



Banco de Portugal

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The Portuguese economy is expected to stagnate in 2011, after a projected rate of growth of 1.2 percent in 2010. This evolution will result from the combined effect of a contraction in domestic demand – beginning in the second half of 2010 – with a slowdown in exports, in line with the growth of external demand directed to Portuguese firms. As for consumer prices, the projections point to an increase of 1.8 percent in 2011, after 1.4 percent in 2010, in a context of moderate increases in wage costs and of higher prices in international markets, in particular in the case of commodities. The risks to economic activity are markedly on the downside and are exacerbated by the fact that the projections only include the set of fiscal policy measures that meet the criteria agreed within the Eurosystem projection exercises, i.e., the measures which are specified in sufficient detail and already approved in legal terms, or with a high probability of legislative approval. In turn, the risks regarding the inflation projection are balanced.

Compared to the summer 2010 Economic Bulletin, GDP growth is revised upwards in 2010, reflecting higher than expected growth in domestic demand and exports. In 2011, economic activity is slightly revised downwards, reflecting lower growth in GFCF, in a context in which exports are slightly revised upwards. The current projection implies the maintenance of the projection for inflation in 2010 and a slight downward revision for 2011, reflecting lower than expected increases in oil and import prices.

The evolution of the Portuguese economy in 2011 will be strongly conditioned by the fiscal consolidation process, as well as by some reduction in the indebtedness of the private sector. In the current context of marked and persistent differentiation of sovereign risk in the euro area, and given the temporary nature of the unconventional policy measures of the Eurosystem – which have ensured the external financing of the Portuguese economy –, the unavoidable process of economic adjustment will tend to intensify from the second half of 2010 onwards. There remains, however, a high level of uncertainty regarding the pace and the magnitude of this process in the projection horizon.

What can be stated with certainty is that the Portuguese economy is currently facing a particularly difficult set of challenges, which will condition the decisions of economic agents in the near future. In fact, the persistence of constraints to external financing is likely to accelerate and accentuate the indispensable balance sheet adjustment of agents - public and private - in view of the maintenance of high net external borrowing in the recent period. Within a monetary union, and under normal financial markets conditions, a deleveraging process of the economy could take place gradually, with the possibility of smoothing the adjustment between the public and private sectors. In contrast, in the current context of sovereign market segmentation and differentiation within the euro area, the pressure on the adjustment falls on all sectors of the economy simultaneously, causing a severe and inescapable contraction dynamics. This adjustment will entail a reduction in the current gap between domestic savings and investment.

With regard to the deleveraging process of the private sector, it should be noted that the large external deficit of the Portuguese economy emerges within a context of particularly low investment and savings rates. In the

case of households, their net lending increased significantly only from 2009 onwards, reflecting a higher savings rate – after the minima recorded in previous years – and the maintenance of a downward trend in the investment rate, which stands currently at an historical low. In turn, in the context of the current crisis, the sector of non-financial corporations initially experienced a rise in net borrowing as a percentage of GDP, only reversing this trend more recently, although to levels which are still high in the European context. This recent evolution resulted from an increase in the sector's savings rate and a further decline in GFCF as a percentage of GDP, to historical lows. The adjustment of balance sheets is expected to intensify in the near future, involving a set of decisions, closely interconnected, between households and corporations. Given the importance of investment in creating conditions to higher economic growth in the future, the adjustment should ideally result from a global reinforcement of savings. This process will imply a moderation in private consumption and an increased recourse to self-financing from non-financial corporations.

The fiscal consolidation process is of paramount importance in the current context. In fact, the concerns of international investors regarding the sustainability of national public finances – in a framework of maintenance of structural weaknesses of the Portuguese economy and of severe turbulence in financial markets in the euro area – led to the differentiation of the risk assessment of the Portuguese economy in international financial markets and increased the urgency of the current fiscal adjustment process. The effort required to fulfil the fiscal commitments for 2011 is very substantial. Indeed, the available information suggests that the 2010 budgetary execution would imply, in the absence of significant temporary measures, a deficit well above the initial goal. Thus, the set of measures needed to recover the ambitious consolidation path initially announced appears particularly challenging. It is in this context that an extensive set of measures was announced in late September, in anticipation of the State Budget for 2011. These measures, as well as others that may be deemed necessary, are part of a fiscal consolidation process that, despite being favourable – and even indispensable – to economic growth in the medium and long term, will have a contractionary impact in the short term. This impact will be exacerbated by the fact that several euro area countries are undergoing processes of fiscal consolidation, by the low levels of official interest rates, as well as by the increasingly tightened credit conditions to households and corporations. The counter-factual of no fiscal adjustment does not emerge, however, as a superior alternative, since it would entail immeasurably higher economic adjustment costs. In fact, a scenario of maintenance of financing constraints in international markets – coupled with the gradual phasing-out of the ECB's non-conventional policies, which have sustained almost entirely the external financing needs of the Portuguese economy – would entail an abrupt adjustment of external imbalances. Within the framework of a monetary union, the impossibility of a rapid adjustment of relative prices with the rest of the world would require an unprecedented contraction in domestic demand and a substantial increase in unemployment. This scenario would thus imply extreme costs in terms of economic and social welfare. Thus, a strict adherence to the budgetary targets currently announced is required. Naturally, the pursuit of these goals must be combined with a strengthening of incentives for economic growth in the medium and long term, particularly as regards the degree of predictability and permanence of policies, the mobility and ability to reallocate resources, the quality in the qualification of human resources and the creation of an institutional framework - in particular with respect to the celerity of the judicial system – favourable to economic growth.

Lisbon, 7 October 2010.