financing conditions, the technical assumption for the short-term interest rate (3-month EURIBOR rate) implied in futures contracts implies its stability over the projection horizon at levels slightly below 1 per cent, comprising a downward revision from the winter issue of the Economic Bulletin. As regards domestic financing conditions, these have been increasingly tighter, translating, *inter alia*, into an increasing spread between lending interest rates and money-market reference rates.² The projection

Table 2

		PROJECTION ASSUMPTIONS					
		EB Spring 2012			EB Winter 2011		
		2011	2012	2013	2011	2012	2013
External demand	yoy	3.9	0.6	4.4	4.7	3.2	5.7
Interest rate							
Short-term (3-month EURIBOR)	%	1.4	0.8	0.8	1.4	1.1	1.1
Long-term ^(a)	%	4.1	2.2	2.2	4.9	3.3	3.7
EUR exchange rate							
EUR effective exchange rate	yoy	-0.2	-3.3	0.1	-0.1	-1.2	0.0
EUR-USD	aav	1.39	1.33	1.33	1.39	1.33	1.33
Oil price							
in USD	aav	111.0	119.6	113.8	111.1	106.7	102.4
in EUR	aav	79.7	90.2	85.6	79.7	80.2	77.0

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

Notes: yoy - year-on-year rate of change, % - per cent, aav - annual average value. An increase in the exchange rate represents an appreciation. **(a)** The annual average value for 2011 corresponds in the first quarter to a market interest rate and in the remaining quarters of that year, as well as over the projection horizon, to an estimate of the interest rate of the EU/IMF Financial Assistance Programme.

- 1 The assumptions for the nominal effective exchange rate of the euro cannot be directly compared with those in the winter issue of the Economic Bulletin, given that this series was revised following an update of the international trade weights underlying its calculation. For further information, see the ECB's methodological note in this update: http://www.ecb.europa.eu/stats/pdf/exchange/Methodological_note_MoBu_Jan2012.pdf.
- 2 For further information, see the Bank Lending Survey – Results for Portugal: January 2012.

exercise assumes that the increasing trend of these spreads will continue into early 2013, to be followed by a moderate narrowing up to the end of the projection horizon, although to levels well above those prevailing before the financial crisis.

The assumptions for the long-term sovereign debt interest rate, as of the second quarter of 2011, reflect an estimate of the average external financing rate under the EFAP, implying its reduction in 2012 and stabilisation in 2013.³ The updated international financing costs of financing institutions imply a downward revision of these assumptions *vis-à-vis* the previous Economic Bulletin.

The assumptions for public finance developments are based on the rule adopted in Eurosystem exercises, which only considers the measures already approved by national parliaments or that have been specified in sufficient detail by governments and are likely to pass the legislative process. Therefore, the present projections include, in particular, the measures underlying the State Budget for 2012. According to these assumptions, the volume of public consumption is projected to contract further over the projection horizon, albeit at a more moderate pace than in 2011. The fall in nominal public consumption is expected to be more significant, reflecting the behaviour of the respective deflator. Worthy of mention in this respect is the suspension of the holiday and Christmas bonuses for civil servants in 2012. This will have a differentiated and gradual nature.

Decline of 1.6 per cent in economic activity in 2011

GDP decreased by 1.6 per cent in 2011, as a result of a contraction in all domestic demand components. In particular, private consumption and Gross Fixed Capital Formation (GFCF) have further intensified their declining trend over the course of the year, in year-on-year terms. The impact of domestic demand developments on GDP was partly offset by continued robust growth of exports of goods and services. Compared with the one projected in the previous Economic Bulletin, GDP growth in 2011 remained unchanged, in spite of a downward revision in all domestic demand components, which was offset by an also downward revision in imports of goods and services. These revisions largely reflect more unfavourable developments than projected for domestic demand in the fourth quarter of 2011. In this context, it is also worth mentioning the deterioration of labour market conditions in 2011, particularly in the fourth quarter, which translated into a fall in employment identical to that observed in the previous year and into a very significant rise in the unemployment rate.

As regards corporate financing conditions, the available evidence suggests that there have been no abrupt aggregate quantitative restrictions on the supply side. There are, however, large differences among corporations and among sectors. Indeed, in a context of strong domestic demand contraction, credit risk has tended to exacerbate in some non-tradable goods sectors corporations, as well as in smaller corporations. In turn, in contrast to the sovereign and banking situation, a range of corporations with better financial situation and with external links managed to increase their recourse to external financing at the end of the year. In 2011, total financing by non-residents to private corporations ascended to about €4,300 million. This explains why total credit⁴ to private corporations has risen by 0.4 per cent at the end of 2011, whereas domestic bank loans⁵ fell by 2.4 per cent.

It is crucial that the banking system continues to help the most dynamic and productive corporations overcome possible temporary liquidity problems and/or restructure their operations, thereby contributing to the necessary restructuring of Portuguese economy.

³ For further information on the EFAP, see <http://www.bportugal.pt/en-US/OBancoeoEurosistema/ProgramaApoioEconomicoFinanceiro/Pages/default.aspx>.

⁴ Including domestic and external credit under the form of loans, debt securities and trade credit.

⁵ Adjusted for the effect of credit sales by the largest Portuguese banks, as well as other operations with no actual impact on corporate financing.

Significant decline in GDP in 2012 and stagnation in 2013

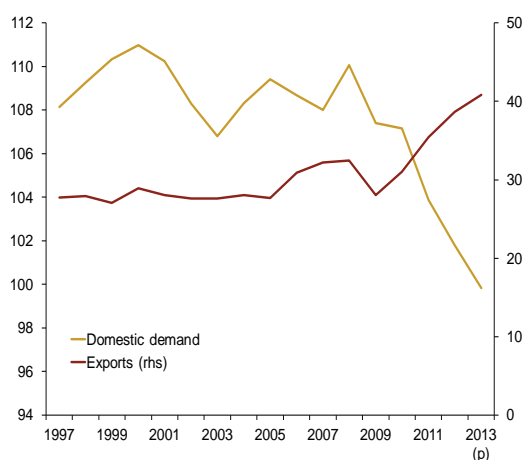
Current projections point to a significant contraction in economic activity in 2012 (3.4 per cent, compared with 1.6 per cent in 2011), followed by stagnation in 2013. These projections reflect a continued sharp fall in domestic demand (around 14 per cent in cumulative terms in the 2011-2013 period). Exports are expected to maintain a role in mitigating the impact of contracting domestic demand, in spite of a slowdown in 2012-2013, against a background of moderating global economic activity. This framework implies a recomposition of expenditure, characterised by a significant decline in the weight of domestic demand in GDP, in tandem with an increase in the weight of exports (Chart 1).

After having contracted by 3.9 per cent in 2011, private consumption is projected to decrease by 7.3 per cent in 2012 and by 1.9 per cent in 2013. This profile largely reflects developments projected for disposable income, in a context where tighter financing conditions limit the capacity of many consumers to smooth fluctuations in consumption levels. Disposable income will probably be significantly restricted over the projection horizon by the impact of fiscal consolidation measures, as well as by a reduction in labour income, in a context of sharp deterioration of labour market conditions. The current projections point to an increase in the savings rate over the projection horizon (Chart 2). In effect, in addition to the maintenance of high mandatory savings levels associated with credit amortization, lower permanent income prospects may lead to a revaluation of consumption decisions by consumers that do not face liquidity constraints, favouring an increase in precautionary savings.

GFCF is projected to decline in 2012 by slightly more than in the previous year (12 per cent, compared with 11.4 per cent in 2011), in line with the profile projected for the business component, which will reflect the continued deterioration of demand prospects of corporations. Over the course of 2013, business GFCF is expected to exhibit a recovery trend, benefiting from the acceleration projected for external demand. Total GFCF, however, is still expected to decline in annual average terms in 2013 (1.7 per cent). In addition, developments projected for disposable income, as well as for financing conditions, are expected to condition residential GFCF developments over the projection horizon. Within the framework of the fiscal consolidation process, public GFCF is projected to decrease very significantly in 2012-2013, similarly to 2011. Changes in inventories are projected to contribute around 0.8 percentage points (p.p.) to GDP growth in 2012, since the very significant destocking recorded in 2011, particularly in the fourth

Chart 1

WEIGHT OF DOMESTIC DEMAND AND EXPORTS IN GDP | AS A PERCENTAGE OF NOMINAL GDP

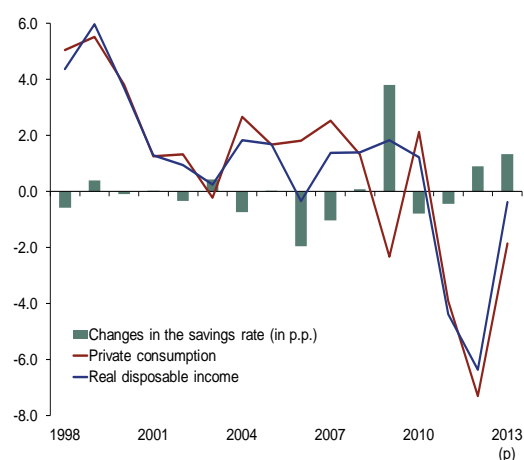


Sources: INE and Banco de Portugal.

Note: (p) – projected.

Chart 2

CONSUMPTION, DISPOSABLE INCOME AND SAVINGS RATE | ANNUAL AVERAGE RATE OF CHANGE



Sources: INE and Banco de Portugal.

Notes: (p) – projected. The savings rate is represented as a percentage of disposable income.

quarter, is considered to be of a temporary nature. In 2013, the contribution of this component to GDP growth is projected to be virtually nil.

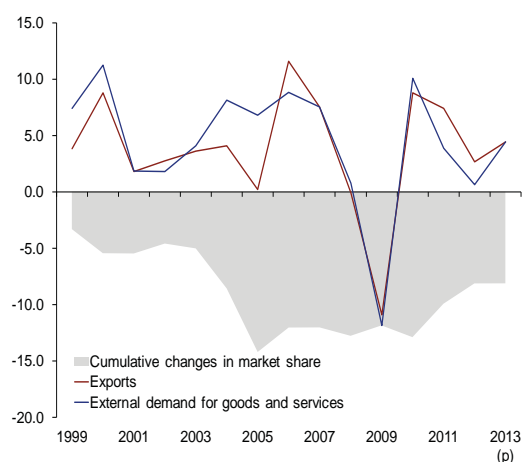
After having grown by 7.4 per cent in 2011, exports are projected to slow down to 2.7 per cent in 2012 and to accelerate to 4.4 per cent in 2013. Underlying these developments, which are common to the goods and services components, is an increase in market share in 2012 (Chart 3). The behaviour of exports reflects the redirection of tradable goods producers to external markets, wider geographical diversification, implying a rise in the weight of extra-EU markets, which are projected to remain buoyant over the projection horizon, and an improvement in relative costs. As previously mentioned, the assumptions for external demand imply a downward revision from the previous Economic Bulletin, a trend that has persisted since the autumn of 2011 (Chart 4). The gradual deterioration of prospects for global economic growth reflects *inter alia* tensions associated with the sovereign debt crisis in the euro area, in tandem with high uncertainty as to the mechanisms for its resolution, in a context of increasingly close interaction between the financial system and real economy. This highly volatile context implies that, although the deceleration of external demand is assumed to be temporary, its developments may fundamentally influence the recovery path of the Portuguese economy, given that demand prospects in the domestic market are highly constrained by the need for continued adjustment of macroeconomic imbalances.

Imports are projected to decline by 5.6 per cent in 2012, a similar contraction to the one recorded in 2011. This component is projected to stabilise in 2013, reflecting the buoyant recovery of some relatively high import-content expenditure components, such as exports and business GFCF. These developments imply a reduction in the import content of final demand in 2011-2013, as observed in previous recessions.

When compared with the previous Economic Bulletin, current projections point to a downward revision of GDP growth by 0.3 p.p. in 2012 and 2013, partly reflecting the revision of exports due to less favourable assumptions for external demand developments, as well as the impact on income prospects and, as a result, on private consumption, of a more marked deterioration of labour market conditions, particularly in 2012.

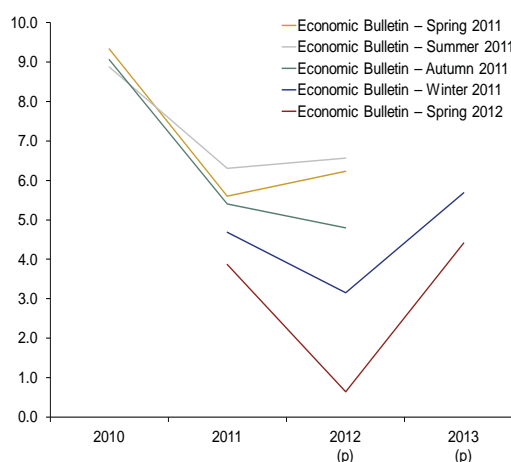
The financing requirements of the Portuguese economy are projected to decline substantially over the projection horizon, from -5.2 per cent of GDP in 2011 to -0.4 per cent of GDP in 2013. This adjustment trend is similar to that observed in the context of the economic stabilisation agreements concluded with

Chart 3
EXPORTS, EXTERNAL DEMAND AND MARKET SHARE | ANNUAL RATE OF CHANGE



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

Chart 4
DEVELOPMENTS IN EXTERNAL DEMAND | ANNUAL RATE OF CHANGE



Sources: ECB, IMF and Banco de Portugal's calculations.
Note: (p) – projected.

the International Monetary Fund (IMF) in the 1970s and 1980s (Chart 5). Underlying these developments is a significant improvement in the trade balance, which is projected to increase from -3.2 per cent of GDP in 2011 to -1.0 per cent of GDP in 2012 and 1.0 per cent of GDP in 2013 (Chart 6). This is largely the result of a volume effect, which offsets a terms-of-trade unfavourable effect in 2012, partly driven by energy. A slight terms-of-trade improvement is projected for 2013. The income account deficit as a percentage of GDP is projected to decline moderately over the projection horizon, reflecting more favourable assumptions for interest rates.

As regards the labour market, employment is projected to decline by 3.6 per cent in 2012 and by 0.7 per cent in 2013 (compared with a 1.5 per cent decrease in 2011). The significant contraction in employment projected for 2012 is expected to be more marked in the private sector, reflecting economic activity developments, as well as carry-over effects resulting from rather adverse dynamics in the fourth quarter of 2011. Employment in the public sector is projected to maintain a relatively constant pace of reduction over the projection horizon, with a sharper fall than in the private sector in 2013.

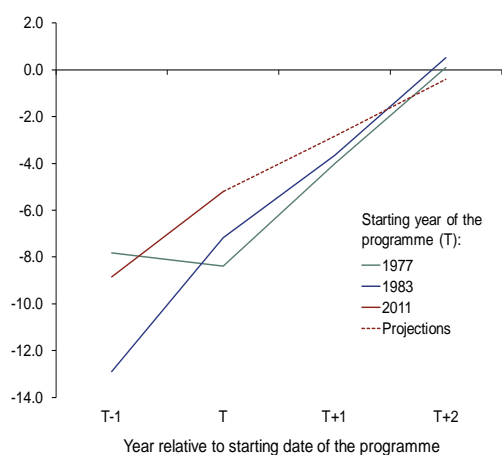
Particularly relevant in the current context is the implementation of structural reforms to increase growth of the Portuguese economy, as envisaged in the EFAP. These include measures to favour competitiveness, especially by promoting competition in some sectors that have so far been protected, and changing the labour market's institutional framework, characterised by marked segmentation (see 'Segmentation', the Issue for Discussion in this Bulletin). In addition, the Programme also includes reforms to boost the institutional framework of the economy, with emphasis on the reform of the judicial system. These measures are deemed essential to promote benefits for the Portuguese economy arising from the correction of current macroeconomic imbalances.

Inflation to remain close to 3 per cent in 2012 and to decrease to around 1 per cent in 2013, with the fading out of fiscal factors

HICP (Harmonised Index of Consumer Prices) inflation is projected to remain relatively stable in 2012 (annual average rate of change of 3.2 per cent, compared with 3.6 per cent in 2011), and to fall to 0.9

Chart 5

DEVELOPMENTS IN FINANCING REQUIREMENTS DURING INTERNATIONAL FINANCIAL ASSISTANCE PROGRAMMES | AS A PERCENTAGE OF GDP

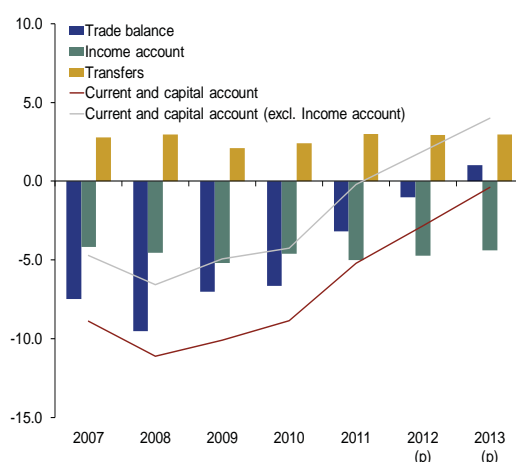


Sources: INE and Banco de Portugal.

Note: As regards the 1977 and 1983 programmes, data refer to the Current Account.

Chart 6

DEVELOPMENTS IN FINANCING REQUIREMENTS | AS A PERCENTAGE OF GDP



Sources: INE and Banco de Portugal.

Note: (p) – projected.

per cent in 2013. These projections reflect a deceleration in the energy component of the HICP in 2012 (from 12.8 per cent to 9.3 per cent) and a 0.2 per cent decline in 2013, largely reflecting the assumptions for oil prices in euros, whereas the non-energy component is projected to remain stable in 2012 (at 2.3 per cent) and decelerate significantly to 1.1 per cent in 2013 (Chart 7).

The stabilisation of the inflation rate in the 2011-2012 period at values which are relatively high given developments in its usual explanatory factors largely reflects increases in administered prices and the rise in indirect taxation. In the context of the deteriorating labour market situation, these increases are not expected to feed through to wages. Growth of administered prices is expected to reach 5.5 per cent in 2012, whereas the contribution of indirect taxation to inflation in 2012 is projected to be close to 2 p.p., largely reflecting the changes in VAT rates implemented in October 2011 (in the case of natural gas and electricity) and in January 2012. In 2013, in tandem with the fading out of these effects, the contribution of indirect taxation to inflation will be virtually nil, and administered prices are expected to grow less than 2 per cent. The behaviour of consumer prices is therefore expected to be more in line with macroeconomic developments.

Current projections point to a decline in unit labour costs in the private sector in 2012 and 2013, in an environment where wages developments are projected to be strongly affected by the deterioration of the labour market situation. Furthermore, wage growth in 2012 will be influenced by the impact of the suspension of holiday and Christmas bonuses in the public sector, and by the 50 per cent cut in overtime payments, which is scheduled to enter into force this year. Import prices of non-energy goods are projected to decelerate over the projection horizon from 5.2 per cent in 2011 to 3.4 in 2012 and 1.4 per cent in 2013.

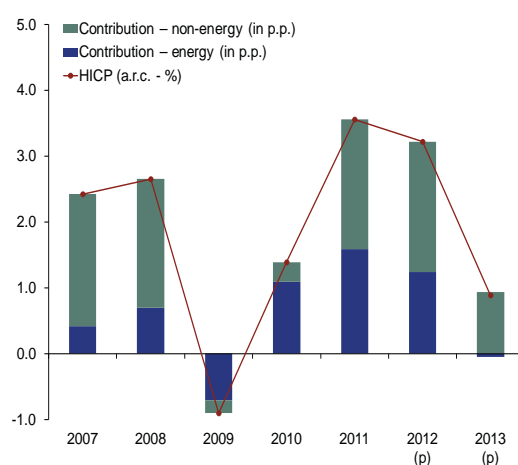
Projections for the inflation rate have remained virtually unchanged from the winter issue of the Economic Bulletin.

Risks of more unfavourable economic activity developments and balanced risks for inflation

Risks inherent in current projections point mainly to the possibility of more unfavourable developments in economic activity, *vis-à-vis* central scenario projections. These risks are largely the result of external factors, due to the persisting high uncertainty surrounding the resolution of the sovereign debt crisis in the euro area. Indeed, notwithstanding the favourable impact of non-standard monetary policy meas-

Chart 7

INFLATION | CONTRIBUTION TO THE ANNUAL RATE OF CHANGE OF THE HICP



Sources: Eurostat and Banco de Portugal.

Note: (p) – projected.

ures adopted by the Eurosystem in late 2011 and early 2012, risks remain of further intensification of interaction mechanisms either between the financial system and the real economy, or between the euro area and the world economy, particularly in the context of the fiscal consolidation plans currently under way in several economies. Against this background, the deceleration in external demand envisaged in the current projections may assume a more expressive or persisting role, with a negative impact on Portuguese exports. At the domestic level, a deterioration of the macroeconomic scenario could lead to the need to adopt additional measures ensuring compliance with the fiscal objective. The risks associated with inflation projections are balanced. On the one hand, the materialisation of risks regarding the projections for economic activity may tend to translate into lower price growth. On the other hand, the possibility of an increase in indirect taxation and administered prices, due to the possible need for additional fiscal consolidation measures, would feed through to an increase in inflationary pressures. Furthermore, possible disturbances in oil supply in the current geopolitical context lead to increased uncertainty as to developments in this commodity price.

Conclusion

Over more than a decade, in a context of extremely benign financial conditions, the Portuguese economy has accumulated sizeable imbalances, due to economic policies and agents' behaviour that were largely inappropriate to the requirements of the new regime emerging from Portugal's integration in the euro area. This has translated into unsustainable indebtedness levels of the public sector, corporations and households, and relevant imbalances in the banking sector financing structure. The Portuguese economy has thus been faced with large vulnerabilities in meeting the increasingly adverse financial conditions observed since 2007-2008. These vulnerabilities have been aggravated by an expansionary fiscal policy, in a context of growing financing costs and increased credit risk segmentation in financial markets, in particular for euro area debtors, thus making it inevitable for the Portuguese State to negotiate an international financial assistance programme in April 2011.

An evaluation of the EFAP enforcement by the European Union and the IMF reveals that the programme, overall, has been fulfilled: the general government deficit stood at approximately 4 per cent of GDP, i.e. below the maximum level determined in the EFAP (5.9 per cent of GDP), even though benefitting from significant extraordinary measures (4 per cent of GDP); the banking sector has carried on its deleveraging process and has strengthened solvency; at the structural level, a number of changes have been introduced in the regulatory framework, covering such different areas as the financial sector, justice, competition policy and labour market.

These results must not induce less attention to future challenges. The correction of macroeconomic imbalances in the Portuguese economy involves a protracted adjustment both of expenditure levels in the public and private sectors and of the leverage degree in the banking sector. However, the deleveraging process must assume an orderly and gradual nature, without compromising the financing of the most competitive sectors in the economy, requiring continued monitoring by the authorities, as laid down in the EFAP. The manner in which these essential objectives are to be met will constrain the trend of economic activity and employment in forthcoming years. A successful adjustment of the Portuguese economy requires a substantial improvement in the quality of the driving factors of potential growth and, in particular, of the institutional framework. The strict implementation of the structural transformation measures envisaged in the EFAP, not only at the legislative level, but chiefly as regards their effective implementation, is thus essential so that the Portuguese economy may attain a sustainable growth path.