Economic Bulletin

June 2016

BANCO DE PORTUGAL
EUROSYSTEM

Economic Bulletin

June 2016

BANCO DE PORTUGAL
EUROSYSTEM

Lisbon, 2016 • www.bportugal.pt

Economic Bulletin | June 2016 • Banco de Portugal Rua do Comércio, 148 | 1100-150 Lisboa • www.bportugal.pt • Edition Economics and Research Department • Design and printing Communication Directorate | Image and Graphic Design Unit • Print run 25 • ISSN 0872-9786 (print) • ISSN 2182-035x (online) • Legal Deposit no. 241772/06

Contents

I
Projections for the Portuguese economy: 2016-2018

Box 1 | Projection assumptions

Box 2 | The recovery of the Portuguese economy in perspective

Box 3 | Medium-term fiscal outlook

Projections for the Portuguese economy: 2016-2018

1. Introduction

Projections for the Portuguese economy point to a moderate recovery in economic activity over the 2016-2018 period (Table 1.1). Annual average growth of gross domestic product (GDP) is expected to be 1.3 per cent in 2016, accelerating to 1.6 per cent in 2017 and declining to 1.5 per cent in 2018, implying that GDP level at the end of the projection horizon will be close to, but still below, that observed before the international financial crisis in 2008 (Chart 1.1). This projection, which is part of the Eurosystem's projection exercise recently published by the European Central Bank (ECB), implies that growth in the 2016-2018 period will be slightly below that projected for the euro area (Box 'Projection assumptions'). Consumer prices should gradually accelerate over the projection horizon, in line with inflation developments currently projected for the euro area as a whole.

The recovery of the Portuguese economic initiated in mid-2013 has shown a relatively moderate pace, particularly taking into account the severity and length of the previous recession (Box 'The recovery of the Portuguese economy in perspective'). In this context, it is important to note that the current recovery occurs in a framework characterised by the high indebtedness level of the different economic agents - either public or private – and the need to carry on the adjustment of their balance sheets.

Table 1.1 • Projections of Banco de Portugal: 2016-2018 | Annual change, in percentage

	Weights 2015	June EB 2016				March projection 2016			
		2015	2016 (p)	2017 (p)	2018 (p)	2015	2016 (p)	2017 (p)	2018 (p)
Gross domestic product	100.0	1.5	1.3	1.6	1.5	1.5	1.5	1.7	1.6
Private consumption	65.9	2.6	2.1	1.7	1.3	2.6	1.8	1.9	1.3
Public consumption	18.1	0.6	1.1	0.4	0.6	0.8	1.1	0.4	0.6
Gross fixed capital formation	15.0	3.9	0.1	4.3	4.6	3.7	0.7	4.5	4.5
Domestic demand	99.2	2.5	1.8	1.7	1.7	2.4	1.4	2.0	1.7
Exports	40.3	5.2	1.6	4.7	4.7	5.1	2.2	5.1	4.8
Imports	39.5	7.4	2.8	4.9	4.8	7.3	2.1	5.6	4.9
Contribution to GDP growth, net of imports (in p.p.) (a)									
Domestic demand		1.1	1.0	0.7	0.7	1.1	0.9	0.8	0.7
Exports		0.4	0.3	0.9	0.9	0.4	0.6	0.9	0.9
Current plus capital account (% of GDP)		1.7	1.9	1.6	1.6	1.7	2.9	2.3	2.3
Trade balance (% of GDP)		1.7	1.6	1.3	1.2	1.7	2.6	2.1	2.0
Harmonized index of consumer prices		0.5	0.7	1.4	1.5	0.5	0.5	1.4	1.6

Sources: Statistics Portugal and Banco de Portugal.

Notes: (p) – projected, (p.p.) – percentage points. For each aggregate, this table shows the projection corresponding to the most likely value, conditional on the set of assumptions considered.

(a) The demand aggregates net of imports are obtained by subtracting an estimate of the imports needed to meet each component. The calculation of import contents was based on data for 2005. For more information, see the Box entitled 'The role of domestic demand and exports in economic activity developments in Portugal', in the June 2014 issue of the *Economic Bulletin*.

The assumptions regarding the external framework of the Portuguese economy continue to point to an acceleration in world economic activity and international trade flows in the projection horizon. External demand is expected to lose some momentum in 2016, but to recover to a more robust pace of growth in 2017-2018. The international framework should continue to be favourable in other segments, given the developments assumed for oil prices and the positive impact of the implementation of the ECB's monetary policy measures on financial integration in the euro area and monetary and financial conditions.

Developments projected for the Portuguese economy are marked by a gradual recovery of domestic demand, with annual average growth of 1.7 per cent over the projection horizon. These developments are consistent with the continued decline in the private sector's leverage level, an indispensable condition for ensuring a sustainable growth pattern of the Portuguese economy in coming years.

Private consumption should grow robustly in 2016 and decelerate gradually over the remaining projection horizon, in line with developments in real disposable income. In contrast, projections point to a marginal change in investment in 2016, followed by relatively robust growth in 2017-2018. The context of higher uncertainty, both internal and external, characterising the second half of 2015 and early 2016 may have considerably limited GFCF's developments in recent quarters. In this context, the projection assumes a mitigation in the short term of the degree of uncertainty still prevailing in the economy. If uncertainty persists, it may imply further postponement of investment decisions, with an impact on the pace of recovery of the economy. This possibility, if materialising, will be of particular importance in a context where capital per employee in the Portuguese economy has remained at relatively low levels, compared with the euro area average.

Exports of goods and services are expected to decelerate in 2016, reflecting developments in fuel exports and the lower growth of external demand directed to Portuguese exporters. In particular, exports to some emerging market economies, especially Angola, should continue to have a negative and significant contribution to the change in total exports in 2016. Reflecting the dissipation of this effect and a more favourable international environment, exports should accelerate in 2017 and 2018, becoming again the most dynamic expenditure component, as seen in recent years.

According to the current projections, the transfer of productive resources to sectors of the economy more exposed to international competition will continue. The degree of openness of the Portuguese economy should increase further after 2017 (Chart 1.2), reflecting a similar increase in the share of exports and imports in GDP. This trend is in contrast to that observed in recent years, when the increase in the degree of openness reflected the strong buoyancy of exports. Over the projection horizon, the Portuguese economy should maintain its external net lending capacity, making room for a gradual reduction in external indebtedness levels.

2. Recent information

Projections for the Portuguese economy in this Bulletin comprise information available up to 18 May 2016 and the technical assumptions consistent with the Eurosystem's projection exercise recently published by the ECB (Box 'Projection assumptions').

In 2015 GDP grew by 1.5 per cent, in real terms, after the 0.9 per cent rise in 2014. Considering the expenditure components net of imports (i.e. subtracting from each component an estimate of the associated imports), this acceleration was characterised by higher growth of domestic demand, in particular of private consumption, and a slight deceleration of exports. In intra-annual terms, economic activity slowed down during the year, with investment and exports decelerating significantly. Activity grew by 1.7 per cent year on year in the first quarter of 2015 and decelerated to 1.3 per cent in the fourth quarter.

In the first quarter of 2016, according to the flash estimate released by Statistics Portugal on 13 May, GDP increased by 0.1 per cent from the previous quarter, maintaining the year-on-year decelerating profile, with 0.8 per cent growth from the first quarter of 2015 (Chart 2.1).

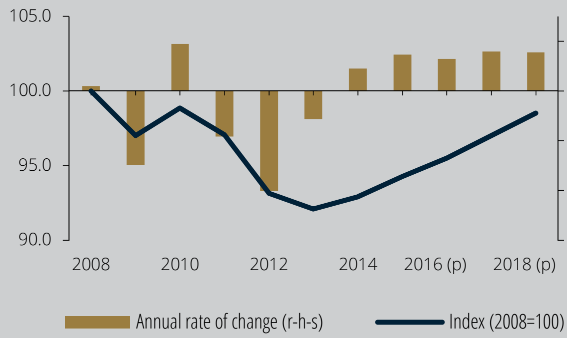
The breakdown of GDP developments into the main expenditure components was only released after the cut-off date for this Bulletin. Nevertheless, based on recent conjunctural data and qualitative information included in Statistics Portugal's flash estimate release, GDP developments in the first quarter of 2016 likely reflect an increase in domestic demand and a decrease in exports from the previous quarter, which correspond, year on year, to a relative stabilisation of domestic demand growth and a deceleration of exports from the fourth quarter of 2015.

Increase in domestic demand in the first quarter of 2016

The increase in domestic demand essentially reflects the buoyancy of private consumption. This occurs in a context of an increase in real disposable income, the maintenance of consumer confidence at historically high levels and an acceleration in consumer credit. The upsurge in disposable income was influenced by employment growth, the rise in minimum wage and the measures for the reinstatement of income announced in the State Budget for 2016 (Box 'Medium-term fiscal outlook'). Private consumption developments were common to non-durable goods and services, and to durable goods, but more marked in the latter case, especially the acquisition of motor vehicles, in a context of frontloaded purchases early in the year in advance of changes to the tax framework included in the State Budget for 2016.

Gross fixed capital formation (GFCF) declined again in the first quarter of 2016 from the previous quarter. This largely reflected a decline in

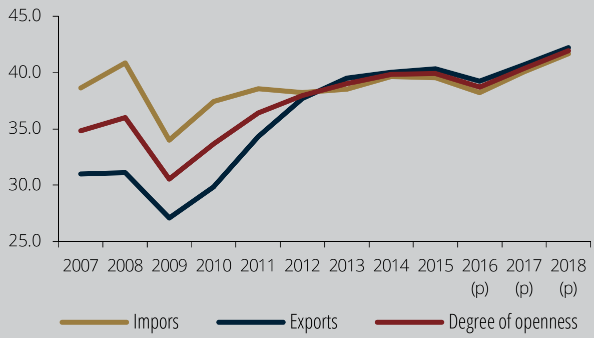
Chart 1.1 • GDP | In percentage and index (2008=100)



Sources: Statistics Portugal and Banco de Portugal.

Note: (p) – projected.

Chart 1.2 • Exports, imports and degree of openess | In percentage of GDP



Sources: Statistics Portugal and Banco de Portugal.

Note: (p) – projected. The degree of openess is measured by the ratio of the average of exports and imports to GDP.

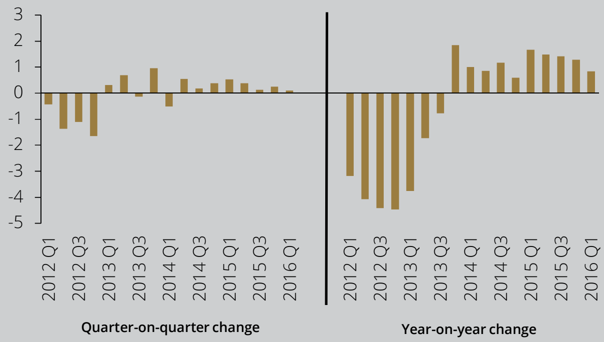
GFCF in construction, partly due to the adverse weather conditions observed early in the year. In turn, transport equipment and machinery and other equipment showed a quarterly increase. Notwithstanding this recovery, the decline in these components over the second half of 2015 limits GFCF growth in 2016 (Chart 2.2). GFCF growth in transport equipment in the first quarter was influenced by frontloaded purchases early in the year, similarly to developments in the case of passenger cars.

Decline in exports from the fourth quarter of 2015

Notwithstanding the increase in external demand, Portuguese exports declined from the last quarter of 2015, decelerating in year-on-year terms. This decline largely reflected the fall in exports of fuel and motor vehicles, influenced by the temporary shutdown of major production units for these goods in early 2016. Extra community exports of goods and services continued to have a very negative contribution to the year-on-year change in total exports. In turn, exports of tourism continued to grow more than total exports.

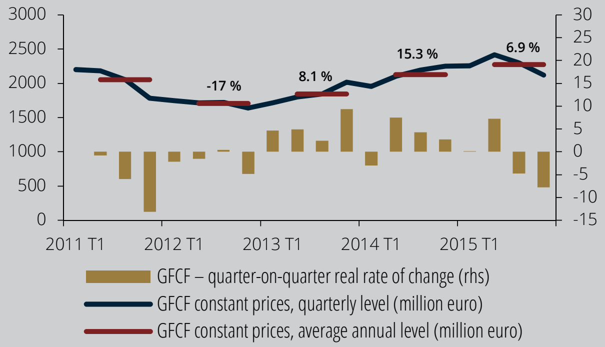
Imports increased in the first quarter of the year from the previous quarter and the respective year-on-year growth remained virtually unchanged. The quarterly increase in imports is in line with developments in overall demand weighted by import content, reflecting the buoyant growth of items with high import content, namely GFCF in machinery and other equipment and transport equipment, as well as consumption of durable goods, in spite of the decline in fuel exports.

Chart 2.1 • Gross domestic product | Real rate of change, per cent



Source: Statistics Portugal.

Chart 2.2 • GFCF in equipment goods, including transport equipment | Real rate of change, per cent



Sources: Statistics Portugal and calculations by Banco de Portugal.

Note: The numbers above the horizontal lines refer to the annual rates of change.

Box 1 | Projection assumptions

Table 1 presents the main assumptions of the projection exercise for the Portuguese economy, which are consistent with information underlying the Eurosystem's projection exercise, published on 2 June. These assumptions are based on information available up to 18 May.

Current assumptions point to an acceleration of world trade over the projection horizon, in line with the recovery of global activity. However, this scenario falls short of that assumed in the projections published by Banco de Portugal in March,[1] as well as of the dynamics observed before the financial crisis. International trade flows maintain the low elasticity to GDP observed in recent years. Economic activity in the euro area is expected to continue its moderate recovery. In 2016 the pace of recovery was revised upwards compared to ECB's March projection exercise, remaining virtually unchanged in 2017 and 2018.

External demand for Portuguese goods and services should remain robust over the projection exercise, reaching growth rates close to 5 per cent at the end of the projection horizon. Growth of imports from the euro area is expected to clearly exceed that of non-euro area markets, reflecting a more favourable outlook for the euro area than for emerging market economies. Compared with March projections, external demand was revised downwards over the projection horizon (0.2, 0.4 and 0.1 percentage points (p.p.) in 2016, 2017 and 2018, respectively).

Based on information on futures markets, the technical assumption for the oil price in USD was revised upwards, when compared with the March projection exercise. These revisions are gradually smaller over the projection horizon. In 2016 the annual average oil price is expected to decline by around 17 per cent from 2015 and stand at a level around 24 per cent above the March estimate. The oil price is expected to increase in 2017 and 2018, to levels slightly above USD 50 at the end of the projection horizon. The revisions to the oil price in euros are somewhat smaller, reflecting the technical assumption for the respective exchange rate.

Table 1 • Projection assumptions

		EB June 2016				Projections March 2016			
		2015	2016	2017	2018	2015	2016	2017	2018
Internacional environment									
World GDP	yoy	2.9	2.9	3.4	3.5	2.9	3.0	3.5	3.7
World trade	yoy	1.9	2.5	4.0	4.3	1.8	2.8	4.2	4.4
External demand	yoy	4.2	3.7	4.5	4.7	4.2	3.9	4.9	4.8
Oil prices in dollars	aav	52.4	43.4	49.1	51.3	52.5	34.9	41.2	44.9
Oil prices in euros	aav	47.2	38.3	42.9	44.9	47.3	31.3	36.9	40.2
Monetary and financial conditions									
Short-term interest rate (3-month EURIBOR)	%	0.0	-0.3	-0.3	-0.3	0.0	-0.3	-0.3	-0.2
Implicit interest rate in public debt	%	3.6	3.5	3.5	3.4	3.7	3.7	3.6	3.6
Effective exchange rate index	yoy	-9.3	2.9	0.3	0.0	-9.3	2.9	0.1	0.0
Euro-dollar exchange rate	aav	1.11	1.13	1.14	1.14	1.11	1.11	1.12	1.12

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

Notes: yoy – year-on-year rate of change, % – per cent, aav – annual average value. An increase in the exchange rate corresponds to an appreciation. The implicit interest rate on public debt is computed as the ratio between interest expenditure for the year and the simple average of the stock of debt at the end of the same year and at the end of the preceding year.

The technical assumption for exchange rates is based on the maintenance over the projection horizon of the average levels observed in the two weeks prior to the cut-off date. After a significant depreciation in 2015, the euro is expected to see an annual average appreciation in 2016, both in nominal terms or *vis-à-vis* the USD, broadly similar to the appreciation assumed in March projections.

The evolution of the three-month EURIBOR rate is based on expectations implicit in futures contracts. Reflecting inter alia the wide range of policy measures adopted by the ECB, these contracts point to the maintenance of negative interest rates over the projection horizon, at levels close to those considered in March projections. Assumptions for the long-term interest rate on Portuguese public debt are based on an estimate of the implicit rate, which includes an assumption for the interest rate for new issuance. This rate maintains a slightly declining profile over the projection horizon, and was revised downwards *vis-à-vis* the assumption considered in March.

The projected fiscal variables are based on the 2015 general government account, compiled by Statistics Portugal and published at the end of March. In line with the rules adopted in the context of the Eurosystem, the exercise incorporates most measures included in the State Budget for 2016, as they are specified in sufficient detail.

For 2016, public consumption is projected to grow (1.1 per cent) chiefly due to an increase in expenditure in intermediate consumption, in line with the State Budget for 2016, partly explained by the rise in expenditure with public-private partnerships of the road sector. In the remaining projection horizon, public consumption is projected to decelerate in real terms (to 0.4 and 0.6 per cent in 2017 and 2018 respectively). These developments reflect, in particular, the assumption of limited growth of expenditure in goods and services and the stabilisation of the number of public employees. As regards the public consumption deflator, positive developments are projected over the whole projection horizon, chiefly in 2016 and 2017, reflecting the impact of the reversal in wage cuts currently in place in the general government.

Turning to public investment, a significant fall in real terms is projected for 2016, resulting from the base effect associated with the fact that the acquisition of real estate by Oitante was registered in 2015, as well as from the sale of military equipment to Romania. To a lesser extent, this register also affects developments forecasted for public investment in 2017. These two operations are not expected to have an impact on GDP developments. Excluding this effect, the public investment-to-GDP ratio is expected to stabilise in 2017 and 2018.

3. Demand, supply and external accounts

Moderate recovery in economic activity

Economic activity in Portugal is expected to grow at a modest pace over the projection horizon, with an average growth in 2016-2018 slightly below that projected for the euro area (Chart 3.1).

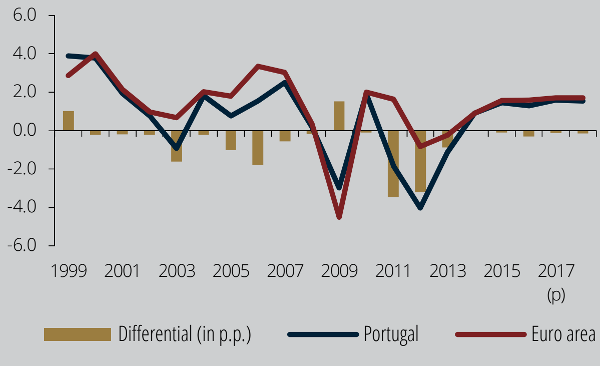
In 2016, GDP should grow by 1.3 per cent, slightly below that seen in 2015. Looking at expenditure components net of imports (i.e. deducting from each component an estimated value for associated imports), this deceleration results from lower growth in both domestic demand, particularly GFCF, and exports. The deceleration in exports is associated in particular with lower external demand growth and the continued unfavourable behaviour of sales to a number of emerging market economies, most notably Angola.

In 2017, Portuguese economic activity is expected to accelerate to 1.6 per cent, reflecting a larger contribution from exports (net of imports), amid an improved international environment, including the unwinding of effects of the negative shock associated with the significant fall in imports from a number of major trade partners in emerging markets. The contribution of domestic demand (net of imports) should decrease only marginally, given that the slight deceleration in private consumption is concomitant with higher GFCF growth. In 2016 and 2017, private consumption should benefit from the positive impact on household disposable income of the reversal of some of the measures implemented under the Economic and Financial Assistance Programme.

In 2018, economic activity is expected to slow down somewhat, to 1.5 per cent, chiefly reflecting domestic demand developments, most specifically a deceleration in private consumption. In this context, GDP levels in Portugal at the end of the projection horizon should stand slightly below those seen prior to the onset of the international financial crisis in 2008 (Chart 3.2).

To sum up, the net contribution of domestic demand should decrease from approximately

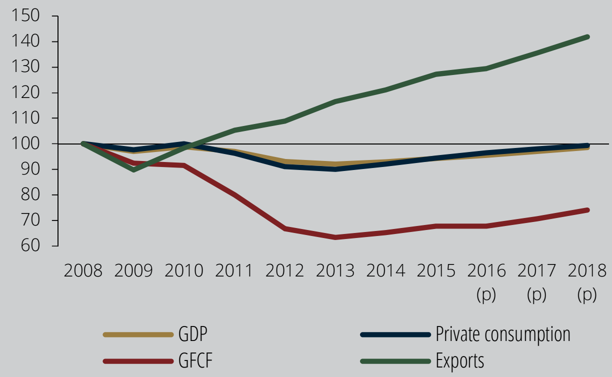
Chart 3.1 • GDP growth in Portugal and in the Euro Area | Rate of change, in percentage



Sources: ECB and Statistics Portugal.

Note: (p) – projected.

Chart 3.2 • GDP breakdow | Index 2008=100



Sources: Statistics Portugal and Banco de Portugal.

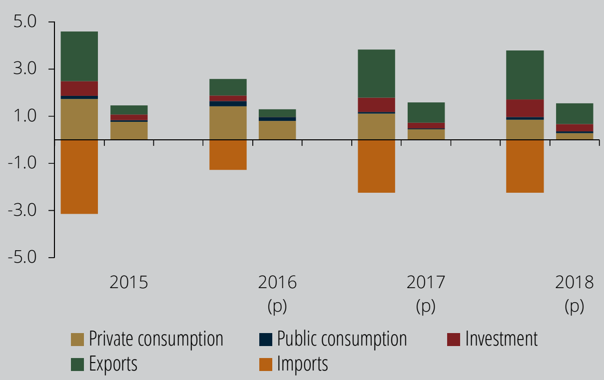
Note: (p) – projected.

1.0 p.p. in 2015-2016 to around 0.7 p.p. in 2017-2018. In turn, the net contribution of exports should decline from 0.4 to 0.3 p.p. between 2015 and 2016, only to increase later on, to 0.9 p.p., in 2017-2018 (Chart 3.3). In this context, the projection is compatible with the continued transfer of productive resources to the sectors of activity most exposed to international competition, as seen in the recent past.

Output *per capita* is expected to grow, in annual average terms, by 1.4 per cent over the 2016-2018 period – similarly to projections for GDP, given the assumption that the population will remain stable over the projection horizon –, which corresponds to higher growth than that seen since the beginning of the euro area (Chart 3.4).

In growth accounting exercises, capital accumulation per worker is a crucial source of economic growth, together with employment, human capital levels and total factor productivity. As regards the first factor, capital levels in the Portuguese economy have been relatively stable since 2011, following persistent falls in investment flows during the recession episodes that characterised the 2008-2012 period. Capital levels per worker in Portugal are low, standing at only about half of the euro area average ratio in 2015. In this context, the contribution of capital input to economic growth has decreased substantially over the most recent period, and a marginally negative contribution is expected over the projection horizon, amid a moderate recovery in investment over the 2016-2018 period. In annual average terms, labour input should make a contribution of around 0.4 p.p. to GDP growth in 2016-2018, following a negative contribution during the 2011-2015 period. The positive contribution of labour input, observed since 2014, is chiefly due to the continued pick-up in the employment rate over the projection horizon. In turn, human capital accumulation, measured by the average number of school years attended by the labour force, should make a positive contribution to

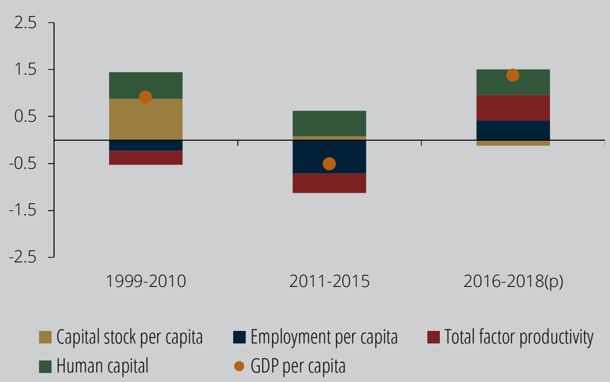
Chart 3.3 • Gross and net contributions to GDP growth | In percentage points



Sources: Statistics Portugal and Banco de Portugal.

Notes: (p) – projected. For each year, the left-hand bar refers to gross contributions from each GDP component and the right-hand bar to the corresponding net contributions.

Chart 3.4 • Breakdown of the growth in real GDP *per capita* | Contributions in percentage points



Sources: Barro and Lee (2013), Quadros de Pessoal, Statistics Portugal and Banco de Portugal.

Notes: The growth accounting exercise of GDP *per capita* is based on a Cobb--Douglas production function. The measures of human capital were constructed from the data of Barro and Lee (2013) 'A new data set of educational attainment in the world, 1950-2010', *Journal of Development Economics* 104, pp. 184-198. For Portugal, these series were annualized and extended using the profile of the average years of education of employment of Quadros de Pessoal (until 2012) and of the Labour Force Survey of Statistics Portugal (in 2013 and 2014).

growth, as has been the case in the past, amid a continued improvement in the skills of working age population. Lastly, GDP growth in 2016-2018 is projected to benefit from favourable developments in total factor productivity, against a background of continued improvements in resource allocation in the economy. This growth in total factor productivity stands in contrast to the fall seen on average since 1999.

Maintenance of moderate growth in domestic demand

Private consumption is expected to grow by 2.1 per cent in 2016, decelerating over the projection horizon to 1.7 per cent in 2017 and 1.3 per cent in 2018. At the end of the horizon, it should stand close to that seen prior to the international financial crisis (Chart 3.5). Private consumption in the course of 2016 is projected to benefit from favourable developments in real household disposable income and more favourable expectations about permanent income, amid improved labour market conditions, an increase in the minimum wage, the reversal of a number of fiscal measures implemented under the Economic and Financial Assistance Programme, and the maintenance of oil prices at historically low levels.

In 2017 and 2018, private consumption is expected to grow approximately in line with real household disposable income, amid a continuously moderate pick-up in employment and an acceleration in consumer prices. In 2017, disposable income should continue to benefit from measures for the reinstatement of income included in the State Budget for 2016. However, in 2018 household disposable income is projected to slow down, particularly in terms of net wages, given the unwinding of the positive impact of the reinstatement of wage cuts in the public sector and the elimination of the surcharge on personal income tax in the 2015-2017 period. In this context, over the projection horizon, the saving rate is expected to increase to around 5 per cent (4.2 per cent in 2015), while households' net lending to other institutional sectors is projected to remain stable.

In terms of composition, consumption of durable goods is projected to grow by 4.6 per cent in 2016. Consumption of durable goods grew by more than 10 per cent in 2014 and 2015, following considerable declines in 2011 and 2012, which partly reflected the postponement of purchases during the recession period. For 2017 and 2018, consumption of durable goods is projected to decelerate to an annual average growth of around 2.5 per cent, approximately in line with the typical elasticity to real disposable income. Despite a pick-up in consumption of durable goods over the past few years, at the end of the projection horizon this component is expected to stand significantly below the levels seen in 2008. In turn, consumption of non-durable goods should grow by 2.2 per cent in 2016, and to decelerate to 1.8 per cent in 2017 and to 1.3 per cent in 2018.

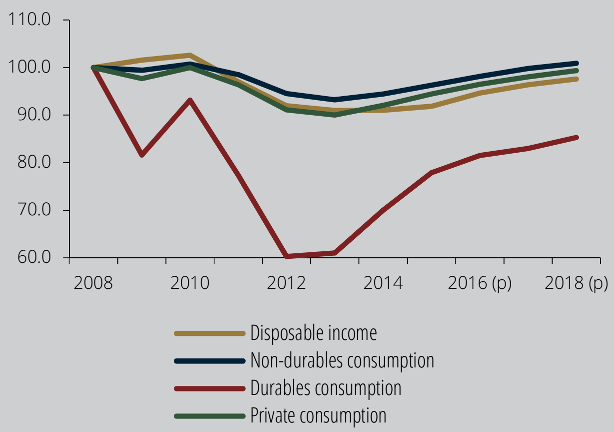
Private consumption growth over the projection horizon should benefit from a reduction in household debt servicing, as seen in the past few years. This is set against a background of lower indebtedness levels and gradual improvements in credit market conditions. Household indebtedness as a percentage of disposable income should decrease further, standing in 2018 around 25 p.p. below levels seen in 2011, which is a key feature of the adjustment process in the Portuguese economy (Chart 3.6).

GFCF is expected to stabilise in 2016, following 3.9 per cent growth in 2015, and return to growth of 4.3 and 4.6 per cent in 2017 and 2018, respectively (Chart 3.7). The deceleration in GFCF in 2016 reflects developments in public and private investment. By type of component, on the one hand, construction decelerates, having been negatively affected by particularly adverse weather conditions in the first months of the year. On the other hand, growth in machinery and equipment in 2016 is limited by the lagged effects of the fall observed in the second half of 2015. This fall may be associated with increased uncertainty at international and domestic level, which seems to have led to the postponement of investment decisions, as well as with the lack of upward pressure on capacity utilisation.

Turning to business GFCF, projections point to low growth in 2016 (1.7 per cent) and a subsequent recovery to growth rates around 5 per cent. This acceleration in business GFCF, in line with economic activity developments, is associated with a reduction in uncertainty in the domestic and external markets, an improvement in demand expectations among firms and the maintenance of favourable financing conditions on the back of the non-standard monetary policy measures adopted by the ECB. Furthermore, there is need for capital stock replacement, following substantial falls in investment in the 2009-2013 period. However, developments in business GFCF should remain constrained by the need of firms to adjust balance sheets given their high indebtedness levels (Chart 3.6). In this context, the projected pick-up in investment is less buoyant than those observed in past post-recession periods (see Box 'The recovery of the Portuguese economy in perspective'). This has an impact on aggregate demand growth in the short term but also in the medium and long term, given that investment is crucial for the incorporation of new technologies in the productive process, which affect the capital stock and productivity and, as such, the potential growth of the economy.

With regard to GFCF in housing, in 2015 the rate of change was positive for the first time since 2000, while housing prices increased in real terms for the second consecutive year, following marked declines since 2011. GFCF in housing is projected to basically stabilise in 2016 and to post annual average growth of approximately

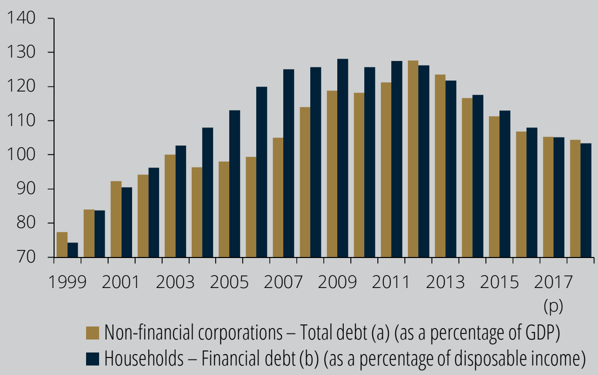
Chart 3.5 • Consumption and disposable income | Index 2008=100



Sources: Statistics Portugal and Banco de Portugal.

Note: (p) – projected.

Chart 3.6 • Debt of the non-financial private sector | End of period figures



Sources: Statistics Portugal and Banco de Portugal.

Notes: (p) – projected.

(a) It includes loans granted to non-financial corporations by other institutional sectors; commercial paper and bonds issued by non-financial corporations held by other sectors and trade credits received from other sectors.

(b) The financial debt corresponds to loans and debt securities issued by the sector.

3 per cent in the 2017-2018 period, chiefly reflecting the increase in household disposable income and the maintenance of favourable financing conditions, as well as the improvement in labour market conditions and the high levels of consumer confidence. However, developments in residential investment over the next few years will be restricted by demographic factors, associated with the recent downward trend in the resident population, and by the still high level of household indebtedness.

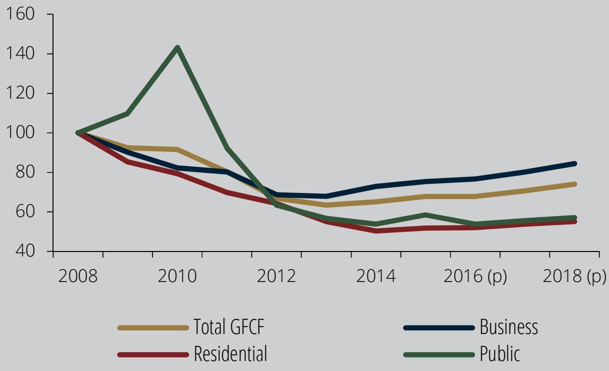
Public investment developments, following a fall of around 60 per cent in the 2011-2015 period, should remain limited by the need for fiscal consolidation (Box 'Medium-term fiscal outlook').

At the end of the projection horizon, total GFCF as a ratio of GDP should remain quite below the average value observed since the beginning of the euro area. In 2018 it is projected to stand at around three-quarters of the value recorded in 2008. This fall largely reflects the strong adjustment in public and residential investment, which is a key feature of the adjustment process in the Portuguese economy (Chart 3.8).

Deceleration in exports in 2016 followed by robust growth in 2017-2018

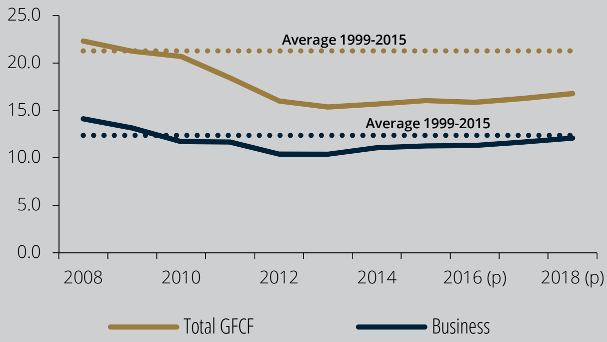
Projections for exports of goods and services point to a slowdown in 2016, with expected growth of 1.6 per cent (5.2 per cent in 2015), followed by a recovery to annual average growth rates of 4.7 per cent in 2017 and 2018. The deceleration in exports in 2016 is explained, on the one hand, by developments in fuel exports, which, following marked growth in 2015 (around 36 per cent) should experience a decline in 2016, which is related to the partial and temporary shutdown of a refinery at the beginning of the year. On the other

Chart 3.7 • Breakdown of GFCF by institutional sectors | Index 2008=100



Sources: Statistics Portugal and Banco de Portugal.
Notes: (p) – projected.

Chart 3.8 • Gross Fixed Capital formation | In percentage of GDP



Sources: Statistics Portugal and Banco de Portugal.
Notes: (p) – projected.

hand, lower growth is projected for the indicator of external demand for Portuguese goods and services (3.7 per cent, compared with 4.2 per cent in 2015). It is worth mentioning that this indicator does not adequately capture the evolution of a number of markets relevant for Portuguese exports, which have posted markedly negative developments. This is the case of Angola, a market whose weight was around 6.5 per cent in total exports of goods and services in 2014 (4.5 per cent in 2015). Exports to this country fell substantially in 2015 (around 27 per cent, in nominal terms), and a similar reduction is expected in 2016. In terms of components, although exports of goods and services are projected to decelerate in 2016, the tourism component should continue to grow much more than total exports – in line with developments observed in recent years –, being one of the sectors that contributed most noticeably to the recovery in the Portuguese economy and the maintenance of external net lending capacity.

In 2017 and 2018, export developments are expected to be in line with assumptions for external demand for Portuguese goods and services, with no significant market share gains being projected for these two years (Chart 3.9). Projected developments in exports consider buoyant growth in both the goods and the services components, in particular in tourism. Given its importance for recent export dynamics, it should be mentioned that exports to Angola are assumed to stabilize in 2017-2018 (at a level around 50 per cent below that observed in 2014).

Exports of goods and services are expected to become again the most buoyant overall demand component in 2017 and 2018, with a contribution to GDP growth (net of associated imports) slightly higher than that of domestic demand. In this context, the weight of exports in GDP is projected to increase from approximately 40 per cent in 2015 to around 42 per cent in 2018 (31 per cent of GDP in 2008), reflecting the further reallocation of productive resources to the sectors most exposed to international competition.

Imports of goods and services are expected to grow over the projection horizon approximately in line with the historical average elasticity of this component to developments in overall demand weighted by import contents. In 2016 imports are expected to decelerate markedly, growing by only 2.8 per cent, after 7.4 per cent in 2015. The deceleration in imports in 2016 reflects a loss of buoyancy of several demand components with high import content. It is worth recalling that 2015 was characterised by strong growth in expenditure components with very high import content, such as consumption of motor vehicles, investment in machinery and equipment, exports of energy goods, as well as imports of pharmaceutical products (Chart 3.10). In 2017 and 2018, imports of goods and services are projected to grow by 4.9 and 4.8 per cent respectively.

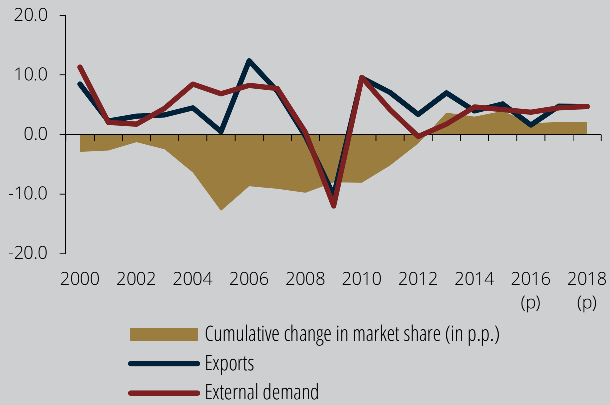
Maintenance of net lending over the projection horizon

Current projections point to the maintenance over the projection horizon of the Portuguese economy's net lending, measured by the combined current and capital account balance. This development, which is associated with an increase in both the saving rate of total economy and the investment rate, suggests a continuation of the adjustment process of the Portuguese economy.

The combined current and capital account balance stood at 1.7 per cent of GDP in 2015, and it is expected to grow to 1.9 per cent of GDP in 2016 and to stabilise at 1.6 per cent of GDP over the remaining projection horizon. The slight increase in the combined current and capital account surplus in 2016 chiefly reflects more favourable developments in the primary income account balance, due to the reduction in government debt interest expenditure, in line with the technical assumptions for the projection exercise. In turn, the goods and services account surplus should decrease slightly in 2016. This is due, on the one hand, to a substantial negative volume effect, reflecting an increase in exports below that of imports, in real terms, as mentioned above (Chart 3.11). On the other hand, a positive terms of trade effect is expected, associated with lower oil prices in 2016 (Box 'Projection assumptions'), which almost fully offsets the volume effect.

In turn, given the technical assumption of an increase in oil prices in 2017 and 2018, an unfavourable terms of trade effect is expected in this period, which will be more marked in 2017. This effect, together with a relatively similar buoyancy projected for exports and imports, in real terms, is expected to lead to a decline in the goods and

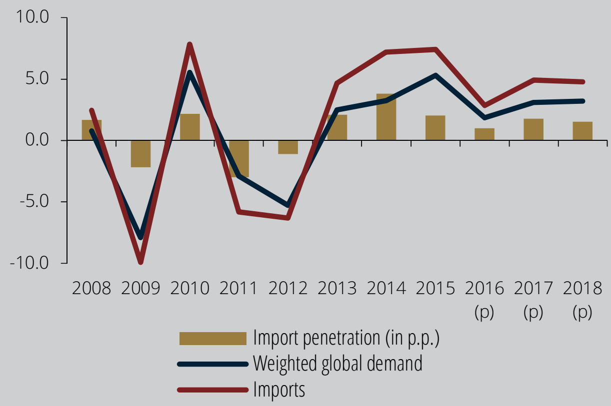
Chart 3.9 • Exports and external demand | Annual rate of change, in percentage



Sources: Statistics Portugal and Banco de Portugal.

Notes: (p) – projected.

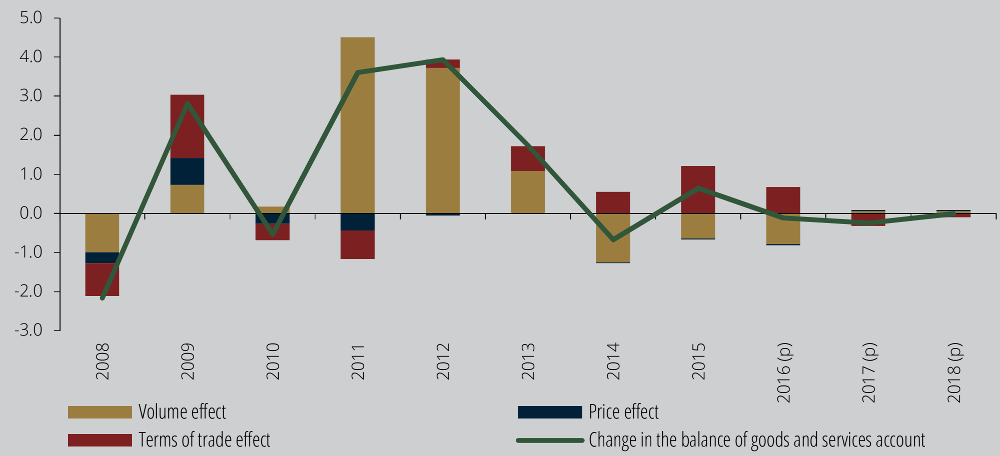
Chart 3.10 • Imports and import-content weighted overall demand | Annual rate of change, in percentage



Sources: Statistics Portugal and Banco de Portugal.

Notes: (p) – projected.

Chart 3.11 • Decomposition of the change in the balance of goods and services account | Percentage of GDP



Sources: Statistics Portugal and Banco de Portugal.

Notes: (p) - projected. For more details on the methodology used, see Box 4.2 'Change in the goods account balance in the first half of 2012', *Economic Bulletin* Banco de Portugal, Autumn 2012.

services account surplus, as well as in the current and capital account, in 2017. In 2018, the current account balance as a percentage of GDP is projected to stand at levels close to those in 2017, stabilising broadly across its main components.

Downward revision of projections for GDP growth

Compared with the projections published by Banco de Portugal in March, GDP growth was revised downwards over the projection horizon. The downward revision by 0.2 p.p. in 2016 reflects a downward revision in GFCF (-0.6 p.p.), particularly in the construction component, which, as mentioned above, seems to have been affected by particularly adverse weather conditions in the first months of the year. Furthermore, exports were revised downwards (-0.6 p.p.), associated not only with the less favourable behaviour in the first quarter of exports of goods and exports of services excluding tourism, but also the downward revision of growth in external demand for Portuguese goods and services. For 2017 and 2018, projections for GDP growth were revised downwards by 0.1 p.p., chiefly reflecting a downward revision of export growth, largely associated with less favourable developments in external demand.

4. Prices and wages

Inflation measured by the rate of change in the Harmonised Index of Consumer Prices (HICP) is expected to gradually increase over the projection horizon, from 0.5 per cent in 2015 to 0.7, 1.4 and 1.5 per cent in 2016, 2017 and 2018, respectively. Compared with the March projections, the projection for consumer price changes was revised upwards in 2016, reflecting the incorporation of more recent HICP data and the revision of the assumption for oil prices.

Compared with the euro area projections, published by the ECB on 2 June, prices in Portugal are expected to continue to grow above the euro area average in 2016 (0.5 p.p.). For 2017 and 2018, prices are projected to grow in line with the euro area average.

Moderate acceleration in prices over the projection horizon

The acceleration of prices projected for the 2016-2018 period reflects a gradual increase in inflationary pressures, arising from the recovery of the global and Portuguese economies and from the positive impact of the set of monetary policy measures adopted by the ECB.

Reflecting the technical assumptions for oil price developments, energy prices are expected to increase in 2017 and 2018, after dropping by around 1 per cent in 2016 (Chart 4.1). Excluding energy, prices are expected to accelerate moderately over the projection horizon. Underlying this scenario is an increase in import prices excluding energy in 2017 and 2018, after a decline in 2016, against the background of an appreciation of the euro in annual average terms.

In addition, amid gradually improving labour market conditions and a recovery in productivity growth, real wages per worker are projected to grow moderately in the private sector, accelerating slightly over the projection horizon. In 2016, developments in nominal wages per worker are influenced by the increase of 5 per cent in the minimum wage.

Unit labour costs in the private sector and the total economy are expected to increase at a moderate pace over the projection horizon. The average change in unit labour costs in the total economy projected for Portugal is broadly aligned with that of the euro area average, according to the Eurosystem's projection exercise.

Over the projection horizon, growth in the GDP deflator in the private sector is projected to remain relatively stable, as a result of, on the one hand, an acceleration in unit labour costs and, on the other hand, a deceleration in gross operating surplus per unit of output (Chart 4.2). Following a sharp increase in 2015, a more moderate, albeit still significant, increase is expected in the gross operating surplus per unit of output in 2016. From 2017 onwards, developments projected for this profit margin indicator point to the gradual unwinding of additional inflationary pressures via this channel.

The increase in gross operating surplus per unit of output seems to be influenced by, inter alia, developments in terms of trade, which increased markedly in 2015 and 2016 as a result of a decrease in oil prices. In addition, the assumption remains that in 2016 the decrease of around 17 per cent in oil prices in euro terms will only be partly passed through to developments in final consumer prices excluding taxes, in line with developments seen in 2015. Taxes on oil products have also risen, contributing to a net increase in indirect taxes in 2016.

The fact that the sharp decline in oil prices is not fully passed through to consumer price developments seems to be the main factor behind the positive inflation differential between Portugal and the euro area in 2016, similarly to 2015.

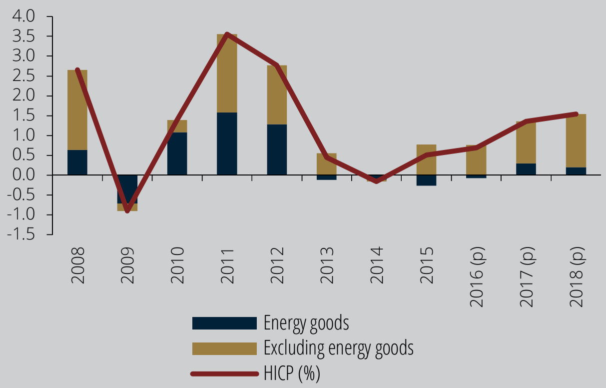
Inflation expectations at low levels

Although this projection is consistent with an increase in inflation over the forecast horizon, inflation expectations for a one-year horizon, both in Portugal and the euro area (calculated on the basis of Consensus Economics data), interrupted the upward trend seen since the start of 2015 and remain at levels significantly below the ECB's price stability objective.

5. Uncertainty and risks

Projections shown here represent the most likely scenario, conditional on the set of assumptions included in Box 1 'Projection assumptions'.

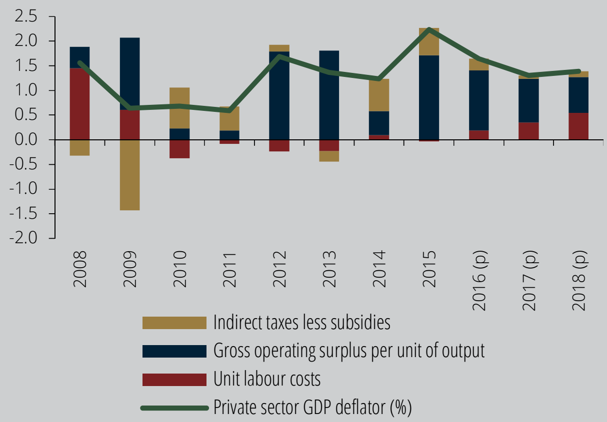
Chart 4.1 • Harmonised index of consumer prices | Contributions to the annual rate of change, in percentage points



Sources: Eurostat and Banco de Portugal.

Note: (p) - projected.

Chart 4.2 • Decomposition of private sector GDP deflator | Contributions to the annual rate of change in percentage points



Sources: Statistics Portugal and Banco de Portugal.

Note: (p) - projected.

Should these assumptions fail to materialise, or should events occur that due to their idiosyncratic nature were not factored into the projections, risks and uncertainties arise. The quantified analysis of the risks and uncertainty surrounding the projection is presented in this section.

Downside risks to economic activity and prices

Over the projection horizon, risk and uncertainty factors, both external and domestic, may be identified. At the international level, the possibility of a slower recovery in economic activity was deemed a risk factor, in particular for emerging market economies, as well as more moderate developments in international trade flows. The materialisation of this risk would lead to lower external demand directed to the Portuguese economy over the projection horizon (Table 5.1). There is also a downside risk associated with the possibility of an upsurge in financial market tensions, with an impact on consumption and investment over the projection horizon, amid high public and private indebtedness. At the euro area level, an increase in sovereign debt interest rates in a number of countries may be triggered by the perception that no progress has been made in fiscal consolidation and/or structural reforms and by the vulnerability of the banking system.

Regarding domestic risks, the possibility that additional measures may be necessary to meet the fiscal targets set by the national authorities was considered, implying lower growth in domestic demand compared with the projections. In addition, a possible loss of momentum in the structural reform process may have a negative impact on business confidence and hamper the recovery in investment. This can also be linked to prevailing risks to financial stability in Portugal.[2] Finally, downside risks to inflation were also taken into account, arising from a slowdown in overall activity and the maintenance of euro area inflation expectations below the ECB's price stability objective.

The set of risks identified above translate into a 55 per cent probability of external demand and public consumption over the projection horizon being more unfavourable than that considered in the projection presented in this Bulletin, while the probability stemming from the identified risks is 58 per cent for private consumption and investment. Lastly, a downside risk was identified for prices, with a 55 per cent probability of occurrence over the projection horizon.

Table 5.1 • Risk factors – Probability of an outcome below the implicit in the projections | In percentage

	2016	2017	2018
Underlying variables			
External demand	55	55	55
Public consumption	55	55	55
Endogenous variables			
Private consumption	58	58	58
Investment	58	58	58
HICP	55	55	55

Source: Banco de Portugal.

Table 5.2 • Macroeconomic scenario - Probability of an outcome below the projections
| In percentage

	Weights	2016	2017	2018
Gross domestic product	100	60	61	60
Private consumption	66	59	61	61
GFCF	15	62	62	61
Exports	40	52	53	54
Imports	40	56	64	64
HICP		54	58	58

Source: Banco de Portugal.

The combination of risk factors mentioned above implies downside risks to economy activity and prices (Table 5.2, Chart 5.1 and Chart 5.2).

6. Conclusions

This Bulletin presents an update of the macroeconomic projections for the 2016-2018 period, which continue to point to a gradual recovery in economic activity, despite a downward revision of GDP growth over the projection horizon compared with the March projections. Underlying the recovery projected for economic activity is a favourable external environment and a reduction of uncertainty levels, both domestically and abroad. Against this background, an acceleration in investment and exports is expected over the projection horizon. The projected pace of growth is slower than that observed in previous periods of recovery in the Portuguese economy, which should be set against the constraints arising from high levels of public and private indebtedness – which are also negatively affecting the recovery of other European economies – and the structural weaknesses of the Portuguese economy.

Chart 5.1 • Gross domestic product
| Rate of change, in percentage

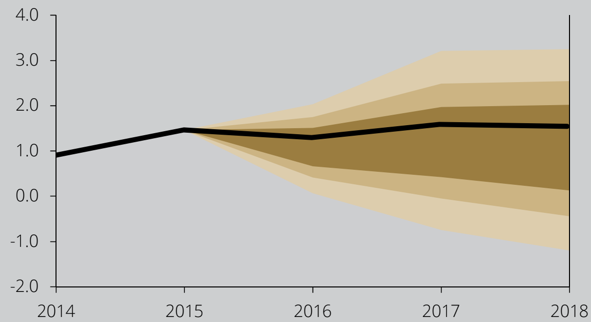
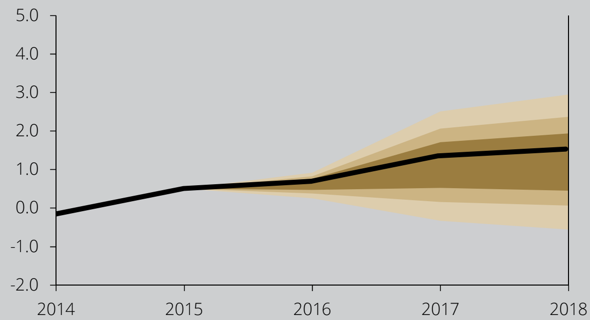


Chart 5.2 • Harmonized index of consumer prices
| Rate of change, in percentage



Source: Banco de Portugal.

The economic slowdown in recent quarters, associated with developments in exports and investment, shows that the Portuguese economy remains very vulnerable to domestic and external shocks, despite the significant progress made in reducing macroeconomic imbalances, which has created the conditions for a more sustainable pattern of economic growth. Against this background, it is crucial to maintain an institutional and tax framework that is predictable and geared towards ensuring macroeconomic stability. It is also essential to proceed with structural reforms favouring investment in physical and human capital, innovation, factor mobility and, ultimately, productivity growth. In addition, national consensus around the need for fiscal consolidation should be preserved, in order to ensure a sustained decline in public debt, which remains a major vulnerability of the Portuguese economy. Finally, the efficiency and stability of the financial intermediation function should be further enhanced. The pursuit of policies safeguarding these objectives should help increase the economy's potential growth and agents' well-being.

Box 2 | The recovery of the Portuguese economy in perspective

The current recovery of the Portuguese economy has been characterised as relatively lacklustre, particularly taking into account the depth and length of the preceding recession. This box aims to compare this recovery with historical standards and the recoveries under way in the euro area. In addition, its intention is to discuss the role of some factors that are contributing to the relatively weak pace of the recovery observed to date and underlying the projection.

The historical comparison exercise requires dating the Portuguese economy's cycles. Recessions and expansions were characterised based on turning points in economic activity, with the cycle troughs identified as the years when GDP reached a minimum (namely 1984, 1993, 2003, and 2013).[3] As of the second quarter of 2009 there was also an economic recovery phase, which however only lasted until the third quarter of 2010. Given that the analysis uses annual data, this short period of recovery is not distinguished from the two adjacent recessions. Hence, the recession prior to the current recovery was considered to have started in 2008 and lasted until 2013.[4] In the international comparison of the latest recovery episode, 2013 was also taken as the trough of the recession preceding the current recovery of the euro area and the other countries considered in the analysis.[5]

The charts comparing the cycles show the evolution of a set of macroeconomic variables five years before (T-5) and after (T+5) the trough (T) of the cycles of the Portuguese economy and other economies under review. As regards the most recent recovery (T=2013), T-5 corresponds to 2008, which makes it possible to compare the levels observed and projected for each variable in the ongoing recovery with those observed before the recession associated with the international financial crisis. Chart 1 shows that the pace of the recent recovery in Portugal is relatively weak compared with that of previous recoveries. Two years after the start of the current recovery, real GDP grew by 2.4 per cent in cumulative terms, similarly to the 2003 recovery (2.6 per cent), but contrasting with the recoveries started in 1993 and 1984 (3.8 and 11.2 per cent respectively). Banco de Portugal's projections point to the maintenance of a moderate growth pace in the 2016-2018 period. This implies that the ongoing recovery remains the weakest when assessed five years after it started. Taking into account that the most recent recession was incomparably more severe and prolonged than the previous recessions, the weak pace of the current recovery suggests that real GDP will not reach the level observed in 2008 (i.e. before the start of the crisis) in the projection horizon. In previous recoveries, this level was surpassed about one year after the start of the recovery.

Chart 1 also shows a comparison of the recent dynamics of the Portuguese economy with those observed in the euro area and the Member States most affected by the sovereign debt crisis (Spain, Greece, Italy, Ireland). For the 2016-2017 period, the European Commission's spring 2016 projections were used for these economies, while Banco de Portugal's projections in this Bulletin were used for Portugal. The pace of the Portuguese recovery is quite similar to the euro area's. It is slower than observed in Spain and especially in Ireland, but faster than that recorded in Italy and Greece. However, the ongoing recovery in the euro area is also less strong by its own historical standards.[6] In addition, notwithstanding the similarity between the paces of the Portuguese and the euro area recoveries, the previous recession was much deeper in Portugal, implying a much slower return to pre-crisis activity levels. In the euro area, those levels were already reached in 2015 in annual terms (in quarterly terms only in the first quarter of 2016).

A comparative analysis of the behaviour of the main expenditure components during the cyclical upswing – both historically and *vis-à-vis* other euro area economies – helps to clarify some reasons behind the relative weakness of the Portuguese economy's current recovery (Chart 2).

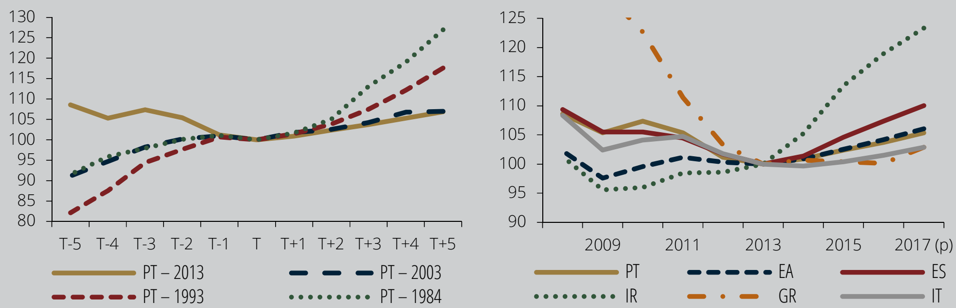
Developments in private consumption during the recent recovery are not very different from those observed in the two previous recoveries, only falling short of that in 1984. The behaviour of this aggregate in Portugal in the current phase of the cycle is also comparable to that shown by Spain and Ireland, and stronger than in Italy and Greece, as well as in the euro area on average. Nevertheless, taking into account projections for 2016-2018, only at the end of the projection horizon is private consumption in Portugal expected to reach levels close to those observed before the crisis.

By contrast, the contribution of public consumption to the ongoing recovery is much lower than observed both in past recoveries and in the euro area. This behaviour should be associated with the high level of public indebtedness in Portugal, which requires a considerable and extended fiscal consolidation effort.

The buoyancy of investment up to 2015 was comparable to that observed in the 1984 and 1993 recoveries, surpassing that observed in 2003. However, the fall recorded by this variable in the recent recession has no comparison with those observed in previous recessions. In addition, the evolution projected for GFCF implies that the recovery becomes comparatively weaker in the 2016-2018 period. When compared to the other economies, the evolution of GFCF in Portugal is quite similar to the euro area's. GFCF is projected to remain below pre-crisis levels in the projection period both in Portugal and, albeit to a lesser extent, in the euro area.

The absence of more robust developments in investment reflects various factors. A relevant issue is the fact that the ongoing recovery follows a severe and prolonged recession, which was associated with a serious global financial crisis, and was in turn succeeded by the euro area sovereign debt crisis and the Portuguese economy's adjustment programme. The international historical experience shows that recoveries following recessions induced by financial crises – where there are broadly based disturbances in financial institutions and markets – tend to be slow.[7] The need to restructure economic

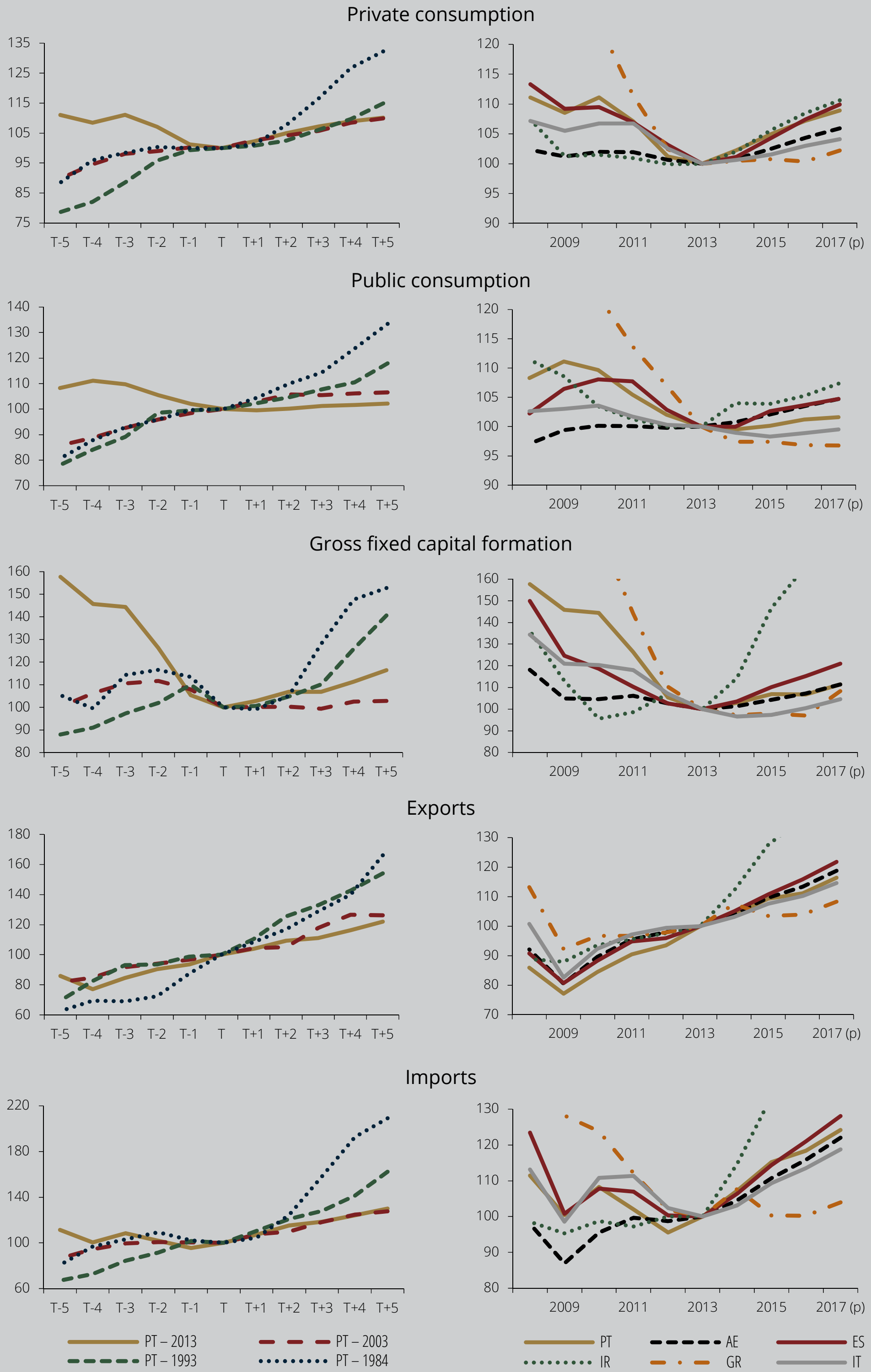
Chart 1 • Evolution of GDP | Index T=100 or 2013=100



Sources: EC (AMECO), Statistics Portugal and Banco de Portugal.

Notes: (p) projected. The left chart presents the evolution of GDP five years before (T-5) and after (t+5) cyclical troughs of the Portuguese economy (T=1984, 1993, 2003 and 2013). The right chart compares the evolution of GDP in Portugal and other economies in the years before and after the most recent cyclical trough (2013).

Chart 2 • Evolution of demand components | Index T=100 or 2013=100



Sources: EC (AMECO), Statistics Portugal and Banco de Portugal.

Notes: (p) projected. The left chart presents the evolution of the variable in question five years before (T-5) and after (t+5) cyclical troughs of the Portuguese economy (T=1984, 1993, 2003 and 2013). The right chart compares the evolution of that variable in Portugal and other economies in the years before and after the most recent cyclical trough (2013).

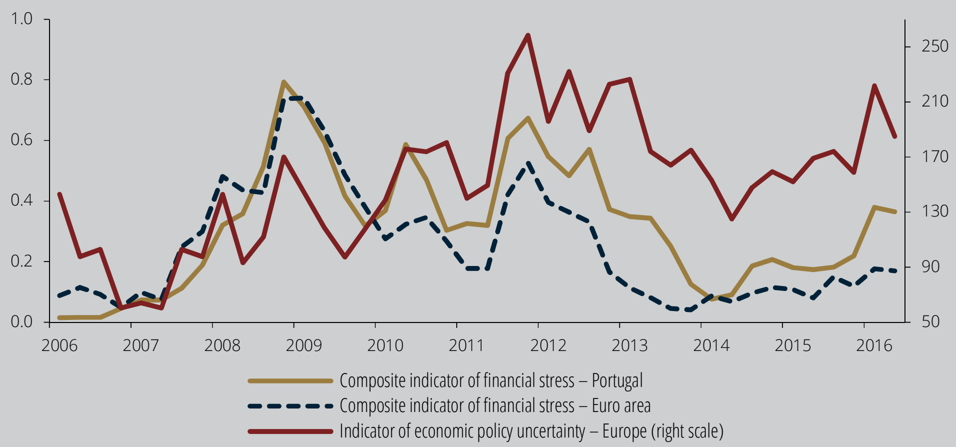
agents' balance sheets as well as disruptions in the functioning of the banking sector – which translate into long-lasting restrictions to credit – tend to hinder the recovery of investment and economic activity.

In spite of the progress recorded, non-financial corporate indebtedness in Portugal remains high, constraining a more marked recovery of investment in the current cycle.[8] In fact, a risk underlying the current projections is that the corporate deleveraging process, weak investment, and low activity growth turn mutually reinforcing. The probability of this risk materialising is increased by the context of relatively high economic uncertainty prevailing in Portugal and the euro area, given its deterrent effects on investment decisions (Chart 3).

Developments in exports in the recent recovery are clearly weaker than in previous recoveries, but in line with the ongoing recovery in the euro area, Spain, and Italy. The weakness of Portuguese exports by historical standards chiefly reflects a less favourable international framework, mirrored by the much less buoyant behaviour of world trade flows than seen in the previous cyclical upswings (Chart 4). This behaviour is associated with lower world activity growth and world trade elasticity – the ratio of trade growth to world GDP growth – than in the past, which reflects cyclical and structural factors.[9] This notwithstanding, in relation to the other economies considered in the chart, Portuguese exports grew the most in the recession period prior to the current recovery. The behaviour of imports in the current recovery was contained compared with that observed in historical recoveries, and relatively close to that of the euro area.

In sum, the analysis shows that the ongoing recovery is relatively weak by historical standards, the lower relative dynamics being accounted for by the behaviour of GFCF and exports (and also to a lesser extent, public consumption). Although the growth pace of both GDP and these variables

Chart 3 • Uncertainty indicators



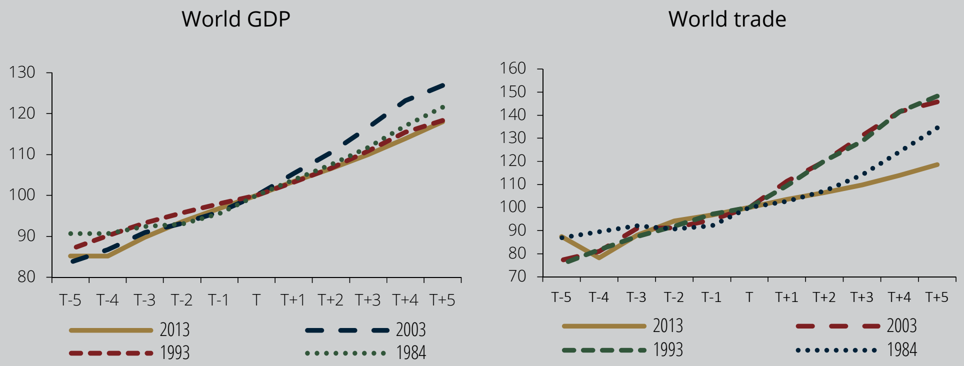
Sources: ECB, www.PolicyUncertainty.com and Banco de Portugal.

Notes: All indicators for 2016 Q2 include information up to end-April. For more information about the composite indicators of financial stress, see Braga, J., Pereira, I. e Reis, T., 2014, 'Indicador de Stress Financeiro para Portugal', *Artigos de Estabilidade Financeira*, Banco de Portugal, 1 and Holló, D., Kremer, M., e Lo Duca, M., 2012, 'CISS – A Composite Indicator of Systemic Stress in the Financial System', *ECB Working Paper*, 1426. In what concerns the indicator of economic policy uncertainty, see Baker, S.R., Bloom, N., e Davis, J.S., 2016, 'Measuring Economic Policy Uncertainty'.

is not much different than that observed/projected for the euro area, the recession that preceded the current recovery was much more severe in the Portuguese case. Hence, the Portuguese economy is not likely to resume the pre-crisis activity levels in the projection horizon, as already observed in the euro area. As regards private consumption, the recovery is in line with historical standards and stronger than observed/projected on average for the euro area.

It is important to note that the Portuguese economy's weak growth in the current phase of recovery also reflects a long-term trend. In fact, there is evidence that the potential output growth of the Portuguese economy stands at levels quite below those prevailing in the previous periods under analysis.[10] This downward trend of potential growth reflects structural weaknesses of the Portuguese economy and seems to have been compounded by the recent crisis, amid slower capital accumulation, a decline in the labour force, and an increase in the non-cyclical component of unemployment. This factor reinforces the need to pursue a demanding agenda of structural reforms to sustain higher economic growth levels in the medium term.

Chart 4 • Evolution of World GDP and trade | Index T=100



Source: IMF.

Note: The charts present the evolution of the variable in question five years before (T-5) and after (t+5) cyclical troughs of the Portuguese economy (T=1984, 1993, 2003 and 2013).

Box 3 | Medium-term fiscal outlook

The State Budget (SB) for 2016, approved by the Portuguese Parliament last March, set the target for the fiscal deficit in national accounts at 2.2 per cent of GDP. With this target, the Government aims to correct the excessive deficit in the current year. In 2015 the fiscal deficit stood at 4.4 per cent of GDP. Excluding the impact of the resolution of Banif,[11] this corresponds to 3.0 per cent and is close to the estimate presented when the SB was prepared (3.1 per cent).[12] Therefore, there is no significant base effect associated with the 2015 budget execution. As regards the change in the structural balance, the Government's estimate, using the European Commission's methodology, points to an increase of 0.3 p.p. of GDP. Indeed, the improvement in the actual balance foreseen for 2016 stems mainly from the expected developments regarding the cyclical component (0.6 p.p. of GDP) and the change in the magnitude of temporary measures (Table 1).

Fiscal developments forecasted for 2016 are affected not only by legislative changes approved in 2016, but also by the lagged effect of measures introduced in previous years. Principal among the latter are the reform of the personal income tax (IRS) (in the part not reflected in 2015 withholding tables), the reduction of the corporate income tax (IRC) rate from 23 to 21 per cent and the change in the taxation of investment funds, with an estimated total impact on the fiscal balance of -0.3 per cent of GDP. By contrast, the effect on the fiscal balance of the measures included in the SB[13] reaches, in net terms,[14] 0.4 per cent of GDP.[15] In addition, the SB classifies as a temporary measure the projected revenue from concessions, which improves the fiscal balance by 0.1 per cent of GDP.

Regarding revenue, the SB measures that contribute to the reduction of this aggregate have an estimated impact of 0.4 per cent of GDP. Among these, the most important are the effect of the partial elimination of the personal income tax surcharge and the reduction in the value-added tax (VAT) for restaurants from July 2016 onwards. However, the SB also envisages measures which will increase corporate income taxation and a number of indirect taxes, namely the tax on oil and energy products, with a positive impact on revenue estimated at 0.5 per cent of GDP.

As regards expenditure, the SB foresees the introduction of a number of significant cost-saving measures (representing 0.5 per cent of GDP), in particular the introduction of upper limits to intermediate consumption (excluding public-private partnerships), the reduction of social assistance expenditure, the control of the number of general government employees and savings in line ministries. However, other measures are projected to boost expenditure, in particular the gradual reversal of the general government employees wage cuts in force, increases in pensions and changes in the rules associated with other social benefits, with an overall impact of 0.3 per cent of GDP.

The estimates included in the SB report point to a rise in revenue of 3.5 per cent in 2016, basically resulting from the increase in taxes on production and imports and in social contributions, in the context of projected improvements in economic activity and the implementation of the abovementioned measures regarding indirect taxes.[16] Conversely, taxes on income and property are projected to decline by 2.0 per cent and an increase is expected in capital revenue associated with the reimbursement of prepaid margins by the European Financial Stability Facility (0.1 per cent of GDP). In addition, the decline projected for expenditure (-1.1 per cent) is concentrated on capital expenditure, resulting in particular from the base effect associated with the 2015 temporary measures.[17] With respect to current expenditure, it is important to highlight the estimated growth of intermediate consumption (8.6 per cent), partly related to the developments foreseen for expenditure with concessions under public-private partnerships. Quite moderate rates of change in compensation of employees and social payments (1.8 and 0.2 per cent respectively) are also noteworthy

Table 1 • Main fiscal indicators in national accounts | As a percentage of GDP

	SB 2016			Statistics Portugal	SP 2016-2020					
	2015	2016	Growth rate: 2015-2016 (a)	2015	2016	2017	2018	2019	2020	Change 2016-2020 (b)
Total Revenue	**43,9**	**43,8**	**3,5**	**43,9**	**43,7**	43,4	**43,1**	**43,0**	**42,7**	**-1,0**
Taxes on income and wealth	10,9	10,3	-2,0	10,8	10,2	10,0	10,0	9,9	9,8	-0,4
Taxes on production and imports	14,5	14,9	6,6	14,5	14,9	14,9	14,9	14,8	14,7	-0,2
Social contributions	11,5	11,4	3,1	11,5	11,5	11,4	11,3	11,3	11,4	-0,1
Other current revenue	6,4	6,3	3,1	6,2	2,5	2,4	2,3	2,3	2,3	-0,2
Capital revenue	0,7	0,9	32,8	0,7	0,9	1,1	1,0	1,0	0,9	0,0
Total expenditure	**48,3**	**46,1**	**-1,1**	**48,3**	**45,9**	**44,8**	**44,0**	**43,2**	**42,4**	**-3,5**
Social payments	19,2	18,6	0,2	19,2	18,6	18,4	18,2	18,0	17,7	-0,9
Subsidies	0,5	0,6	25,5	0,7	0,8	0,6	0,6	0,6	0,6	-0,1
Compensation of employees	11,1	10,9	1,8	11,3	11,1	10,8	10,5	10,2	10,0	-1,1
Intermediate consumption	5,9	6,2	8,6	5,9	6,2	5,9	5,7	5,5	5,4	-0,8
Interest	4,7	4,6	0,4	4,6	4,4	4,2	4,1	4,0	3,8	-0,6
Other current expenditure	2,8	2,8	4,5	2,5	2,5	2,4	2,3	2,3	2,3	-0,3
Investment	2,2	2,0	-5,6	2,2	1,9	2,0	2,0	2,1	2,1	0,2
Other capital expenditure	1,9	0,4	-75,2	1,9	0,5	0,6	0,6	0,6	0,6	0,1
Overall balance	**-4,3**	**-2,2**	**-**	**-4,4**	**-2,2**	**-1,4**	**-0,9**	**-0,1**	**0,4**	**2,5**
Structural balance (c) (in percentage points of GDP)	-2,0	-1,8	-	-	-1,7	-1,3	-0,8	-0,4	-0,1	1,5
change	-0,6	0,3	-	-	0,3	0,4	0,5	0,4	0,3	-
Public debt	**128,8**	**127,7**	**-**	**129,0**	**124,8**	**122,3**	**118,7**	**114,5**	**110,3**	**-14,5**

Source: Ministry of Finance.

Notes: (a) in percentage. (b) in p.p. (c) The structural balance is adjusted for the impacts of the cycle and temporary measures as computed by the Ministry of Finance according to the European Commission methodology. (d) At the time of the presentation of the SB, national accounts data for 2015 was not available, explaining the differences between the values considered in this document and in the SP.

As highlighted by several international institutions, compliance with the 2.2 per cent target for the fiscal deficit in 2016 is subject to non-negligible risks. In fact, in addition to uncertainty associated with the macroeconomic scenario, additional details on some of the fiscal consolidation measures presented is yet to be disclosed, in particular those related to savings in line ministries and in intermediate consumption. Moreover, there is some uncertainty about the impact of the legislative changes introduced in the context of the SB discussion in the Parliament. It should be noted that the latest European Commission estimates, published in early May, point to a fiscal deficit significantly above the official target (2.7 per cent of GDP). Following these forecasts, the Country Specific Recommendations (CSR) of the European Commission, published on 18 May 2016, include the reduction of the fiscal deficit to 2.3 per cent of GDP in 2016, stating that this figure would be consistent with a 0.25 p.p. improvement in the structural fiscal balance.

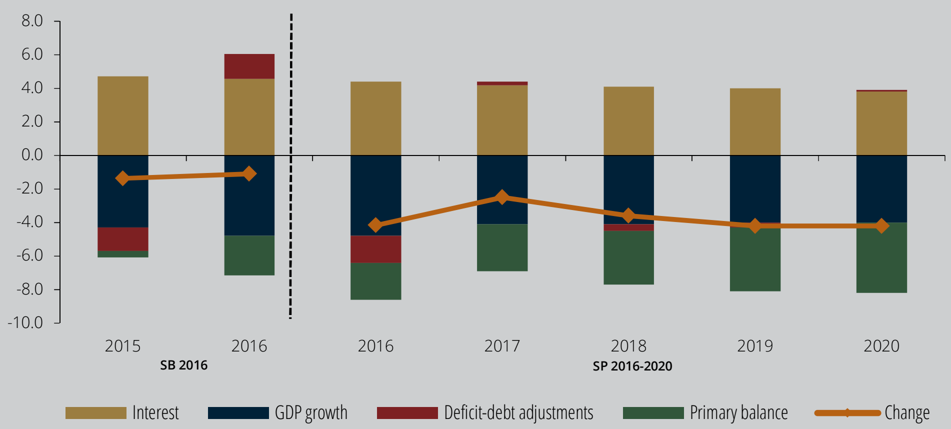
At the end of April the government presented the National Reform Programme and the Stability Programme (SP) for the 2016-2020 period. Regarding the fiscal outlook, according to the projections presented, the fiscal balance should stand at 0.4 per cent of GDP in 2020, increasing by 2.5 p.p. from 2016 (Table 1). A significant part of this improvement stems from the recovery in economic activity, as the cyclical component of the balance presented in this document rises by approximately 1.2 p.p. in this period. Taking additionally into consideration the exclusion of the amount of the temporary measures considered in 2016[18] (0.2 per cent of GDP), the rise foreseen for the structural fiscal balance in the period under review stands at 1.5 p.p. The projected fiscal consolidation is particularly demanding, as it must be reconciled with the implementation of a number of measures already presented, which contribute to a deterioration of the fiscal position in 2017. In particular, the elimination of the personal income tax surcharge, the effect of the change in VAT for restaurants from July 2016 onwards and the suppression of the wage cuts in force since 2011 will have a negative impact on the fiscal balance estimated at 0.4 p.p. of GDP in 2017.

As regards developments in the main fiscal aggregates it is important to highlight the reduction foreseen for the ratio of total expenditure to GDP, which reaches -3.5 p.p. between 2016 and 2020. Revenue as a percentage of GDP will also decline though less sharply (-1.0 p.p.). Indeed, the consolidation measures presented in this document are basically concentrated on expenditure, including the nominal freezing of other current expenditure and intermediate consumption excluding public-private partnerships. In addition to these components, compensation of employees and social payments also make a significant contribution to the reduction of the expenditure ratio. Moreover, savings are foreseen in interest payments contributing to a reduction of the fiscal balance by 0.6 p.p. between 2016 and 2020, anticipating the maintenance of a favourable environment in the sovereign debt market.

As to the government debt ratio, the projection for 2016 presents a considerably lower figure in the 2016-2020 SP (124.8 per cent) than in the SB (127.7 per cent). This difference results basically from the estimate for the deficit-debt adjustments.[19] According to the SP, the public debt-to-GDP ratio is expected to decline at a virtually constant pace until 2020, to 110.3 per cent, with an increasing contribution from the primary balance to this development (Chart 1). Note that savings with interest payments mentioned above are also influenced by the developments foreseen for the debt. Maintaining a sustained declining trend of the public debt ratio over the next years is key to reducing the vulnerability of the country to adverse shocks.

In sum, the developments defined in the SP configure a clear improvement in the fiscal situation over the projection horizon, with particular focus on prospects of a positive fiscal balance being

Chart 1 • Breakdown of the change in the public debt | Percentage points of GDP



Source: Ministry of Finance.

reached in 2020. However, it should be noted that the programme does not foresee compliance with the reduction of the structural balance stipulated in the European rules (0.6 p.p.)[20] nor does it anticipate that the MTO for the structural balance (recently revised from -0.5 per cent to 0.25 per cent) is reached over the programme's horizon. Against this background, in the 2016 CSR, the European Commission proposes the implementation of additional measures to ensure compliance with a 0.6 p.p. reduction in the structural balance in 2017. Over the medium term, the sustained improvement of the fiscal situation in Portugal should be associated with increased public expenditure efficiency and a favourable institutional framework, namely through the adequate implementation of the budget framework law, as also pointed out by the European Commission in the context of the recommendations.

Notes:

1. *Projections for the Portuguese economy: 2016-2018*, Banco de Portugal, March 2016.

2. *Financial Stability Report of Banco de Portugal*, May 2016.

3. In quarterly terms, the troughs corresponded to the first quarter of 1984, second quarter of 1993, second quarter of 2003, and fourth quarter of 2012.

4. In quarterly terms, the recession period identified lasted from the second quarter of 2008 to the fourth quarter of 2012.

5. The Euro Area Business Cycle Dating Committee (CEPR) places the trough of euro area's latest recession in the first quarter of 2013.

6. See the *press release* of October 2015 of the Euro Area Business Cycle Dating Committee.

7. See Reinhart, C. and Rogoff, K. (2009), *The Aftermath of Financial Crises*, American Economic Review, 99(2): 466-72 or IMF (2009), *World Economic Outlook*, Chapter 3 – *From recession to recovery: How soon and how strong?*, April.

8. See Box 2.2.1 'Developments in corporate indebtedness in Portugal and the euro area', *Economic Bulletin,* Banco de Portugal, May 2016.

9. *Understanding the weakness in world trade* (*Economic Bulletin*, Issue 3, 2015, ECB).

10. According to EC estimates/projections, average potential output growth in Portugal is expected to stand at around zero per cent in the 2014-2017 period, compared with 1.1 per cent in the 2004-2007 period, 2.9 per cent in the 1994-1997 period, and 3.7 per cent in the 1985-1989 period (these figures are relatively close to those considered by other international organisations).

11. For more detailed information on the impact of the resolution of Banif on general government accounts, see Press Release of Statistics Portugal of 31 March 2016 on the first notification of 2016 in the context of the excessive deficit procedure.

12. Note that, as regards the composition of revenue and expenditure, the figures disclosed by Statistics Portugal on 24 March diverged significantly from the SB estimate.

13. In this box, measures included in the SB cover not only those resulting from Law No 7-A/2016, approving the State Budget for 2016, but also those that have been approved at the end of 2015.

14. Net effect means, in the case of measures that affect wages and pensions, the deduction of the respective impact on revenue from taxes and social contributions.

15. The quantifications referred to in this paragraph differ from those presented in Table II.3.6 of the SB report. The differences result from taking on board the impact of measures relating to the revaluation of assets for corporate income tax purposes and to the general government employees hiring policy, according to information disclosed in the Report by the Portuguese Public Finance Council No 2 of 2016. In addition, a different quantification is considered for the effect of the change in the investment fund taxation regime, taking as a reference the Report by the Portuguese Public Finance Council No 5 of 2016.

16. The SB foresees an acceleration of the GDP growth rate by 1.5 per cent in 2015 to 1.8 per cent in 2016.

17. Note that excluding the base effect associated with the resolution of Banif according to the quantification presented by Statistics Portugal on 30 March, the growth rate of total expenditure would be 1.8 per cent.

18. The SP also takes into consideration an impact of temporary measures on the 2017 fiscal balance (0.2 per cent of GDP). This impact is associated with the recovery of the guarantee called in 2010 which had been granted by the Portuguese State to Banco Privado Português.

19. The deficit-debt adjustments in the SP include the effects associated with the sale of financial assets held by the State, which were not considered in the SB.

20. This convergence value towards the medium-term objective (MTO) is foreseen in the Stability and Growth Pact for a country under the preventive arm, with a debt ratio above 60 per cent of GDP and during normal cyclical conditions.

II
Series

Quarterly series for the Portuguese economy: 1977-2015

Annual series on household wealth: 1980-2015

Quarterly series for the Portuguese economy: 1977-2015

As in previous years, this section discloses the update of the quarterly long series for the Portuguese economy. These series are distributed in three blocks: expenditure, disposable income and labour market.

The dataset released in this Bulletin presents the same breakdown as the previous ones and includes, for the first time, quarterly figures for 2015.[1] The data is consistent with the latest version of the Quarterly National Accounts published by Statistics Portugal on 31 May 2016 and closely follows the methodological procedures described in detail in Cardoso and Sequeira (2015).[2]

As regards the main expenditure components, the series for the period from 1995 onwards match the quarterly data released by Statistics Portugal, both at current prices and in volume (chain-linked volume data with reference year 2011).

In turn, disposable income series are seasonally and calendar effects adjusted (whenever a seasonal pattern was identified), and for this reason, for the period from 1999Q1 onwards, they may differ from the ones published by Statistics Portugal (in the Quarterly Sector Accounts).

In the labour market block, series are arranged according to two different measures: full-time equivalent (National Accounts concept) and thousands of individuals (Labour Force Survey concept). Note that, the series measured in thousands of individuals, as well as the unemployment rate series, only differ from those published in the Labour Force Survey due to seasonal adjustments.

In general, seasonal adjustments were performed using the X13-ARIMA procedure (via the *JDemetra+ software*).

Notes

1. Quarterly series for the 1977-2015 period are only available in electronic format on Banco de Portugal's webpage for this *Economic Bulletin*.
2. Cardoso and Sequeira (2015), *Quarterly series for the Portuguese economy: 1977-2014*, Banco de Portugal, *Occasional Paper* No. 1.

Annual series on household wealth: 1980-2015

The annual series on household wealth, for the period between 1980 and 2015, correspond to an update of the estimates published in the *Economic Bulletin* of June 2015. These wealth estimates, published annualy,[1] include the financial component (assets and liabilities) and housing (the main component of non-financial wealth). The underlying concepts and methodology are identical to those described in Cardoso, Farinha and Lameira (2008).[2]

The financial series (assets and liabilities) presented here are consistent with the latest version of financial national accounts published by Banco de Portugal, which are available for the 1994-2015 period. Financial series for the period before 1994 were retropolated using the implicit rates of change in the previous wealth estimates and obtained in accordance with the methodology described in Cardoso, F. and Cunha, V. (2005).

The methodology used to estimate housing wealth is based on a method normally used to calculate capital stock estimates – the perpetual inventory method. This method involves, first, successively accumulating fixed capital investment (in this case, in housing), and then, postulating reasonable assumptions for its service life and depreciation method.

The series on housing wealth was adjusted, by benchmarking 2010 on the estimate for housing wealth, based on the Household Finance Survey (*Inquérito à Situação Financeira das Famílias*). The survey data provide a one-off estimate for 2010, while the other years are calculated in compliance with rates of change implicit in the series updated with the usual methodology, based on long series of GFCF in housing. The long series of GFCF in housing used to calculate the respective housing stock include the latest national accounts data (for the 1995-2015 period) and were retropolated using implicit rates of change in the series previously estimated.

Notes

1. The series are only available in electronic format on Banco de Portugal's webpage for this *Economic Bulletin*.

2. Cardoso, F., Farinha, L. and Lameira, R. (2008), *Household wealth in Portugal: revised series*, *Occasional Paper* No. 1, Banco de Portugal. This publication corresponds to a revision of the series previously published in Cardoso, F. and Cunha, V. (2005) *Household wealth in Portugal: 1980-2004*, *Working Paper* No. 4, Banco de Portugal, where the methodology is described in more detail.