22. PORTUGAL

A modest recovery hampered by weak investment

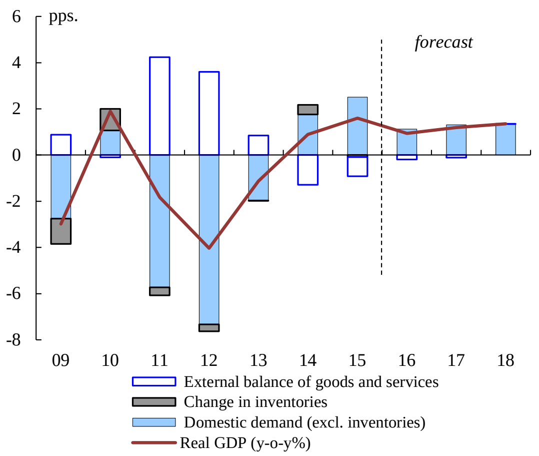
The economic recovery continues, albeit at a modest pace, driven by private consumption but held back by weak investment. Unemployment is set to continue to decline, reaching 9.5% by 2018. Inflation is projected to increase by the end of the forecast horizon to reach 1.4%.The general government headline deficit is expected to reach 2.7% of GDP in 2016 and to remain below 2.5% over the forecast horizon. The structural balance is forecast to broadly stabilise in 2016 and 2017 followed by a slight deterioration in 2018.

A gradual pick-up in growth dependent on a rebound in investment

Real GDP growth in Portugal remains weak though a gradual improvement is projected over the forecast horizon. Growth was stable at 0.9% (y-o-y) in the second quarter of 2016 and marginally accelerated to 0.3% on a quarterly basis. Despite a substantial reduction in investment, the contribution of domestic demand to economic growth remained positive, although it dropped from 1.6 pps. to 0.6 pps. in the second quarter. This drop was driven by a marked deceleration in the growth of durable goods consumption, mainly of motor vehicle components after an exceptional first quarter. The contribution of net external trade turned slightly positive, reflecting the more intense slowdown in imports.

The European Commission's Economic Sentiment Indicator (ESI) improved by the end of the third quarter. Nevertheless, private consumption growth is expected to be more modest in the coming quarters in line with more stable consumption of durable goods, the still high level of household debt and increased oil prices. Investment is projected to improve marginally by the end of this year, as slightly improved confidence indicators point to a less negative outcome for construction than in the first two quarters. Investment in machinery and equipment fared better than construction investment in the first half of 2016 and a positive trend is expected to continue over the remainder of 2016, particularly since employment is still improving and investment in transport equipment is growing. Weak public investment has played a role in depressing private investment, as EU funds absorption was low. Taking into account the delay in budget execution processes, a more positive outcome in public investment and some positive spillover to the private sector could be expected in the coming quarters. Coming from a low level in 2016, investment is set to gather pace in 2017, driven by the gradual pick up in investments co-financed by the EU under the new programming period for such funding. In 2018, investment growth is forecast to gain momentum with the additional support of strengthening external demand, particularly in emerging markets. However, bank credit is expected to pick up only gradually over the forecast horizon as the banking system remains burdened by the large stock of non-performing loans. Feeble external trade activity over the first half of the year mainly reflected the weak economic outlook in markets outside the EU and the contraction in exports of services. Short term indicators confirm that, despite some weakness in the export of goods, exports of services increased significantly, mainly due to exceptionally high tourism. Looking ahead, exports are forecast to grow in line with foreign demand, whereas imports are expected to outweigh exports, mainly due to increased investment. As a result, the contribution of net trade to GDP growth is forecast to remain slightly negative in 2016 and 2017 while it is set to turn neutral in 2018.

Graph II.22.1: **Portugal - Real GDP growth and contributions**



Overall, real GDP growth in Portugal is projected to moderate to 0.9% in 2016, before picking up slightly to 1.2% in 2016 and 1.4% in 2018. This will depend on a rebound in investment, which has so far remained fragile and sensitive to the materialisation of any negative shock. Thus, risks to the forecast are tilted to the downside.

Labour market outlook improves and inflation set to increase

HICP inflation increased to 0.6% in September 2016. It is expected to average 0.7% in 2016, mainly driven by higher indirect taxes, and then gradually rise to 1.4% in 2018 on the back of higher oil prices. Job creation remained robust in the first half of 2016 and the unemployment rate fell to 11.2%. Employment growth is expected to slow down over the forecast horizon while a moderate decrease in the labour force is expected to bring unemployment down to 11.1% in 2016 and around 10% in 2017 and 2018.

Public finances benefitting from the recovery

The general government deficit is forecast to reach 2.7% of GDP in 2016. Lower revenue collection is expected to be largely offset by the containment of expenditure, in particular due to the freezing of intermediate consumption. As a result, the structural balance is projected to remain broadly unchanged in 2016.

The headline deficit is projected to decrease to 2.2% of GDP in 2017, mainly due to a one-off operation (a guarantee to BPP bank worth ¼ pps. of GDP) and the continued moderate economic recovery. As the impact of discretionary measures is expected to be broadly neutral, the structural balance is projected to remain broadly unchanged. Under the no-policy change assumption, both the headline deficit and the structural balance are set to slightly deteriorate in 2018.

Risks to the fiscal outlook are tilted to the downside, linked to the uncertainties surrounding the macroeconomic outlook, the potential deficit impact of banking support measures and possible spending slippages.

After reaching 129.0% at the end of 2015, Portugal's gross public debt-to-GDP ratio is expected to rise to 130.3% in 2016, mainly due to a downward revision in projected proceeds from sales of financial assets, including Novo Banco, and higher issuance of government debt for the planned recapitalisation of the state-owned bank CGD. The ratio is forecast to decline to 129.5% in 2017 and to 127.8% in 2018, due to primary budget surpluses and continued economic growth.

Table II.22.1:

Main features of country forecast - PORTUGAL

	2015		Annual percentage change						
	bn EUR Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP	179.5	100.0	1.1	-1.1	0.9	1.6	**0.9**	**1.2**	**1.4**
Private Consumption	117.8	65.6	1.2	-1.2	2.3	2.6	**1.8**	**1.1**	**1.0**
Public Consumption	32.7	18.2	1.6	-2.0	-0.5	0.8	**0.6**	**0.4**	**0.5**
Gross fixed capital formation	27.4	15.3	-0.8	-5.1	2.3	4.5	**-1.4**	**3.7**	**4.1**
of which: equipment	8.9	5.0	0.1	8.1	13.3	9.7	**3.0**	**7.6**	**6.7**
Exports (goods and services)	72.8	40.6	4.3	7.0	4.3	6.1	**2.8**	**3.7**	**4.1**
Imports (goods and services)	71.5	39.8	3.0	4.7	7.8	8.2	**3.3**	**4.1**	**4.3**
GNI (GDP deflator)	175.3	97.6	1.0	0.0	0.5	0.9	**1.0**	**1.3**	**1.4**
Contribution to GDP growth: Domestic demand			1.0	-2.0	1.7	2.6	**1.1**	**1.4**	**1.4**
Inventories			0.0	0.0	0.4	-0.1	**0.0**	**0.0**	**0.0**
Net exports			0.1	0.9	-1.3	-0.8	**-0.2**	**-0.1**	**0.0**
Employment			0.0	-2.9	1.4	1.4	**1.0**	**0.7**	**0.5**
Unemployment rate (a)			8.6	16.4	14.1	12.6	**11.1**	**10.0**	**9.5**
Compensation of employees / head			3.0	3.6	-1.8	-0.3	**1.2**	**1.1**	**1.1**
Unit labour costs whole economy			1.8	1.8	-1.3	-0.5	**1.3**	**0.5**	**0.2**
Real unit labour cost			-0.6	-0.5	-2.0	-2.5	**-0.4**	**-1.1**	**-1.5**
Saving rate of households (b)			9.5	7.8	5.2	4.4	**4.5**	**4.3**	**4.1**
GDP deflator			2.5	2.3	0.8	2.1	**1.8**	**1.7**	**1.7**
Harmonised index of consumer prices			2.5	0.4	-0.2	0.5	**0.7**	**1.2**	**1.4**
Terms of trade goods			0.0	1.7	1.2	3.2	**2.5**	**1.3**	**1.0**
Trade balance (goods) (c)			-10.4	-4.0	-4.7	-4.3	**-3.6**	**-3.4**	**-3.3**
Current-account balance (c)			-8.8	0.7	-0.3	-0.3	**0.5**	**0.8**	**1.2**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-7.1	2.3	1.0	0.9	**1.6**	**2.0**	**2.3**
General government balance (c)			-5.3	-4.8	-7.2	-4.4	**-2.7**	**-2.2**	**-2.4**
Cyclically-adjusted budget balance (d)			-5.3	-2.7	-5.7	-3.6	**-2.3**	**-2.2**	**-2.7**
Structural budget balance (d)			-	-3.0	-1.9	-2.3	**-2.4**	**-2.4**	**-2.7**
General government gross debt (c)			70.8	129.0	130.6	129.0	**130.3**	**129.5**	**127.8**

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.