

## OVERVIEW

In an international context affected by the most profound and synchronised world economic recession of the last decades, the Portuguese economy decelerated markedly in 2008, in particular at the end of the year, entering a recessive period that will persist during 2009. These developments reflected a clear interaction between negative economic and financial shocks on a global scale, characterised by a growing scope in terms of geography and financial market segments. This framework of high systemic risk potentiated the deepening of international cooperation, with several countries' governments and central banks, including Portugal, adopting a diversified set of measures to stabilise the financial system and support the economic activity. The Portuguese economy – strongly integrated at an economic and financial level – was directly affected by these developments, namely through a marked fall in external demand, a deterioration of financing conditions for households and companies and, generally, an increase in the risk aversion and uncertainty of economic agents. In a context of persistency of some fragilities that condition factor productivity and restrict agents' solvency conditions in an inter-temporal perspective – with special reference to the relatively low level of human capital in the labour market and the high indebtedness level of several economic sectors – Portugal registered again, in 2008, one of the lowest rates of growth among the euro area and European Union countries. In this adverse environment, the unemployment rate showed a slight reduction in 2008, remaining at historically high levels, and starting a new increasing trend in the first quarter of 2009.

The intensification and globalisation of the financial crisis at the end of 2008, in the wake of the bankruptcy of the investment bank Lehman Brothers, happened in a context of deceleration of economic activity in several advanced economies since mid-2007, with steep increases in commodity prices in the first half of the year, significant corrections in some housing markets and an intensification of financial deleveraging in several countries. The combination of these factors created a confidence crisis that was rapidly transmitted to the global financial system, leading to a massive asset sell-out, which affected all segments of the financial market and more sharply the money and wholesale debt markets. Reference should be made to the fact that the interest rates of non-guaranteed operations in the money market were significantly affected by liquidity and credit risk premiums during 2008, which determined the emergence of positive and significant differentials *vis-à-vis* the official interest rates, reaching maximum values in October and conditioning the transmission of changes in the official interest rates to the bank interest rates. This fact is particularly relevant for the Portuguese economy, considering the prevalence of interest rates for loans indexed to the money market interest rates.

The strong deterioration of world economic activity exacerbated the expectation of losses in the financial system, with a series of mutually reinforcing negative effects between economic activity prospects and the financial markets being observed. In this context, there was an abrupt fall in aggregate demand and in world trade flows in the last quarter of 2008. To face a potential downward spiral, several countries' governments and central banks, including Portugal, adopted, in a framework of strong international cooperation, a broad set of measures to support the financial system and stimulate economic activity, unprecedented in terms of number and amounts involved (see “Box 1.2 *Operational framework of the Eurosystem, Federal Reserve and Bank of England in the context of the financial crisis*”, “Box 1.3 *Government measures to support the financial sector and stabilize the financial markets*”, and “Box 1.5 *Fiscal policy in the context of the economic and financial crisis*”, of this Report). These measures contributed to decrease systemic risk and increase the confidence of economic agents in the financial system, with some signs of a decrease in uncertainty and risk aversion in the financial markets appearing from the first quarter of 2009, although still remaining at very high levels. There continues to subsist, however, some uncertainty regarding the final impact on economic activity

of the whole set of government interventions. Particularly, the transfer of financial risk from the private sector to the public sector, resulting from some of these measures, together with the fiscal impact of the functioning of automatic stabilisers in the current recessive period, as well as the discretionary fiscal measures to stimulate the economy, have raised questions regarding the sustainability of public finances in several advanced economies, creating upward pressures on the sovereign debt yield rates (see “Box 1.1 *Evolution of the sovereign debt yield spreads in the euro area in the context of the financial crisis*”, of this Report). This increase in the long term public debt yield spreads has been an additional penalty to the financing costs of these countries’ economic agents.

Portuguese banks showed great capacity to adapt to this particularly adverse financial context, continuing to perform their financial intermediation task (see *Financial Stability Report 2008*, Banco de Portugal). Despite the unfavourable evolution in the international wholesale debt markets, bank lending remained relatively sustained. This was achieved with the help of a significant expansion of client resources, in particular resident household deposits. Besides reflecting the adoption of more competitive strategies by banks to capture client deposits, that expansion essentially reflected a growing demand, on behalf of investors, for financial applications less sensitive to market fluctuations. Additionally, credit supply was also sustained by a growing resource to financing through the Eurosystem’s monetary policy operations and, to a lesser extent, by the maintenance of some access to international wholesale debt markets. In this context, credit to the private non-financial sector continued to present a relatively high growth in 2008, especially credit to non-financial corporations, although with a clear deceleration, particularly in the second half of the year. This dynamic was equally observed in other advanced economies (see “Box 1.4 *Financing of the private non-financial sector in the euro area, United States and United Kingdom*”, of this Report).

In the context of the global economic and financial crisis, and according to estimates from Banco de Portugal, the Portuguese economy stagnated in 2008, after growing 1.8 per cent in the previous year. On the demand side, the deceleration of economic activity in 2008 resulted from a virtual stabilisation in private consumption growth and weaker dynamism in the remaining components of global demand, particularly Gross Fixed Capital Formation (GFCF) and exports, in a context of growing deterioration of demand prospects in internal and external markets. Note that, unlike what happened in more recent years, private consumption grew at rhythm inferior to that of disposable income, implying a slight increase in the savings rate. On the supply side, the evolution of GDP per capita was marked by a negative contribution of total factor productivity, contrasting with positive contributions in the previous years. In line with international developments, the GDP intra-annual growth profile was characterised by a clearly downward trajectory during 2008, with a special mention to the abrupt and severe fall observed in the fourth quarter. The deceleration of GDP in the last quarter of the year was broad-based in terms of its major components, being worth highlighting the strong fall in volume in GFCF and in exports of goods and services. Given the magnitude and nature of the shocks underlying this evolution, the marked contraction of the Portuguese economy will tend to persist in 2009.

In what regards the evolution of GFCF, the estimates of Banco de Portugal point to a change of -1.7 per cent for the year as a whole, with more recent indicators confirming the materialization of a strong contraction in the first months of 2009. This evolution is in line with the cyclical sensitivity of this macro-economic aggregate, and reflects the uncertainty surrounding the evolution of the international financial situation and its interaction with the significant deterioration of the world economic activity. The deceleration of GFCF in 2008 reflected the generalised slowdown of its components. GFCF in “Machinery and equipment” was proven to be the most dynamic component in investment, registering, nevertheless, a deceleration of 2.4 percentage points (p.p.), to 4.9 per cent. As opposed to that, GFCF in “Construction” registered a significant fall, and GFCF in “Transport equipment” registered a growth rate close to zero, despite presenting a sharp intra-annual deceleration.

In the context of a growing deterioration in the external environment, namely in Portugal's main trade partners, goods and services exports registered a steep deceleration in 2008 (from 7.5 per cent in 2007 to -0.4 per cent). This behaviour reflected less dynamism both in goods and in services exports. Reference should be made that services exports continued to register a positive growth in 2008 as a whole, reinforcing their respective weight in total national exports. The dynamics of Portuguese services exports in recent years allowed them to maintain their share in world exports of services, which contrasts with share losses in world exports of goods (see "Box 4.1 [The structural evolution of services exports in the Portuguese economy](#)", of this Report). In turn, geographically, it is worth highlighting that extra-community exports continued to reinforce the trend, seen in recent years, of an increase of its weight in total Portuguese exports, with a special mention to the high dynamism of exports of goods to Angola.

One of the relevant elements in the international economic evolution at the end of the year was the abrupt fall in world trade flows, which continued during 2009. This collapse in world trade was precipitated by the generalized break of confidence and by the high level of uncertainty, and was exacerbated by difficulties in accessing to commercial credit in the context of the intensification of the financial crisis. Additionally, the phenomenon of vertical specialisation of production on a global scale, seen in the last years, may have also contributed for this strong contraction in world trade. In Portugal, vertical specialisation activities also gained importance in the last decades, and more relevantly in the manufacturing industry (see Amador and Cabral, "Vertical specialization in Portuguese international trade", *Economic Bulletin-Summer 2008*). In this context, national exports also recorded a significant fall in the last quarter of 2008, and sharper still in the first quarter of 2009. This fall was transversal in terms of groups of goods.

The fall in exports together with a smaller deceleration in imports – in line with the evolution of global demand weighted by imported content – contributed to the significant increase of the external deficit of the Portuguese economy in 2008. This evolution was also influenced by the loss in terms of trade, as a result of the annual average increase in commodity prices in international markets. In macroeconomic terms, the external deficit increase reflected the decrease in the General Government and private sector's savings rates, and the maintenance of the level of investment as a percentage of GDP. The financing of external deficit in 2008 was strongly conditioned by the crisis in the international financial markets. In fact, after a long period of deepening financial integration of the Portuguese economy - with very strong financial flows with the exterior - there was, in the second half of 2008, an abrupt change in the direction and magnitude of the financial flows with the rest of the world. This way, during 2008, the current and capital account deficit (10.5 per cent of GDP) was financed by a reduction in external assets of about 13 per cent of GDP, with a fall in external liabilities of about 2 per cent of GDP.

Despite the marked deceleration of activity in 2008, the labour market in Portugal was characterised by a slight decrease in the unemployment rate and by a moderate growth in total employment. In turn, compensation of employees maintained a high rate of growth, contributing to the acceleration of real disposable income. In this context, it matters to mention that inflation expectations (in the horizon of one year) remained above 2 per cent during 2008. These expectations have a relevant role in determining nominal wages in Portugal (see "Box 5.1 [The price and wage dynamics in Portugal: evidence based on qualitative information](#)", of this Report). Accordingly, recent expectations of a marked decrease of inflation in 2009 should be gradually transmitted to the wage negotiations in Portugal. In this environment, the maintenance of a negative inflation differential *vis-à-vis* the euro area is foreseeable, in line with what has been observed since September of 2007.

Given the marked contraction in activity since the last quarter of 2008, the favourable developments in the labour market described above did not persist. In fact, at the beginning of 2009, there was a strong

decrease in employment and a sharp increase in the unemployment rate, to historically high levels. This evolution occurred in the context of a structural deterioration in labour market conditions, which was reflected in a significant increase in the unemployment rate over the last decade. The percentage of households with unemployed individuals also showed an upward trajectory in this period, standing at levels above the unemployment rate usually computed based on individuals (see “Box 3.2 *Unemployment in households over the business cycle*”, of this Report). Also, since 1996, there was a moderate growth in wage distribution inequality, less marked than the one in the period between 1982 and 1996 (see “Box 3.1 *The evolution of wage inequality: 1982-2006*”, of this Report). This recent evolution can be explained by the increase in the supply of qualified work, together with significant changes in the demand for qualifications.

One of the defining traits of 2008 was the inversion in the process of structural consolidation of public accounts, after two years of a significant consolidation. In 2008, the general government deficit stood at 2.6 per cent of GDP, a value identical to 2007, and thus remaining below the 3 per cent reference value. However, the 2008 execution was characterized by a very significant amount of temporary measures that, according to the definition used in Eurosystem, amounted to 1.1 per cent of GDP. This way, the estimate of Banco de Portugal for the cyclically adjusted deficit excluding temporary measures was 4.7 per cent of trend GDP in 2008, which represents a 1.4 p.p. deterioration compared to 2007. The deterioration of the budgetary position reflected mainly the dynamism in primary current expenditure, particularly pension expenditure and intermediate consumption. The medium term correction of the current imbalances in public finances is crucial so that its sustainability is not put under question. In the current conjuncture, the risks of unsustainability may have particularly adverse effects, given the potential negative repercussions on the economies’ financing conditions. There was a generalized deterioration of the structural public finance positions in developed countries in 2008, a result which is expected to intensify in 2009. This evolution suggests the need to adopt strategies that allow returning to fiscal consolidation paths. In the specific case of Portugal, such a strategy should aim for the medium term objective for the structural deficit, as set in the Stability Program. In this context, the prospects for the public expenditure in the medium and long term are especially relevant, in particular regarding pension expenditure. The recent reform in the pension system was an important contribution to ensure the sustainability of public finances, being crucial that the reform is applied consistently (“Box 2.1 *Update of projections of age related public expenditure: Portugal in the EU context*”, of this Report).

The trend growth of productivity is the determining element for the economic well-being of a society in the long run, as it defines the trend growth of real wages and the sustainable growth of the consumption of goods and services by households. According to the estimates of Banco de Portugal, calculated based on different statistical methods, trend productivity growth showed a marked deceleration since the end of the 90s, standing in the most recent years at the lowest value of the last decades. The low rate of growth of trend productivity of the Portuguese economy has contributed to the reduction of the relative level of GDP per capita *vis-à-vis* the euro area and the European Union, in the last ten years. This divergence is even stronger when one analyses measures of national income *per capita*, given the overall downward trend of the external income balance in Portugal during this period, in a context of progressive worsening of the Portuguese international investment position (see “Box 3.3 *The evolution of the Gross National Income per capita in Portugal*”, of this Report).

With the objective of assuring a sustained resume of the Portuguese economy’s real convergence with the EU average, it is crucial *inter alia* to adopt measures that give incentives for economic agents to invest more in physical and human capital, that promote a contractual framework more favourable to corporate activity and to the mobility of factors of production, and that increase the speed in the judicial system. These measures become particularly urgent in an environment of growing external competitiveness in some sectors of activity, of persistence of some rigidity factors in the labour market, and of

maintenance of a relatively low level of human capital in the population. Additionally, there are other factors that will tend to condition the trend growth of the Portuguese economy in the future. Particularly, in the absence of a significant acceleration in productivity, the maintenance of a significant disparity between domestic investment and savings – reflected in a high current and capital account deficit – will not be sustainable indefinitely, both at the level of the aggregate economy and at the level of individual agents. This fact is especially relevant in a context like the current one, where the international financing conditions became more restrictive. It is worth noting that in the context of a monetary union, the adjustment processes among economies tend to be long, particularly – as is the case of the Portuguese economy – in the absence of speculative bubbles in assets' markets and in the presence of solid financial systems. Given the relatively high level of indebtedness in the economy, the gradual and growing activation of the intertemporal solvency restrictions regarding the various economic agents – households, corporations and the General Government – will tend to be reflected in a lower dynamism of aggregate demand during a probably long period. It is this effect which should be compensated through an acceleration of structural adjustment and an ensuing growth in productivity.