Projections for the Portuguese economy: 2017-19

These macroeconomic projections of Banco de Portugal refer to the period from 2017 to 2019. The Portuguese economy is expected to maintain a recovery path over the projection horizon, with a pace of growth in line with that currently projected for the euro area as a whole.[1] After an increase of 1.4 per cent in 2016, the Portuguese gross domestic product (GDP) is expected to increase by 1.8 per cent in 2017, 1.7 per cent in 2018, and 1.6 per cent in 2019. In 2019 real output stands at a level close to that recorded in 2008, which clearly illustrates the unprecedented nature of this latter economic cycle (Table 1, Chart 1).

Developments in activity over the projection horizon are sustained by strong growth of exports – reflecting a favourable external economic and financial environment and the maintenance of gains in market share – and a shift in domestic demand towards greater buoyancy of gross fixed capital formation (GFCF). This pace of recovery continues to be affected by the need for adjustment of the sectoral balance sheets of the Portuguese economy and structural constraints to greater potential growth.[2]

The behaviour of exports, of both goods and services, has been among the most significant aspects of the adjustment process of the Portuguese economy, providing for a marked reorientation of productive resources towards sectors that are more exposed to international competition. In 2019 exports of goods and services are projected to stand approximately 60 per cent above the level registered in 2008 (Chart 1). This increase in openness abroad is accompanied by strong growth of business investment

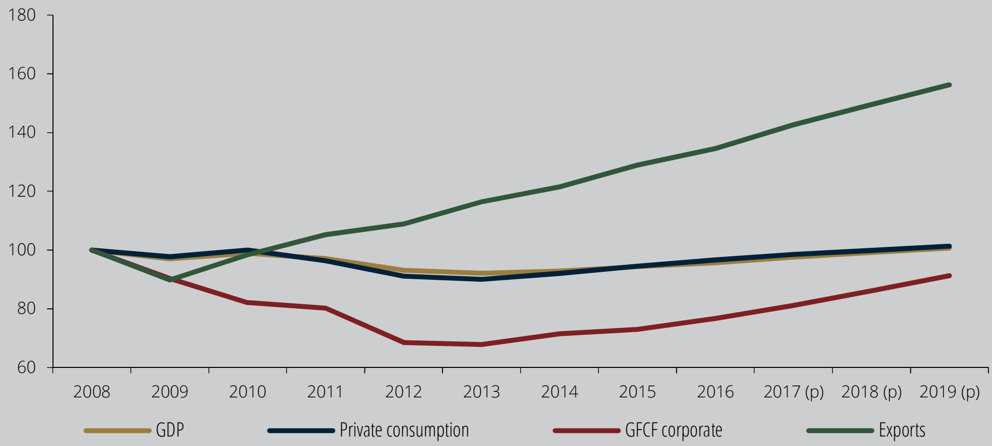
Table 1 • Projections of Banco de Portugal: 2017-19 | Annual rate of change, per cent

	Weights	March 2017 projections				EB December 2016			
	2016	2016	2017(p)	2018(p)	2019(p)	2016(p)	2017(p)	2018(p)	2019(p)
Gross domestic product	100.0	1.4	1.8	1.7	1.6	1.2	1.4	1.5	1.5
Private consumption	65.8	2.3	2.1	1.4	1.4	2.1	1.3	1.4	1.3
Public consumption	18.1	0.8	0.2	0.5	0.2	1.0	0.0	0.4	0.2
Gross fixed capital formation	14.8	-0.3	6.8	5.0	4.8	-1.7	4.4	4.3	4.5
Domestic demand	98.8	1.5	2.5	1.8	1.7	1.2	1.5	1.7	1.6
Exports	40.2	4.4	6.0	4.8	4.5	3.7	4.8	4.6	4.4
Imports	39.1	4.4	7.3	4.8	4.7	3.5	4.8	4.9	4.4
Contribution to GDP growth, net of imports (in p.p.)(a)									
Domestic demand		0.5	0.8	0.7	0.7	0.4	0.5	0.6	0.6
Exports		0.9	1.0	0.9	0.9	0.8	0.9	0.8	0.9
Employment(b)		1.6	1.6	1.0	1.1	1.5	1.0	0.9	1.0
Unemployment rate		11.1	9.9	9.0	7.9	11.0	10.1	9.4	8.5
Current plus capital account (% of GDP)		1.7	1.0	1.1	1.2	1.1	0.9	0.9	1.1
Goods and services account (% of GDP)		2.2	1.4	1.3	1.4	2.2	1.9	1.8	1.8
Harmonised index of consumer prices		0.6	1.6	1.5	1.5	0.8	1.4	1.5	1.5

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 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*.
(b) Total employment, in number of individuals according to the national accounts concept.

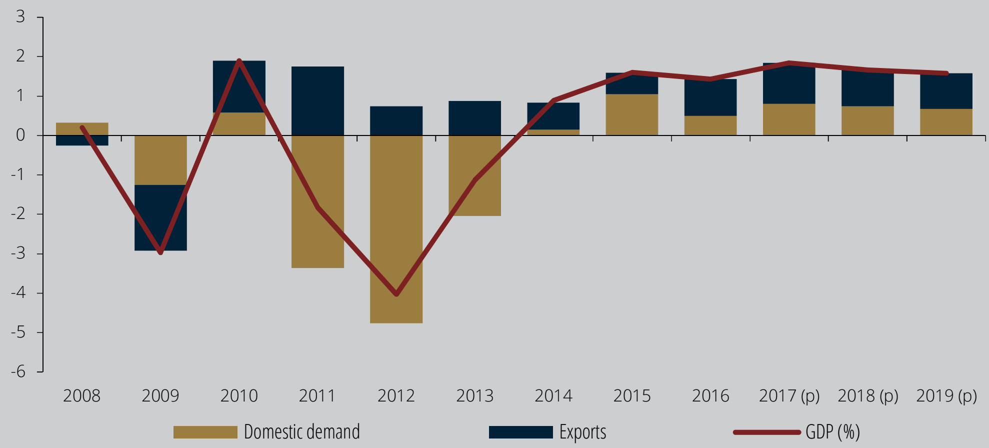
over the projection horizon, which will continue to benefit from the maintenance of accommodative monetary and financial conditions and favourable prospects regarding developments in overall demand. In turn, private consumption – in spite of an improvement in the labour market and high confidence levels – will continue to be affected by low growth of real wages and the need to continue the process to reduce the households' indebtedness level. In the 2017-19 period, the contribution of exports to GDP growth will continue to be higher than the contribution made by domestic demand (net of the respective import content) (Chart 2). Against this background, the Portuguese economy is expected to maintain, over the projection horizon, its external net lending position, which is key for the ongoing recovery process.

Chart 1 • GDP and main components, constant prices | Index 2008 = 100



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

Chart 2 • Net contributions to real GDP growth | In percentage points



Sources: Statistics Portugal and Banco de 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*.

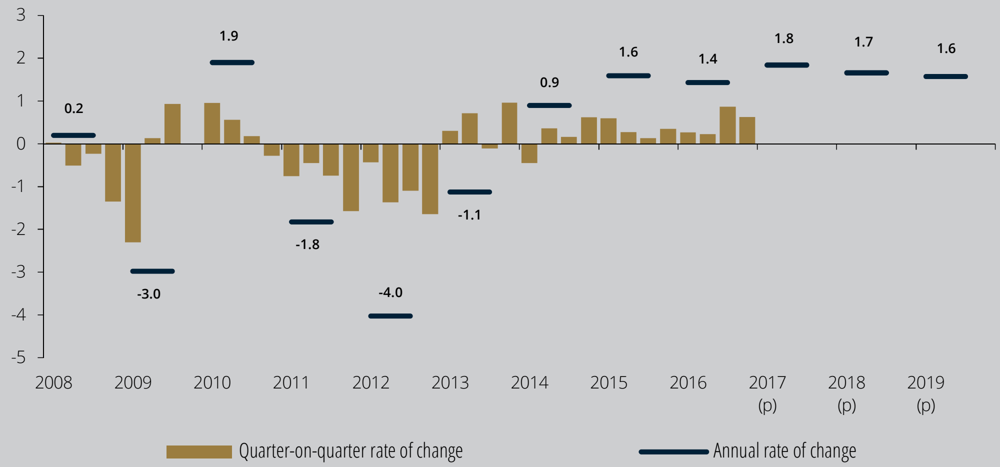
Compared with previous projections in the December issue of the *Economic Bulletin*, the annual GDP growth rate was revised upwards by 0.4 percentage points (p.p.) in 2017, 0.2 p.p. in 2018, and 0.1 p.p. in 2019. These revisions reflect that the buoyancy of economic activity in late 2016 and early 2017 is higher than anticipated in the previous projection exercise, and reflect also the overall favourable impact of external environment assumptions. In particular, the upward revision of external demand and the effect of the actual depreciation of the euro have more than offset the negative effect of the change in terms of trade associated with the oil price rise (see Box "Projection assumptions").

The revision of the projections for 2017 largely reflects the lagged impact of the incorporation of information related to the National Quarterly Accounts for the fourth quarter of 2016. In effect, at the end of 2016, private consumption, GFCF and exports posted higher growth than that implied in the December issue of the *Economic Bulletin*. This is strengthened by the positive developments of investment and export indicators relating to early 2017, as well as by the maintenance of the high confidence level among economic agents, as regards consumers and most activity sectors of the economy.

The pattern of intra-annual growth during 2016 – characterised by an increase from the foregoing semester of 0.6 per cent in the first half of the year and 1.3 per cent in the second half of the year – has a positive effect on annual GDP growth in 2017.[3] In effect, in 2016, economic activity accelerated clearly from the first to the second half of the year (Chart 3). The acceleration in the course of the year reflected, among others: (i) the recovery in extra-EU exports, especially to Angola, (ii) the acceleration in intra-EU exports, in particular to Spain, (iii) the implementation of investment decisions, in a context of declining uncertainty about the developments of the Portuguese economy, and (iv) the dissipation of several temporary factors, especially associated with the construction sector.[4]

Turning to developments in the main components of demand, private consumption is expected to increase by 2.1 per cent in 2017, compared to 2.3 per cent in 2016. This combines a slight acceleration of consumption of non-durable goods and services with a deceleration of consumption of durable goods. Consumption of non-durable goods and services is expected to grow overall in line with real disposable income, against the backdrop of an increase in employment and moderate growth in real wages. In 2017 a positive

Chart 3 • Gross domestic product, constant prices | Per cent



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

influence is exercised by the 5.1 per cent increase in minimum wages and the maintenance of some measures to reinstate income set out in the State Budget. The deceleration in consumption of durable goods, in turn, occurs after very significant increases in recent years, partly associated with purchases that were postponed during the economic recession periods.

Projections for 2018 and 2019 point to a significant deceleration in private consumption to 1.4 per cent in both years. Private consumption is expected to grow in line with real disposable income, in a context of annual growth in employment of around 1 per cent and limited increases in real wages due to small productivity gains. The share of consumption of durable goods in GDP is projected to stabilise in these two years. Households' savings rate remains at historically low levels, and the deleveraging of households is expected to continue.

GFCF high growth stands out in these macroeconomic projections. After 5 per cent increase in 2016, business GFCF is expected to continue to grow at around 6 per cent over the projection horizon. Such growth is based on positive expectations for overall demand, as well as on continued favourable financing conditions. Developments in business GFCF also reflect the need for capital stock recovery and the increase in the capacity utilisation rate, which has been gradually approaching pre-crisis average values.

Current projections also incorporate information on investments in large infrastructures to take place in the 2017-19 period. Moreover, both private and public investments benefit from the normalisation of financing allocated through European funds, which is expected to occur after the initial transition stage to the current Portugal 2020 programme.

After the continued decline in the share of GFCF in housing in GDP since the early 2000s, this ratio is anticipated to stabilise somewhat at around 3 per cent over the projection horizon. Growth of GFCF in housing in the 2017-19 period is associated with the assumption of maintaining access to financing with low interest rates, and a gradual improvement in the labour market situation, although remaining limited by the high household indebtedness level.

In a context of robust growth of external demand for Portuguese goods and services, exports are expected to grow by around 5 per cent in annual average terms, i.e. above the increase projected for external demand (Chart 4). A market share gain of 1.9 per cent is projected for 2017, which will gradually decline over the projection horizon.[5]

Exports of both goods and services are expected to be buoyant. The performance of tourism exports stands out, favoured by important international events that will take place in Portugal. In 2017 exports of goods will also benefit from the unwinding of some negative temporary effects associated with the decline in production in industrial units in the energy and automotive sectors in 2016. In addition, in the case of the automotive sector, information was incorporated regarding an expected increase in production capacity of an industrial unit, which will boost the growth of those exports in 2017 and 2018.

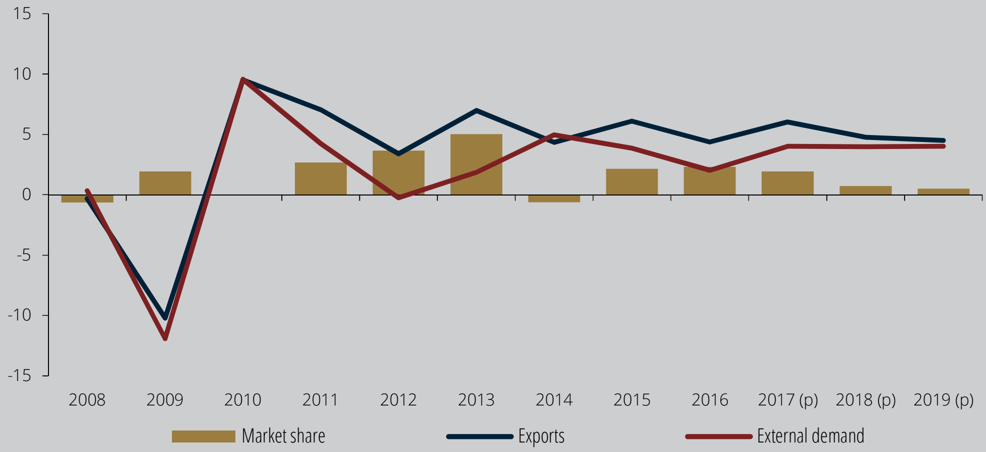
Developments in imports over the projection horizon are in line with overall demand weighed by import content, taking into account past average standards.

Overall, current projections point to a strengthening of the upward trend of internationalisation of the Portuguese economy, with an increase in openness – measured by the share of exports and imports in GDP, in nominal terms – from 72 per cent in 2008 to 79 per cent in 2016 and to 91 per cent in 2019. This trend in more marked in exports, with a share in GDP rising from 31 per cent in 2008 to 40 per cent in 2016 and to 46 per cent in 2019 (Chart 5). Developments in the openness of the Portuguese economy over the projection horizon are chiefly due to the strong growth of the volume of exports and imports, and are also associated with an increase in external trade deflators exceeding that of the GDP deflator.

The goods and services account surplus declines by 0.8 p.p. of GDP in 2017, reflecting in equal measure negative volume and terms of trade effects. The greater buoyancy of imports in volume, when compared to exports, reflects significant growth of expenditure items with high import content – especially investment – while the loss in terms of trade is associated with the oil price rise. The decline in surplus is slightly less sharp in the case of the current and capital account, in a context of maintenance of low interest rates and normalisation in the distribution of Community funds in the context of the ongoing European funding programme. A slight increase in the current and capital account surplus is forecast for 2018 and 2019.

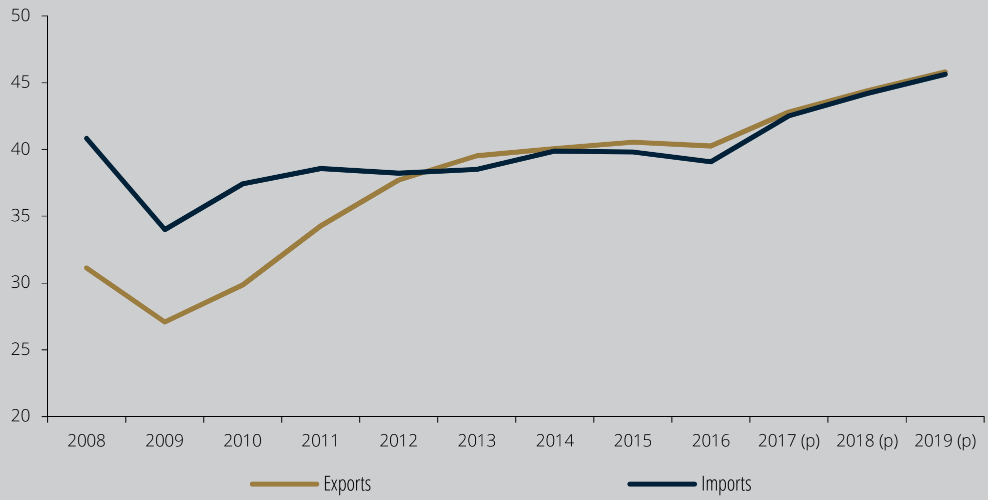
As regards the labour market, employment is expected to grow by 1.6 per cent in 2017 and approximately 1 per cent in 2018 and 2019. These developments reflect the gradual resuming of changes in employment more in line with its historical elasticity to activity, and implies a recovery in productivity, to a level that is lower than that observed in prior phases of recovery. In the 2017-19 period, however, average productivity

Chart 4 • Exports of goods and services and external demand | Annual rate of change, per cent



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

Chart 5 • Exports and imports | As a percentage of GDP



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

growth is projected to be low, which will be reflected in also low real wage growth. At the end of the projection horizon, the annual average level of employment will stand 8.5 per cent above the minimum registered in 2013, although remaining 5 per cent below the level observed in 2008.

Over the projection horizon, it is assumed a relative stabilisation of active population, after a period of continued reduction. This assumption reflects the current demographic and migratory trends, as well as the gradual increase in retirement age. This implies the maintenance of a downward profile for the unemployment rate, declining from around 11 per cent in 2016 to approximately 8 per cent in 2019. These levels compare with a peak of around 16 per cent in 2013.

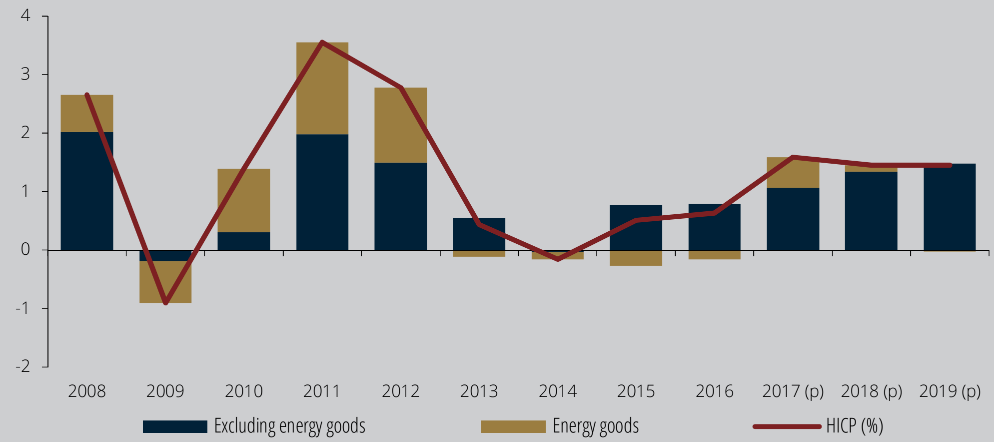
Inflation, measured by the rate of change of the Harmonised Index of Consumer Prices (HICP), will increase at the beginning of the projection horizon, from 0.6 per cent in 2016 to 1.6 per cent in 2017, and stabilise at 1.5 per cent in the 2018-19 period (Chart 6). The acceleration of prices in 2017 largely reflects an increase in energy prices – discontinuing the downward trend observed during the four previous years – in line with the technical assumptions for oil price developments. This acceleration is more marked than that published in the December issue of the *Economic Bulletin*, translating into an upward revision of 0.2 p.p. of the annual rate of change of the HICP in 2017. A relative stabilisation of energy prices is expected for 2018 and 2019, reflecting the assumption that the oil price will be maintained at around USD 56.

As regards the non-energy component, a gradual acceleration is expected over the projection horizon, in the framework of moderate growth of the Portuguese economy, reduction in the unemployment rate, increase in import prices and rising inflation expectations, both in Portugal and in the euro area. Moreover, these projections also include the effect of a rise in national minimum wage in 2017.

After two consecutive years of positive inflation differentials from the euro area average, largely influenced by differences in pass-through from the fall in international oil prices, and considering the most recent projections for the euro area published by the European Central Bank (ECB), a marginally negative inflation differential is expected from 2017 to 2019.

In short, current projections suggest continued recovery of economic activity in the 2017-19 period, with a growth pattern characterised by

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.

high buoyancy of exports and business investment, which will be accompanied by an increase in employment in the private sector and a continued decline in the unemployment rate. This profile is consistent with the maintenance of fundamental macroeconomic balances, namely the external surplus of the Portuguese economy. Nonetheless, the pace of economic growth projected is slower than that necessary to restart the real convergence process towards the euro area, which results from the persistency of important structural constraints to growth.[6] In this context, it is important to enhance the shift of resources to corporations more exposed to international competition and more productive, and to continue the process of reducing the high indebtedness level of different sectors, reducing the vulnerabilities of the Portuguese economy to shocks. The importance and urgency of progress in these fields are reinforced by the maintenance of high uncertainty and the persistence of downward risks, at both the internal and external level.

Box | Projection assumptions

The projections for the Portuguese economy here presented are based on a set of assumptions which are consistent with the ECB's projection exercise published on 9 March. The cut-off date for technical assumptions on oil prices, interest rates and exchange rates was 14 February (Table 2). The remaining information is based on data available up to 17 March.

With regard to the international environment, global economic activity and world trade are expected to accelerate slightly over the projection horizon, similarly to developments shown in the previous issue of the *Economic Bulletin*. Against this background, external demand for Portuguese goods and services (weighted by Portugal's export structure) is projected to remain robust over the projection horizon and was revised upwards for 2017, compared with the previous projection exercise. Growth in external demand is expected to be slightly higher than in world trade. This reflects higher growth in euro area demand than demand from extra-euro area markets, and its relatively high weight in Portuguese exports. Euro area economic activity was revised slightly upwards for 2017 and 2018, compared with the December projection exercise.

Following the completion of the December projection exercise, oil prices recorded an increase towards the end of 2016. Over the projection horizon, the price of Brent oil is expected to stand at around USD 56 per barrel, which corresponds to an increase of around USD 4 per barrel, on average, compared with the previous exercise. The upward revision in oil prices is slightly higher in euro.

In effect, the technical assumptions for the exercise imply a depreciation of the euro against the US dollar, in annual average terms, in 2017. The euro is expected to remain over the projection horizon at the level closest to parity recorded since the start of the 2000s. The euro effective exchange rate (against 19 trade partners) is expected to depreciate slightly in 2017, influenced by the depreciation of the euro against the US dollar and the marked appreciation of the euro against the pound sterling. The exchange rate expected for the euro, both against the US dollar and in effective terms, is lower than that published in the December 2016 issue of the *Economic Bulletin*.

Against the background of an accommodative monetary policy, interest rates are expected to remain very low, but to increase over the projection horizon. The level projected for this short-term interest rate remained virtually unchanged from that published in the December issue of the *Economic Bulletin*. The long-term interest rate on Portuguese public debt was revised slightly downwards in 2017 and 2018, compared with the assumptions released in December.

Turning to public finance variables, the projection incorporates the measures specified in sufficient detail in the State Budget for 2017, similarly to the December issue of the *Economic Bulletin* and in accordance with the rules applicable to the Eurosystem's projection exercises.

Public consumption is projected to decelerate in real terms in 2017 and to grow moderately in 2018 and 2019, resulting in cumulative growth of around 1 per cent in this three-year period. These developments are the result of a reduction in costs with public-private partnerships of the road sector, in line with information included in the State Budget for 2017, and the assumption that the number of public employees will stabilise. In 2016 and 2017, public consumption is negatively affected by the impact of a reduction in normal working hours of public employees from the second half of 2016 onwards. A positive change is expected in the public consumption deflator over the projection horizon. In 2017 these developments reflect the remaining effect from the gradual reversal of wage cuts for public employees.

Public investment is expected to recover in 2017 and to stabilise, as a ratio of GDP, over the remaining projection horizon.

Table 2 • Projection assumptions

		March 2017 projections				EB December 2016			
		2016	2017	2018	2019	2016	2017	2018	2019
International environment									
World GDP	yoy	2.9	3.3	3.5	3.6	2.9	3.3	3.4	3.5
World trade	yoy	1.7	3.5	3.9	3.9	1.5	3.2	3.9	4.0
External demand	yoy	2.0	4.0	4.0	4.0	2.0	3.4	4.0	4.1
Oil prices in dollars	aav	44.0	56.4	56.5	55.9	43.1	49.3	52.6	54.6
Oil prices in euros	aav	39.8	52.7	52.8	52.3	38.8	45.3	48.3	50.1
Monetary and financial conditions									
Short-term interest rate (3-month EURIBOR)	%	-0.3	-0.3	-0.2	0.0	-0.3	-0.3	-0.2	0.0
Implicit interest rate in public debt	%	3.3	3.3	3.3	3.3	3.4	3.4	3.4	3.3
Effective exchange rate index	yoy	2.6	-0.6	0.0	0.0	2.8	0.4	0.0	0.0
Euro-dollar exchange rate	aav	1.11	1.07	1.07	1.07	1.11	1.09	1.09	1.09

Sources: ECB, Bloomberg, Thomson Reuters and 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 three-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. Assumptions for the long-term interest rate on Portuguese public debt are based on an assumption for the implicit rate, which includes an assumption for the interest rate associated with new issuances.

Notes

1. See "ECB staff macroeconomic projections for the euro area", March 2017.

2. For a more thorough discussion of some of these constraints, see: Dias, Daniel, Marques, Carlos Robalo and Richmond, Christine (2014), "Resource allocation, productivity and growth in Portugal", *Economic Bulletin*, October, Banco de Portugal; Amador, João and Soares, Ana Cristina (2013), "Competition in the Portuguese economy: Estimated price-cost margins under imperfect labour markets", *Economic Bulletin*, Spring, Banco de Portugal; and the Special issue "Demographic transition and growth in the Portuguese economy", *Economic Bulletin*, October 2015.

3. The carry-over effect of GDP developments in 2016 on its growth in 2017 stands at around 1 p.p. The calculation of this effect implies that the quarterly GDP levels in 2017 will be the same as in the fourth quarter of 2016 (zero quarter-on-quarter rates of change in the course of 2017).

4. A more detailed analysis of economic developments in 2016 will be made available in the May issue of the *Economic Bulletin*, to be published on 3 May.

5. Market share developments are qualitatively similar, taking into account external demand adjusted for the impact of Angola. This adjustment is relevant given that imports from Angola are not explicitly considered in the indicator external demand for Portuguese goods and services calculated within the scope of the Eurosystem.

6. See endnote 2.