Projections for the Portuguese economy in 2017

Continued recovery process of the Portuguese economy

According to the projections prepared by Banco de Portugal, the recovery process of the Portuguese economy continues in 2017, with GDP rising 2.5%, after an increase of 1.5% in 2016 (Table 1). Growth in 2017 is 0.3 p.p. higher than currently projected for the euro area[1] interrupting the real divergence trend recorded since 2000 (Chart 1). The level of GDP in 2017 is 1.5% lower than in 2008, which corresponds to the level recorded before the recession associated with the most recent international financial crisis (Chart 2).

Projections for 2017 comprise information available up to 22 September, as well as a set of assumptions consistent with the ECB's projection exercise (Box 1 below).The international environment of the Portuguese economy continues to be very favourable, with external demand accelerating from 2016 and increasing by more than 4%. The monetary and financial environment is also benign, with the persistence of an accommodative monetary policy stance in the euro area and improving economic agents' financing conditions.

The ongoing economic recovery is supported by higher GFCF buoyancy, whose growth for 2017 is projected to stand at 8%, and by a shift of productive inputs to sectors more exposed to international competition, with goods and services exports growing approximately 7% in 2017, around 44% above the level recorded in 2008 (Chart 2). The increasing internationalisation of the Portuguese economy is accompanied by the maintenance of a current and capital account surplus, which is expected to stand at 1.8% of GDP in 2017.

Table 1 • Projections of Banco de Portugal for 2017 | Annual rate of change, in percentage

	Weights 2016	EB October 2017		EB June 2017	
		2016	2017 (p)	2016	2017 (p)
Gross domestic product	100.0	1.5	2.5	1.4	2.5
Private consumption	65.5	2.1	1.9	2.3	2.3
Public consumption	18.0	0.6	0.3	0.5	0.4
Gross fixed capital formation	15.3	1.6	8.0	-0.1	8.8
Domestic demand	99.1	1.6	2.5	1.5	2.6
Exports	39.9	4.1	7.1	4.4	9.6
Imports	39.0	4.1	6.9	4.4	9.5
Contribution to GDP growth, net of imports (in p.p.) (a)					
Domestic demand		0.6	1.0	0.5	0.7
Exports		0.9	1.5	0.9	1.8
Employment (b)		1.6	3.1	1.6	2.4
Unemployment rate		11.1	9.0	11.1	9.4
Current plus capital account (% of GDP)		1.7	1.8	1.7	2.1
Goods and services account (% of GDP)		2.2	1.7	2.2	2.0
Harmonised index of consumer prices		0.6	1.6	0.6	1.6

Sources: Banco de Portugal and Statistics 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. 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*. (b) Total employment, in number of persons, according to the national accounts concept.

Growth projected for private consumption is lower than that of GDP – amid improving labour market conditions (with a sharp acceleration of employment, a reduction of the unemployment rate and a slight rise in the labour force) and high confidence levels – and continues to be conditioned by weak growth of real wages and by a continuing reduction in household indebtedness (Chapter 3 of this *Economic Bulletin*).

After growing 2.9% in the first half of 2017, GDP is projected to decelerate in the second half of the year (Chart 3). This deceleration chiefly reflects the export performance. Following strong market share gains of exports in the second half of 2016 and in the first half of 2017, a slight market share gain is expected in the second half of 2017 (Chart 4).[2] Throughout 2017, exports continued to make a contribution to annual GDP growth (net of their import content) higher than that of domestic demand, whose contribution remains relatively stable in intra-annual terms.

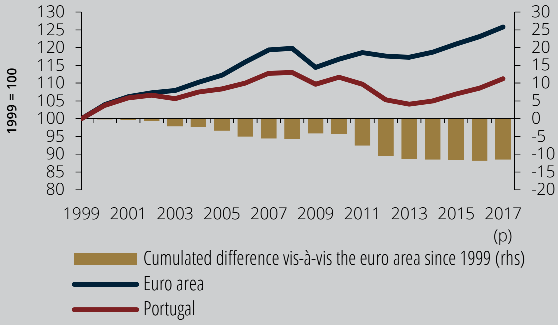
The set of information available for 2017 broadly confirms the scenario outlined in the June issue of the *Economic Bulletin*. GDP growth remains unchanged from the previous projection exercise, with an upward revision of the contribution of domestic demand to GDP growth (net of its import content) offsetting the downward revision of the contribution of exports (Table 1). These revisions are partly associated with the incorporation of the Quarterly National Accounts for the second quarter of 2017.

Shift in domestic demand, with higher investment buoyancy

The contribution of domestic demand to GDP growth in 2017 (net of its import content) is around double the figure recorded in 2016, remaining however lower than that of exports (Chart 3). The rise in the contribution of domestic demand reflects strong GFCF growth and a slight deceleration of private consumption.

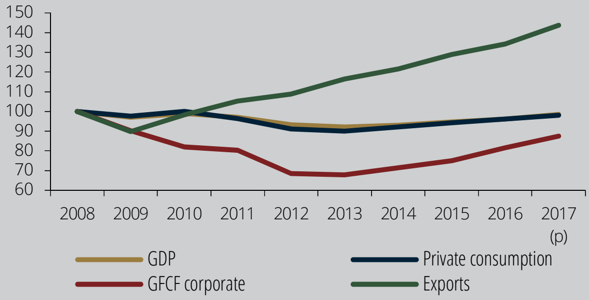
The deceleration of private consumption in 2017 chiefly reflects developments in durable goods consumption. After high growth in the recent past, partly associated with the materialisation of

Chart 1 • GDP developments in Portugal and the euro area (constant prices)



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

Chart 2 • GDP and main components (constant prices) | Index, 2008 = 100



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

consumption decisions postponed during the crisis period, durable goods consumption (particularly cars) is anticipated to decelerate significantly in 2017. Despite recovering, the durable goods stock level implied in the current projection stands at clearly lower levels than those recorded before the international financial crisis.[3]

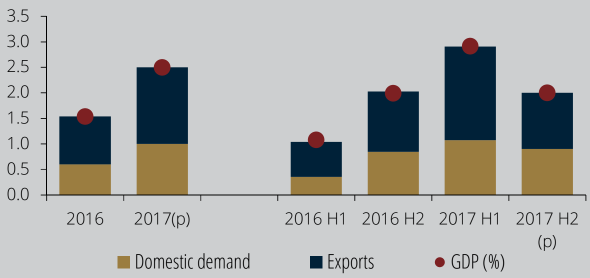
In turn, consumption of non-durable goods and services accelerates in 2017, amid an acceleration of real disposable income and the maintenance of an accommodative monetary policy, with consumer confidence remaining at historically high levels. Growth of real disposable income combines a marked increase in employment with weak growth of real wages.

Turning to GFCF, growth of 8% is projected for 2017, after a 1.6% rise in 2016. The acceleration of GFCF mainly reflects developments in the public component (Box 1 below) and GFCF in housing, with corporate GFCF maintaining strong growth, like in 2016. The rise in investment remains conditioned by the high indebtedness level of the Portuguese economy, being consistent with the continuation of the process of reduction of corporate and household debt.

In 2017 GFCF in housing grew significantly above GDP, after having declined almost uninterruptedly since the early 2000s, as a result of the sector's restructuring process. Growth of GFCF in housing is associated with the improving labour market situation and continued access to financing at historically low interest rates, with a rise in new loans for house purchase being anticipated for 2017 (Chapter 3 of this *Economic Bulletin*). This type of investment has become more attractive, reflecting a rise in its rate of return compared with other long-term investments, namely with lower risk. The most recent European-wide trend of investment portfolio shifts, combined with other incentives, namely of a tax nature, may justify the rise in demand by non-residents. In line with the recovery of the real estate market, house prices are expected to continue growing at well above inflation in 2017.

The corporate component of investment increases around 7% in 2017. Since 2016 the percentage of companies reporting investment limiting factors declined significantly, standing at levels below those observed before the financial crisis (Box 7 of this *Economic Bulletin*). Strong corporate

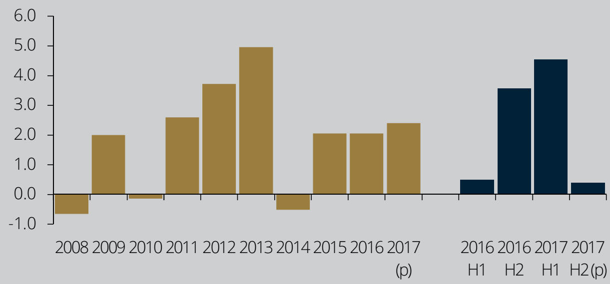
Chart 3 • Net contributions to real GDP growth
| In percentage points



Sources: Banco de Portugal and Statistics Portugal.

Notes: (p) – projected. The demand aggregates net of imports are obtained by subtracting an estimate of the imports needed to meet each component. The calculation of import content 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*.

Chart 4 • Export market share of goods and services
| Per cent



Sources: Banco de Portugal, ECB and Statistics Portugal.

Note: (p) – projected.

GFCF growth reflects the maintenance of positive expectations about developments in overall demand, the maintenance of favourable financing conditions and the need to recover and modernise the capital stock. In addition, the projection for corporate GFCF growth incorporates information on investment in large-scale infrastructures towards the end of 2017 and on financing through European funds, in the transition to the Portugal 2020 programme, also impacting public investment.

Favourable developments in investment and, particularly, in corporate investment, is very relevant for the Portuguese economy's current and potential growth. However, its recovery pattern is still insufficient relative to the levels observed before the crisis. In 2017 corporate GFCF stands around 12% short of the figure recorded in 2008.

Increase in export market shares

Growth of around 7% projected for goods and services exports in 2017 is significantly higher than the rise in external demand for Portuguese goods and services (Chapter 2 of this *Economic Bulletin* and Box 1 below), even if adjusted for Angola's impact[4] (4.5% and 5.7% respectively). These developments suggest the maintenance of significant market share gains in 2017, as observed on average since 2010. The positive performance of exports in 2017 is taking hold amid the appreciation of the euro and unfavourable developments in the traditional price-competitiveness indicators. Against this background, market share gains denote Portuguese companies' competitive capacity in international markets, which goes beyond price-driven competitiveness gains.[5]

Strong export growth is broadly based across the goods and services component. However, the performance of tourism exports is particularly remarkable (Box 8 of this *Economic Bulletin*) – in 2017 they are around 77% above the level recorded in 2008 – as well as that of tourism-related services exports.

In intra-annual terms, projections point to a pattern of deceleration in exports in the second half of 2017. In the second half of 2016 and first half of 2017 exports were very buoyant reflecting (i) the rebound in extra-Community exports, in particular to Angola, (ii) the acceleration of intra-Community exports, in particular to Spain, (iii) the winding-up of some temporary negative effects, associated with the reduction in production of industrial units in the energy and automobile sectors in 2016, and (iv) the extraordinary growth of tourism exports (Chapter 6 of this *Economic Bulletin*). In the second half of 2017, exports are projected to continue growing, being positively influenced by the rise in the productive and export capacity of an industrial unit of the automobile sector and due to the fact that important international events will take place in the Portuguese territory towards the end of 2017. However, the increase in the export level in the second half of the year will correspond to a deceleration in year-on-year terms, reflecting the normalisation of some of the effects mentioned above.

As usual, growth projected for goods and services imports is in line with developments in overall demand weighted by import content, taking into account the average patterns observed in the past. The 6.9% rise in imports in 2017 reflects buoyant growth in some overall demand components with high import content, namely corporate investment, goods exports and, to a lesser degree, durable goods consumption.

Maintenance of the net lending capacity of the economy

Current projections point to the maintenance of the Portuguese economy's net lending capacity, as measured by the current and capital account surplus, at a level close to that recorded in 2016. In the current situation of high external indebtedness, the existence of a surplus in external accounts is crucial for ensuring the credibility and macroeconomic stability of the Portuguese economy.

The relative stabilisation of the current and capital account surplus in 2017 reflects a decline in the goods and services surplus, which is stronger than that projected in the June issue of the

Economic Bulletin, and an improvement in the balances of the remaining components, in line with the previous projection. The deterioration of the balance of the goods and services account reflects a negative volume effect and, to a lesser extent, a loss of terms of trade. The negative volume effect results from higher import than export buoyancy, in real terms, which is more marked in the current projections. The loss of terms of trade is associated with a rise in oil prices denominated in euro, being slightly lower than in the previous projection exercise.

Developments in the current and capital account are also influenced by the global monetary and financial environment, with the maintenance of low interest rates, and by the distribution flow of Community funds under the ongoing European financing programme, which is anticipated to increase in the second half of 2017.

Rise in employment and reduction in output per worker

Labour market developments projected for 2017 are characterised by a 3.1% rise in employment, 1.5 p.p. higher than in 2016 and 0.7 p.p. higher than projected in the previous exercise, and by a reduction in the unemployment rate to 9.0%. The level of employment projected for 2017 is, however, around 6% lower than in 2008, with the unemployment rate 0.7 p.p. above the level recorded in 2008.

Growth of employment is higher than that projected for GDP, resulting in a decline in apparent labour productivity, already observed from 2014 to the first half of 2017 (Chapter 5 of this *Economic Bulletin*). A number of factors play a role in the very weak dynamic of apparent labour productivity. They include inter alia the low capital level per worker, which is far lower than the euro area average[6] and misallocation of productive resources in Portuguese companies.[7] The reduction in apparent labour productivity at aggregate level in the recent past mainly reflects the changes occurred in each industry (Box 6 of this *Economic Bulletin*).

Acceleration of consumer prices

Inflation, as measured by the rate of change in the HICP, rose from 0.6% in 2016 to 1.6% in 2017, remaining unchanged relative to the June *Economic Bulletin*. Compared with the latest projections for the euro area, a virtually zero differential is anticipated vis-à-vis the euro area.[8] The acceleration of prices in 2017 reflects similar contributions by the energy and non-energy components, while in the latter developments in services prices, particularly in tourism-related activity, stand out (Chapter 7 of this *Economic Bulletin*) (Chart 5).[9]

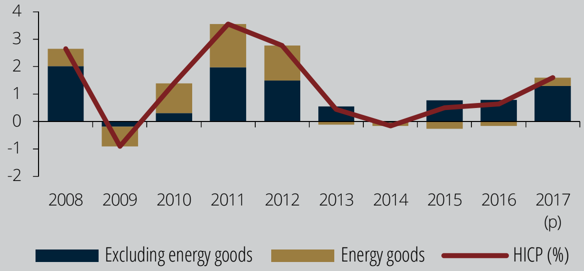
The rise in inflation reflects increases in import prices in 2017, after a fall in 2016. These developments were broadly based across oil prices and non-energy commodity prices, being partially mitigated by the euro appreciation (Chapter 2 of this *Economic Bulletin*). In addition, labour market developments contributed to an acceleration in unit labour costs in the private sector, reflected in increasing domestic inflationary pressures, amid above potential activity growth. The acceleration in unit labour costs in the private sector chiefly reflects declining apparent labour productivity, which is partially offset by the deceleration of nominal wages.

Moderate nominal wage growth is a phenomenon that is common to other European economies and is associated with a number of factors. These include weak evolution of productivity, translated into real wage growth that is limited in historical terms, in particular when compared with previous economic upturns (Chart 6). Other relevant factors are moderate inflation expectations and slack in the labour market. The latter has been decreasing, though it may be higher than suggested by the traditional measures, in line with broader indicators of labour underutilisation (Chapter 5 of this *Economic Bulletin*). The number of companies reporting difficulty in hiring skilled workers as a factor limiting investment (main factor or not) is relatively low, compared with other factors. However, this number increased in 2017, across the various activity sectors. The rise projected for nominal wages also incorporates information on the minimum wage and the reinstatement of public sector wages.

The rise in productivity remains a major challenge

The current projections point to the continuation of the recovery process of economic activity in 2017, amid a particularly favourable economic, financial and monetary environment. As this process progressively reaches a mature phase, an intra-annual deceleration pattern is expected, consistent with the current sustainable growth pace of the Portuguese economy. Against this background, promoting conditions for higher productivity growth is one of the major challenges of the Portuguese economy, being crucial for rising its growth potential and for a structural convergence process towards the average well-being levels in the European Union.

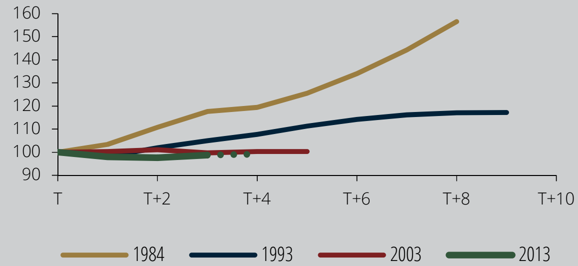
Chart 5 • Harmonised index of consumer prices | Contributions to the annual rate of change, in percentage points



Sources: Banco de Portugal and Eurostat.

Note: (p) – projected.

Chart 6 • Developments in real wages across different economic recoveries | Index, T=100



Sources: Banco de Portugal and Statistics Portugal.

Notes: The economic recoveries considered were determined on the basis of the Portuguese economic cycle and started (T) in 1984, 1993, 2003 and 2013. The 2009 recovery was not considered due to its limited duration. The dotted line corresponds to the projection period.

Box 1 | Assumptions of the projection exercise

The projections for the Portuguese economy are based on a set of assumptions consistent with the ECB's projection exercise, published on 7 September, with cut-off date of 14 August in the case of the technical assumptions for oil prices, interest rates and exchange rates, and 24 August for the remaining set of indicators (Table C.1.1).

In general, there are no significant changes in these assumptions compared with the previous *Economic Bulletin*. As to the international environment, a scenario of acceleration of global economic activity and world trade persists in 2017. Economic activity in the euro area grows 2.2% in 2017, having been revised upwards by 0.3 p.p. from the June projection exercise. External demand for Portuguese goods and services (weighted by the structure of Portuguese exports) is projected to grow above 4% in 2017. Oil prices will rise by approximately 18% in 2017, after successive falls since 2013, with their annual average standing at around 52 US dollars. The maintenance of an accommodative monetary policy stance by the ECB contributes to the persistence of interest rates at low levels.

The main change in the projection assumptions from the previous exercise refers to exchange rate developments. The effective exchange rate of the euro (against 19 trading partners) is expected to appreciate in 2017, by a magnitude similar to that observed in 2016. The exchange rate of the euro is higher than published in the June *Economic Bulletin*, which pointed to a relative stabilisation of the effective exchange rate from 2016 and the one published in the March projections note, which assumed a depreciation. The rise in the euro effective exchange rate reflects, inter alia, the economic and political factors that have contributed to the appreciation of the euro against the pound sterling and to a smaller appreciation against the US dollar.

The public finance variables incorporate specific measures with sufficient detail in official documents, following the rules used in the Eurosystem exercises. In addition to these measures, information available until the cut-off date for the budget outturn and developments in the number of civil servants were also taken on board.

Table C.1.1 • Projection assumptions

		EB October 2017		EB June 2017	
		2016	2017	2016	2017
International environment					
World GDP	yoy	3.0	3.5	3.0	3.3
World trade	yoy	1.8	5.3	1.5	4.5
External demand	yoy	2.0	4.5	1.7	4.5
Oil prices in dollars	aav	44.0	51.8	44.0	51.6
Oil prices in euros	aav	39.8	46.0	39.8	47.6
Monetary and financial conditions					
Short-term interest rate (3-month EURIBOR)	%	-0.3	-0.3	-0.3	-0.3
Implicit interest rate in public debt	%	3.3	3.2	3.3	3.2
Effective exchange rate index	yoy	2.9	2.5	2.6	0.3
Euro-dollar exchange rate	aav	1.11	1.13	1.11	1.08

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

Notes: yoy – year-on-year rate of change, aav – annual average value. An increase in the exchange rate corresponds to an appreciation of the euro. The technical assumption for bilateral exchange rates assumes that the average levels observed in the two weeks prior to the cut-off date will remain stable over the projection horizon. The technical assumption for oil prices is based on futures markets. Developments in the 3-month Euribor rate are based on expectations implied in futures contracts. The implicit interest rate on public debt is computed as the ratio of interest expenditure for the year to the simple average of the stock of debt at the end of the same year and at the end of the preceding year. The implicit rate includes an assumption for the interest rate associated with new issuances.

Public consumption is projected to grow by 0.3% in real terms in 2017. Turning to the staff costs component, developments in the number of civil servants assume the persistence of the growth momentum observed in the first half of the year. This effect is mitigated by the impact of the reduction of standard working time of public sector employees implemented in mid-2016. Moreover, a slight reduction is expected in goods and services expenditure associated, inter alia, with a decrease in expenditure with public and private partnerships of the road sector, in line with the State Budget for 2017. For the public consumption deflator growth is projected to be 2.1%, reflecting expectations about price developments and the gradual reinstatement of public sector wages in 2016.

Turning to public investment, the current estimate maintains the assumption of strong acceleration of this item in 2017, albeit less marked than the estimate included in the 2017-21 Stability Programme. Note that this variable is influenced by one-off effects associated with the sale of military equipment, which reached a particularly high amount in 2016, strengthening the projected acceleration.

Notes

1. *ECB staff macroeconomic projections for the euro area*, September 2017.

2. Intra-annual developments in the export market share remain unchanged in qualitative terms, if account is taken of Angola's impact on external demand for Portuguese goods and services. This adjustment is important given that imports by Angola are not explicitly considered in the external demand indicator calculated within the Eurosystem.

3. Box 2 'An analysis of developments in the stock of consumer durable goods in Portugal', *Economic Bulletin,* June 2017.

4. The adjustment for Angola's impact on external demand for Portuguese goods and services is important as imports by Angola are not explicitly considered in the external demand indicator calculated within the Eurosystem.

5. Box 6.1 'Developments in unit values of Portuguese exports of goods', *Economic Bulletin, May* 2017.

6. Box 5.1 'Capital per worker and productivity', *Economic Bulletin, May* 2017.

7. Dias, Daniel, Marques, Carlos Robalo and Richmond, Christine (2014), 'Resource allocation, productivity and growth in Portugal', *Economic Bulletin*, October 2014.

8. See note 1.

9. Considering the pronounced growth of tourism-related prices, the projection points to the annual change in the HICP to be higher than that of the CPI and that of the private consumption deflator.