BANCO DE PORTUGAL
EUROSYSTEM

Projections for the Portuguese economy: 2016-2018

1. Summary

Projections for the Portuguese economy published in this article point to continued moderate economic growth, broadly in line with developments currently projected for the euro area as a whole. For 2016, growth is expected to stand at 1.5 per cent, similarly to 2015, against a deteriorating international environment – in spite of the accommodative monetary policy stance –, decelerating business investment and resilient non-durable private consumption. In 2017 the Portuguese economy is expected to accelerate to 1.7 per cent, reflecting buoyant investment and exports.

In the 2016-17 period, private consumption is influenced by the measures included in the State Budget for 2016. For 2018, economic activity is projected to slow down to 1.6 per cent, reflecting ongoing structural constraints on the potential growth of the Portuguese economy, in particular the high indebtedness of the public and private sectors (Table 1). Against this background, the Portuguese economy's net lending over the projection horizon is expected to be higher than in 2015, with the increase in 2016 being largely influenced by significant gains in terms of trade.

Table 1 • Projections of Banco de Portugal: 2016-2018 | Annual change, in percentage

	Weights	Projection March 2016				EB December 2015		
	2015	2015	2016(p)	2017(p)	2018(p)	2015(p)	2016(p)	2017(p)
Gross domestic product	100.0	1.5	1.5	1.7	1.6	1.6	1.7	1.8
Private consumption	65.9	2.6	1.8	1.9	1.3	2.7	1.8	1.7
Public consumption	18.2	0.8	1.1	0.4	0.6	0.1	0.3	0.1
Gross fixed capital formation	15.0	3.7	0.7	4.5	4.5	4.8	4.1	6.1
Domestic demand	99.2	2.4	1.4	2.0	1.7	2.4	1.8	2.1
Exports	40.3	5.1	2.2	5.1	4.8	5.3	3.3	5.1
Imports	39.5	7.3	2.1	5.6	4.9	7.3	3.6	5.6
Contribution to GDP growth, net of imports (in p.p.)(a)								
Domestic demand		1.1	0.9	0.8	0.7	1.1	0.9	0.9
Exports		0.4	0.6	0.9	0.9	0.4	0.8	0.9
Current plus capital account (% of GDP)		1.7	2.9	2.3	2.3	2.4	2.5	2.3
Goods and services account (% of GDP)		1.7	2.6	2.1	2.0	1.6	1.7	1.3
Harmonised index of consumer prices		0.5	0.5	1.4	1.6	0.6	1.1	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*.

Developments in the current and capital account balance are therefore expected to result in a gradual decrease in the levels of external indebtedness. Consumer prices are projected to gradually accelerate over the projection horizon, in line with the developments in inflation currently projected for the euro area.

Overall, the risks surrounding the projection for economic activity and inflation are on the downside.

These projections are based on information available up to 17 March and the technical assumptions are compatible with the latest projection exercise of the European Central Bank (ECB) (Box 'Projection assumptions').

Box | Projection assumptions

Table 2 shows the main technical assumptions of projections for the Portuguese economy. These assumptions are in line with data underlying the ECB's projection exercise, released on 10 March, and are based on data available up to 15 February for oil prices and exchange rates and 25 February for the remaining data.

The current assumptions point to an acceleration of world trade over the projection horizon, in line with the recovery in overall activity. This acceleration is projected to be both lower than the projection assumptions published in the December *Economic Bulletin* and the dynamics observed before the financial crisis. As in the past few years, the elasticity of international trade flows to GDP is expected to remain low. Euro area economic activity is projected to continue to recover moderately. The pace of recovery was revised down from the December projection exercise, mostly as a result of a more negative assessment of the euro area external environment.

Table 2 • Projection assumptions

		Projections March 2016				EB December 2015		
		2015	2016	2017	2018	2015	2016	2017
Internacional environment								
World GDP	yoy	2.9	3.0	3.5	3.7	2.9	3.4	3.7
World trade	yoy	1.8	2.8	4.2	4.4	1.5	3.5	4.2
External demand	yoy	4.2	3.9	4.9	4.8	3.9	4.3	4.8
Oil prices in dollars	aav	52.5	34.9	41.2	44.9	53.8	52.2	57.5
Oil prices in euros	aav	47.3	31.3	36.9	40.2	48.4	48.1	52.9
Monetary and financial conditions								
Short-term interest rate (3-month EURIBOR)	%	0.0	-0.3	-0.3	-0.2	0.0	-0.2	-0.1
Implicit interest rate in public debt	%	3.7	3.7	3.6	3.6	3.8	3.6	3.5
Effective exchange rate index	yoy	-9.3	2.9	0.1	0.0	-9.3	-0.7	0.0
Euro-dollar exchange rate	aav	1.11	1.11	1.12	1.12	1.11	1.09	1.09

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.

External demand for Portuguese goods and services is expected to remain robust over the projection horizon, stabilising around 5 per cent growth in 2017 and 2018. Euro area demand is expected to grow considerably more than demand from markets outside the euro area, reflecting a more favourable outlook for the euro area than for emerging market economies. Compared with the December *Economic Bulletin*, external demand was revised downwards in 2016 and slightly upwards in 2017.

Oil prices were considerably revised, compared with the previous *Economic Bulletin*. Futures market prices, which support the technical assumption, point to a strong downward revision of oil prices in USD over the projection horizon. In 2016 the average annual price of oil is expected to decrease sharply, to a level around one-third below that projected in December. For 2017 and 2018, oil prices are expected to increase, but remain considerably below the levels seen in 2013, standing close to USD 45 at the end of the projection horizon. Downward revisions in oil prices in USD are slightly more marked in euro, reflecting the technical assumption for the euro exchange rate.

The technical assumption for exchange rates is based on the maintenance throughout the projection horizon of the average levels observed over the two weeks prior to the data cut-off date. After a considerable depreciation in 2015, the euro is expected to appreciate in 2016 in annual average terms, both in effective nominal terms and against the dollar, compared with a slight depreciation in the December exercise.

Developments in the three-month EURIBOR are based on expectations implicit in futures contracts. Reflecting inter alia the ECB's broad set of policy measures, these contracts point to the maintenance of negative interest rates over the projection horizon, at slightly lower levels than expected in the December *Economic Bulletin* for 2016 and 2017. The assumption for the long-term interest rate for Portuguese public debt is based on an estimate for the implicit rate, including an assumption for the interest rate for new issuances. This rate was revised slightly upwards in 2016 and 2017, compared with the assumption used in December.

The fiscal projections followed the rules used in the Eurosystem's exercises. Most measures included in the State Budget for 2016 were therefore incorporated in the projections, as these had sufficient detail.

Public consumption is projected to accelerate in 2016 and to grow by 1.1 per cent in real terms. This reflects prospects of an increase in expenditure on former shadow toll motorways and goods and services expenditures included in the State Budget for 2016, as well as an assumption that the number of civil servants will almost stabilise in annual average terms. For 2017 and 2018, in the absence of discretionary measures, public consumption is projected to remain relatively stable in real terms. Developments in the public consumption deflator are expected to be positive and robust up to 2017, as a result of the reversal in the public administration wage cuts currently in place.

Nominal public investment is expected to drop in 2016, in line with the change projected in the State Budget for 2016. Developments in public investment are expected to be highly influenced by military procurement in 2016 and, to a lesser extent, in 2017. Excluding this impact, Banco de Portugal projections point to this item stabilising in 2016 and growing in line with nominal GDP over the remaining horizon.

2. The Portuguese economy in 2015

Slowdown in activity in the second half of 2015

In 2015 economic activity continued to follow the gradual recovery path that started in 2013, with gross domestic product (GDP) growing by 1.5 per cent, in real terms, after a 0.9 per cent increase in 2014. Looking at expenditure components net of imports (i.e. deducting from each component an estimated value for associated imports), this acceleration was characterised by higher domestic demand growth, particularly as regards private consumption, and a slight deceleration in exports. In the course of 2015 economic activity slowed down, year on year, from 1.6 per cent in the first half to 1.4 per cent in the second half of the year, mirroring developments in both domestic demand and exports.

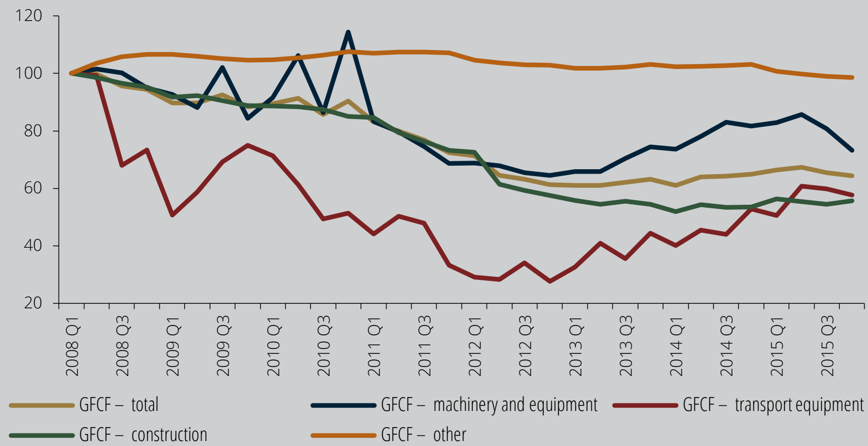
On the domestic demand side, private consumption accelerated from 2.2 per cent in 2014 to 2.6 per cent in 2015, against a background of enhanced labour market conditions (with an increase in employment and a reduction in the unemployment rate) and more marked consumer credit growth.

This acceleration mainly reflected the non-durable consumption component. Consumption of durable goods grew by more than 10 per cent in 2015, despite decelerating in the second half of the year.

Public consumption increased by 0.8 per cent in 2015, after a 0.5 per cent decrease in the previous year, reflecting, among other factors, a less substantial reduction in the number of civil servants and an increase in intermediate consumption expenditure.

Gross fixed capital formation (GFCF) accelerated from 2.8 per cent in 2014 to 3.7 per cent in 2015, mirroring developments in construction and, to a lesser extent, in GFCF in transport equipment, which more than offset a strong deceleration of GFCF in machinery and equipment (Chart 1). In 2015 GFCF in construction posted a positive growth rate, thus interrupting the downward trend that had been seen since 2001. In turn, GFCF in machinery and equipment fell in the second half of the year, following a period of high growth since the second half of 2013. These unfavourable developments took place amid heightened domestic uncertainty and an interruption in the upward

Chart 1 • GFCF and main components | Index 2008 T1 = 100



Source: Statistics Portugal.

Note: In 2010 the series on GFCF – machinery and equipment is influenced by developments in the component 'Weapon systems'.

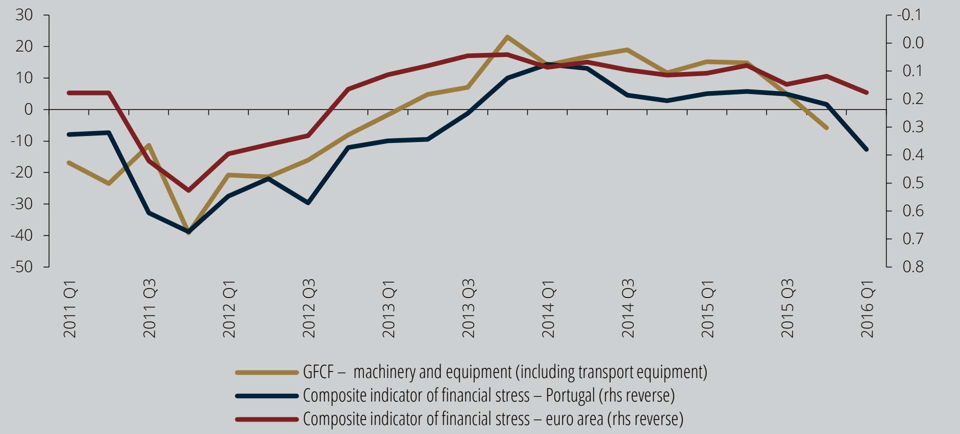
trend of capacity utilisation, in both manufacturing and services. The pick-up in financial turmoil that characterised the world economy at the end of 2015 seems to have also contributed to this (Chart 2). GFCF developments in the fourth quarter were below those projected in the December *Economic Bulletin*, which largely explains the downward revision by 0.1 percentage points (p.p.) of annual GDP growth in 2015.

With regard to exports, the acceleration from 3.9 per cent in 2014 to 5.1 per cent in 2015 was considerably influenced by a strong momentum in energy goods exports, with very high import content, which was conditioned by a base effect resulting from the temporary closure of a refinery unit in the first quarter of 2014. This base effect also influenced the developments in changes in inventories. Excluding energy goods, exports decelerated in 2015, which largely reflected very unfavourable developments in exports to Angola and Brazil, whose economies have been adversely affected by substantial oil price declines and a loss of momentum in international commodity markets. Exports of goods excluding energy to intra-EU markets continued to grow steadily, standing at approximately 6 per cent in 2015. Finally, tourism exports continued to grow significantly at 8.0 per cent, despite increasing less than in 2014.

Imports accelerated slightly, from 7.2 per cent in 2014 to 7.3 per cent in 2015, with a substantial increase in the first half of the year, only to decelerate in the second half of the year. Developments in the first half of 2015 chiefly reflected the profile of exports of energy goods and the exceptional imports of a number of pharmaceutical products. In turn, the slowing momentum of domestic demand components with greater import content in the second half of 2015, most notably, private consumption of motor vehicles and GFCF in machinery and equipment, led to a deceleration in imports in the second half of the year.

The goods and services account surplus increased in 2015, to 1.7 per cent of GDP. Although, in real terms, imports of goods and services grew more than exports, this negative volume effect was more than offset by a very positive change in terms of trade, which was associated with the marked decline in oil prices.

Chart 2 • GFCF – machinery and equipment (including transport equipment) | Year-on year rate of change, in percentage



Sources: ECB, Statistics Portugal and Banco de Portugal.

Note: The composite indicators of financial stress for 2016 Q1 include information up to 17 March. For more details on these indicators of financial stress see Braga, J., Pereira, I. and Reis, T., 2014, 'Composite Indicator of Financial Stress for Portugal', *Financial Stability Papers*, Banco de Portugal, 1, for Portugal and Holló, D., Kremer, M. and Lo Duca, M., 2012, 'CISS – A Composite Indicator of Systemic Stress in the Financial System', *ECB Working Paper*, 1426, for the euro area.

Despite the fall in oil prices, the Harmonised Index of Consumer Prices (HICP) grew by 0.5 per cent in 2015, following a slight decline by 0.2 per cent in the previous year. Amid a depreciation of the euro, rising import prices excluding energy goods and subdued wage developments in the private sector, the price increase in 2015 reflected an acceleration in services and food prices, while non-energy industrial goods prices declined less markedly. In 2015 the inflation differential compared with the euro area was positive, chiefly reflecting higher price declines for energy goods in the euro area average than in Portugal.

3. Main aspects of the projections for the Portuguese economy

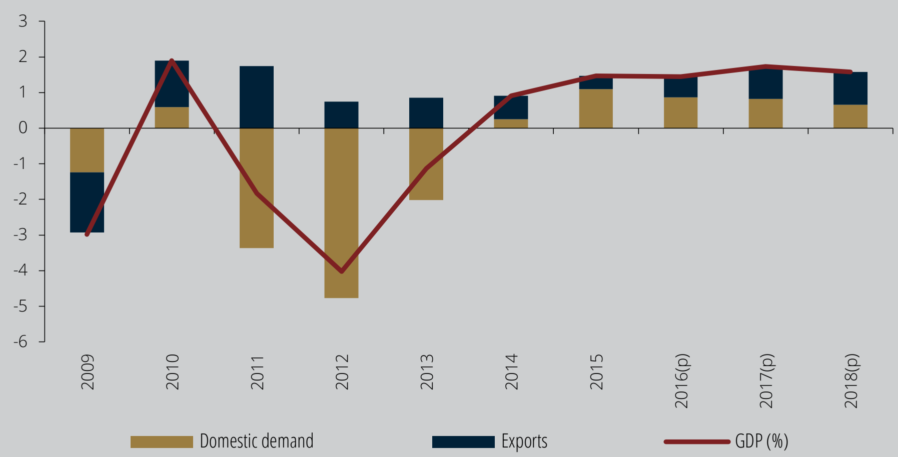
Moderate pick-up in activity, slowing down at the end of the projection horizon

Projections for the Portuguese economy point to continued moderate recovery in economic activity, with a slight slowdown at the end of the projection horizon. This slowdown chiefly reflects developments in domestic demand, namely in private consumption, whereas exports maintain a contribution net of imports close to 1 per cent in the projection horizon (Chart 3). In the 2016-2018 period, on average, GDP growth is expected to be similar to that projected for the euro area, and, at the end of the projection horizon, its level is close to that observed before the start of the international financial crisis (Chart 4).

Growth of private consumption is projected to be slightly below 2.0 per cent in 2016 and 2017, and to decelerate in 2018. These developments are consistent with the continued decline in households' indebtedness as a percentage of disposable income, which in 2018 will be approximately 20 p.p. lower than in 2008.

Consumption growth projected for 2016 is lower than in 2015, largely reflecting developments in consumption of durable goods, in particular motor vehicles. After the high buoyancy observed in 2014 and 2015, with real growth rates above 10 per cent, partly associated with purchases postponed during the recession

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



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

period, developments in consumption of durable goods over the projection horizon are projected to be in line with historical elasticity to disposable income. Data made available for 2016 points to the possibility of some frontloaded purchases early in the year, due to changes in the fiscal framework associated with motor vehicles, included in the State Budget for 2016.

Non-durable consumption growth in 2016 is projected to be lower than in the previous year. This reflects the relative stabilisation of the current consumption level in the last quarter of 2015, following its growth in the three previous quarters, as well as the deceleration in main short-term indicators in early 2016, against a background of particularly high uncertainty. However, the current consumption level is expected to recover during the year, in line with an acceleration of real disposable income, influenced by the continued improvement in labour market conditions, the rise in the minimum wage and the measures for the reinstatement of income included in the State Budget for 2016.

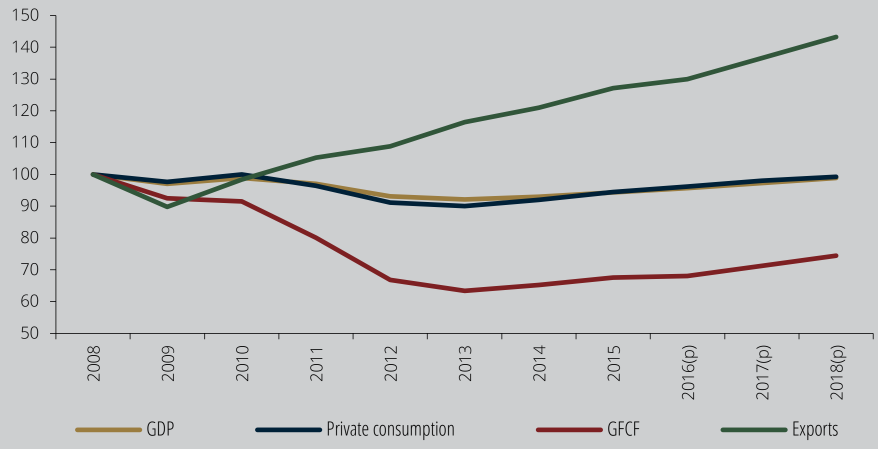
For 2017 and 2018 private consumption developments are projected to be in line with the profile of households' real disposable income, in a context of moderate recovery of employment, wage moderation in the private sector and acceleration in consumer prices. In 2018 private consumption and households' disposable income are expected to decelerate, largely reflecting a slowdown in net wages, after the positive impact on households' incomes 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.

GFCF is expected to decelerate strongly from 3.7 per cent in 2015 to 0.7 per cent in 2016, largely reflecting developments in the corporate component. This is affected by negative developments in investment in machinery and equipment at the end of 2015, which seem to have extended into early 2016, according to most recent information on imports of machinery. Over the course of the year, the level of business GFCF is expected to recover, in line with developments in economic activity.

As regards GFCF in housing, projections point to further growth in housing investment in 2016, in line with the increase in disposable income and an improvement in labour market conditions. In early 2016, however, this component is expected to develop negatively, although temporarily, due to the influence of adverse weather conditions.

Over the remaining projection horizon, GFCF is expected to recover, with growth above 4 per cent. This is associated with a rise in overall

Chart 4 • Developments in GDP main components | Index 2008 = 100



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

demand, as well as a gradual improvement in funding conditions. The buoyancy of GFCF, however, will be lower than previously projected. In fact, the current economic cycle has been associated with weak investment buoyancy. This extends into developed economies and, in particular, the euro area, and is actually among the most significant characteristics of the current stage of economic growth. As regards the Portuguese economy, the high indebtedness level of non-financial corporations is one of the factors that will continue to affect investment decisions. Given the recovery expected for business GFCF, its share in GDP at the end of the projection horizon is expected to stand close to the average in the past two decades (Chart 5).

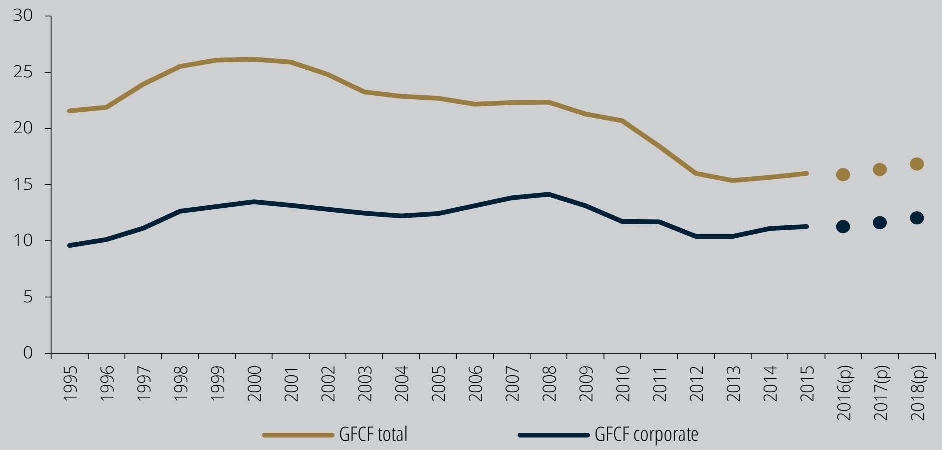
Exports maintain robust growth over the projection horizon

After a growth of 5.1 per cent in 2015, current projections for exports of goods and services point to an increase of 2.2 per cent in 2016 and an acceleration to rates around 5 per cent in 2017 and 2018. Against a framework of relative stabilisation in growth of external demand, in line with the technical assumptions, the deceleration of exports in 2016 essentially reflects a decline in exports of energy, due to the temporary closure of a refinery at the beginning of the year. In addition, the decline observed in 2015 in the level of exports to some emerging market economies, namely Angola and Brazil, seems to be of a permanent nature. In 2017 and 2018 growth of exports largely reflects developments in external demand, considering that the market share remains relatively steady.

Robust growth of exports, common to both goods and services, leads to the continued channelling of productive resources towards sectors with higher exposure to international competition. In 2017 and 2018, exports have a higher net contribution to GDP growth than domestic demand. The share of exports in GDP is projected to increase from around 40 per cent in 2015 to approximately 42 per cent in 2018 (around 30 per cent of GDP in 2008).

Over the projection horizon, imports will evolve in line with the average historic elasticity of this component to the increase in overall demand weighted by import content. Imports are projected to decelerate significantly in 2016, growing slightly less than exports, due to the marked deceleration of the overall demand for components with higher import content, namely consumption of durable goods (motor vehicles), business investment and exports of energy goods.

Chart 5 • Gross fixed capital formation | In percentage of GDP



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

Current and capital account surplus over the projection horizon

According to current projections, the adjustment process of accumulated external imbalances in the Portuguese economy is expected to continue over the projection horizon, with the maintenance of net lending by the Portuguese economy, measured by the combined current and capital account balance. These developments reflect an increase in the savings rate of the total economy and, to a lesser extent, in the investment rate.

The current and capital account balance stood at 1.7 per cent of GDP in 2015, and is expected to reach 2.9 per cent of GDP in 2016 and 2.3 per cent of GDP in 2017 and 2018. The increase in surplus of 1.2 p.p. of GDP projected for 2016 largely reflects the increase in the goods and services surplus. Developments in this surplus almost fully reflect a favourable effect in terms of trade, associated with the decline in the oil price (See Box 'Projection assumptions'). In turn, from 2017 onwards, an adverse terms of trade effect is expected, due to the technical assumption of an increase in oil prices.

Downward revision of activity growth from the previous *Economic Bulletin*

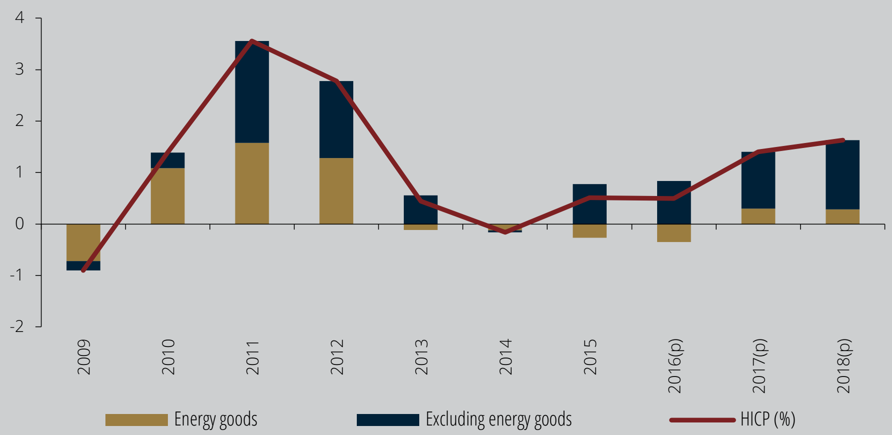
Compared with the December issue of the Economic Bulletin, GDP growth in 2016 is revised downwards in current projections, given that the upward revision of public consumption resulting from fiscal assumptions was more than offset by the lower buoyancy of GFCF and, to a lesser extent, of exports, in line with the downward revision of external demand.

For 2017, GDP growth projection is revised slightly downwards, reflecting the downward revision of investment, as a result of a revaluation of the investment profile over the projection horizon. In turn, both public and private consumption are revised slightly upwards. In the latter case, the revision is in line with the impact of fiscal measures on disposable income.

Moderate acceleration in consumer prices over the projection horizon

After a decline of 0.2 per cent in 2014, inflation measured by the rate of change of the harmonised index of consumer prices (HICP) rose by 0.5 per cent in 2015, and prices are projected to grow similarly in 2016 and to accelerate in 2017 and 2018. At the end of the projection horizon, inflation is projected to stand at levels below, but close to, 2 per cent (Chart 6).

Chart 6 • Harmonised index of consumer prices | Contributions to the annual rate of change, in percentage points



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

Compared with the December issue of the *Economic Bulletin*, the projected change in consumer prices was revised downwards in 2016 and 2017, reflecting the incorporation of more recent information from the HICP as well as oil price developments.

Price developments projected for the 2016-2018 period reflect gradually increasing inflationary pressures, brought about by moderate – but above potential – growth of the Portuguese economy, the positive impact of the monetary policy measures adopted by the ECB, as well as the incorporation of the technical assumption of the increase in commodity prices and oil prices in euros in 2017 and 2018 (Box 'Projection assumptions').

Over the projection horizon, inflation developments are based on moderate growth in real wages, in parallel with the gradual decline in the unemployment rate and the recovery of productivity growth. The assumption of an acceleration in import prices excluding energy is also considered, particularly in 2017 and 2018.

In 2016, there is a slight increase in inflation, notwithstanding a strong decline in the oil price and a small appreciation of the euro. These factors are partly offset by a net increase in indirect taxes, namely excise taxes on oil products, and the impact of the increase in the minimum wage. In addition, similarly to 2015, the assumption that the sharp decline in the oil price is not fully passed on to consumer price developments is also maintained, with an increase in the differential between the oil price and the final consumer price, net of taxes. Concomitantly, based on the projections for the euro area recently published by the ECB, a positive inflation differential vis-à-vis the euro area is projected for 2016, as observed in 2015. Current projections point to an unwinding of this differential over the projection horizon.

Although this projection is consistent with a rise in inflation over the projection horizon, inflation expectations in the medium and long term – both in Portugal and in the euro area – have halted the upward trend observed since early 2015, and remained at levels significantly below the ECB's price stability objective.

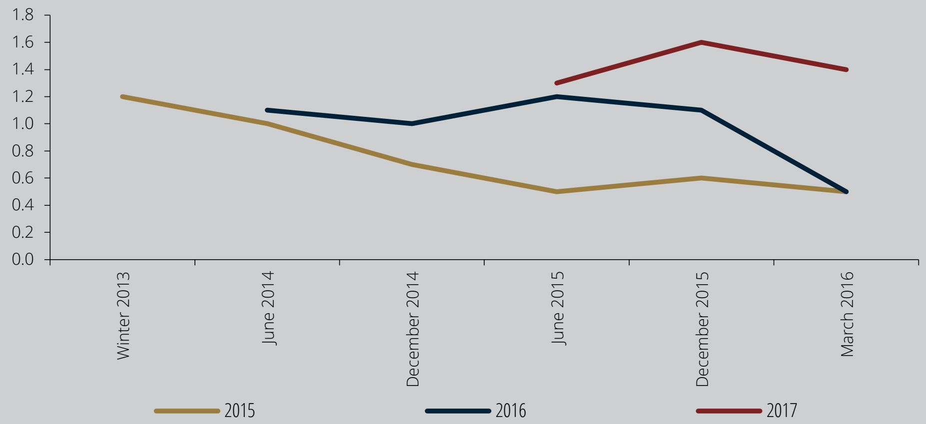
4. Risk analysis

Downside risks to economic activity and inflation

These projections represent the most likely scenario, conditional on the set of assumptions included in Box 'Projection assumptions'. This scenario is subject to various downside risks, most notably the following: the possibility of lower growth in activity and international trade flows in both the euro area and emerging market economies, which would lead to loss of momentum in external demand for Portuguese goods and services; the possibility of heightened financial market tensions, with a negative impact on consumption and investment over the projection horizon against a background of high public and private indebtedness; the potential need for further measures to meet fiscal goals, which would result in a reduction in domestic demand compared to the baseline scenario, namely in 2016; and the possibility of a postponement of structural reforms. An upside risk stemming from the possibility of further monetary policy measures by the ECB is also taken into account, which would have a positive impact on economic activity and consumer prices over the projection horizon.

With regard to consumer prices, downside risks over the projection horizon are also considered, stemming from a slowdown in global activity, the maintenance of inflation expectations below the ECB's price stability objective and the possibility of a reduction in refining and distribution margins of oil products. In this context, projections for inflation in Portugal have recently been revised downwards on a regular basis, amid unexpected oil price decreases and persistent inflation in the euro area at particularly low levels (Chart 7).

Chart 7 • Projections for the annual rate of change of the HICP | In percentage



Source: Banco de Portugal.

5. Conclusions

Current projections point to a small pick-up in the economy, following a strong contraction in activity over the 2011-13 period. At the end of the projection horizon, which for the first time includes 2018, GDP will edge close to the levels seen prior to the international financial crisis. This projection shows a number of constraints that still remain in the Portuguese economy: high public and private indebtedness, adverse demographic developments, distortions in labour and product markets, insufficient investment levels, and the fall in trend growth in the main destination markets for Portuguese exports.

The past and projected path for GDP suggests that measures to drive short and medium-term economic growth should be made subject to policies guided by three goals. The first is the need to ensure that public debt, which currently stands close to 130 per cent of GDP, follows a downward path. This would guarantee that the Portuguese economy would be able to withstand negative shocks in the future. The second is the need to press forward with structural reforms geared in particular towards strengthening the real economy and the financial system and improving incentives to innovation and resource mobility, while guaranteeing the predictability of the fiscal and institutional framework. Finally, the present and future generations must be prepared for a competitive and increasingly complex economy, which can be achieved by fully developing their potential.

These three dimensions – public debt sustainability, adequate structural reforms and development of human potential – are fully embodied in the existing EU institutional framework.