Executive Summary

Fiscal developments until the 2nd quarter of 2018

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EXECUTIVE SUMMARY

In the first six months of 2018 the General Government deficit was 1 865 M€, equal to 1.9% of the Gross National Product (GDP) generated over the period. Over half this amount (938 M€; that is 1% of GDP) was due to temporary and one-off measures that occurred above all in the 2nd quarter, in regard to the full impact of the Novo Banco recapitalisation, the extraordinary payments relating to court decisions involving Lisbon Council and the share of extraordinary expenditure relating to the 2017 forest fires. On top of this, there is the cost of compensating those who subscribed to debt issued by the Espírito Santo Group and sold at Banco Espírito Santo branches (the so-called BES victims), which brings the net negative impact on the balance in the 1st half of the year to 1 059 M€ (1.1% of GDP).

Net of the fiscal impact of the Caixa Geral de Depósitos (CGD) recapitalisation that took place in 2017, the budget deficit in the in the 1st half of this year (in nominal terms) was marginally smaller than in the same period last year resulting in a 0.1 p.p. decrease due to the growth in GDP. By sector, this decrease reflects the positive contributions of the central government and social security funds subsectors, which offset the less positive performance of the regional and local government subsector, where the budget surplus fell.

Compared to the figures in the budget programming documents, the preliminary estimate of the national statistical authorities for the half-year deficit is 1.2 p.p. of GDP above the target set in the 2018-2022 Stability Program (0.7% of GDP), a more stringent outcome than the commitment made in the State Budget for 2018 (1.1% of GDP). Bearing in mind the aforementioned effects will continue unchanged until the end of the year, this difference will shrink to 0.6 p.p. of GDP on an annual basis.

The primary surplus up to June stood at 1 525 M€, equal to 1.5% of the GDP generated in the six months. Despite the primary surplus, the rise in primary expenditure, which includes the factors referred to above, meant there was a decrease in year-on-year basis.

In the 1st half of the year total General Government revenue saw year-on-year growth of 2.9%, which is lower than the Ministry of Finance (MF) forecast for the year as a whole (4.2%). Almost all this increase can be explained by the growth in tax and social contributions revenue (3.3%). Growth in tax revenue (3.1%) flows solely from indirect taxes and is slightly higher than the annual goal set by the MF for the year as a whole (3%). Of special note is the performance of VAT revenue where a positive change of 4% was responsible for around 42% of the growth in revenue from indirect taxes. However, the level of revenue from indirect taxes recorded up to June was lower than the annual target set out in the 2018-2022 Stability Program (4.8%). On the other hand, social contributions were up by 3.7%, although they fell short of the growth forecast by the MF for the full year (4.2%). This performance was penalised by imputed social contributions, where the decrease (-3.5%) partially reflects the change in the way Christmas bonuses are paid within General Government, unlike actual social contributions which grew faster in the 2nd quarter to consolidate half-year growth at a level (5.7%) higher than forecast for the year as a whole (4.9%).

Non-tax and non-contributions revenue recorded year-on-year growth of 0.5% in the 1st half of the year. The increased revenue from carbon emission licences, obtained by the Environment Fund, explains part of sales' contribution to the positive change in non-tax and non-contributions revenue over the period. Sales performance was good enough to offset the decreases in both other current revenue (-0.1%, despite the increase in the dividends distributed by the Bank of Portugal), and capital revenue (-20.7%), where the change was due to the base effect associated with a share of the Banco Privado Português guarantee received in the same period in 2017.

As for expenditure, year-on-year growth went from 0.1% in the 1st quarter to 2.7% for the first two quarters of 2018 together. Most of this change was driven by the increase in the share capital of Novo Banco undertaken by the Resolution Fund in the 2nd quarter of 2018 by activating the contingent capital mechanism underlying the sale agreement and, to a lesser extent, the loan granted by the Treasury to the Credit Recovery Fund "FRC- INQ – ESI Commercial Paper and Rio Forte", following the enforcement of guarantees relating to a group of investors commonly known as the "BES victims".

The recording of these two transactions produced an overall impact of 913.4 M€ in capital transfers, which largely explains the increase in capital expenditure seen in the 1st half of the year (1 216 M€). Primary current expenditure rose by 82 M€ while interest payments fell by 216 M€, which reduced public expenditure growth in the first six months of the year (2.7%). By the middle of the year public expenditure growth was below the figure in SP/2018 (which is 4.1% for the full year) but it was influenced by the change in the Christmas bonus payment model that accounts for the decrease in compensation of employees and social transfers.

Spending on social transfers other than in kind fell by 65 M€ in the first six months of the year, although SP/2018 predicted an annual increase of 1 010 M€. This is a large deviation even when taking into account the change in the way the Christmas bonus is paid and the policy measures set out in SP/2018, which include the extraordinary increase in pensions from the 3rd quarter of 2018. Therefore, it is accepted that this expenditure could be less than forecast.

Intermediate consumption increased by just 30 M€ in year-on-year terms, a little over one fifth of the increase underlying SP/2018. For its part, the rate of growth in Gross Fixed Capital Formation in the 1st half of the year (6.3%) is well below that foreseen in SP/2018 for the full year (28.7%).

The public debt ratio fell to 124.9% of GDP in the 2nd quarter of 2018 (125.4% in the previous quarter). The nominal increase in debt in the quarter in question (0.3%) was less than annual nominal growth in GDP (0.7%), which explains the decrease in that ratio. Moving in the opposite direction, public debt net of central government deposits rose by 2 p.p. of GDP totalling 118.2% at the end of the 2nd quarter. That performance is explained by a decline in central government deposits (2.5 p.p. of GDP) larger than in total nominal debt, as the former were partially used to finance the repayment of the Treasury Bond that matured in June. Therefore the decrease in cash and bank deposits (-3 464 M€) was the factor that had the most influence on the stock-flow adjustment (-737 M€), whose favourable (negative) change explained a change in debt (754 M€) that was around half of the budget deficit recorded in the 2nd quarter (1 491 M€). The October notification under the Excessive Deficit Procedure (EDP) updated the estimate for the 2018 debt ratio, following the downward revision of that indicator in 2016 and 2017. This new MF estimate places the public debt ratio for 2018 at 121.2%, that is 1 p.p. below the revision made in April in the SP/2018 and 2.3 p.p. lower than the initial forecast in SB/2018. For that estimate to be achieved a decrease in the debt ratio of 3.7 p.p. of GDP (around 1 850 M€) will be required in the 2nd half of the year.

As for the outlook for the year and ignoring changes to the public finance management mechanisms, the CFP holds its estimate for the deficit of 0.5% of GDP indicated in September. This is because there are a number of factors that contribute to an improvement in the budget balance in the second half of the year compared to the first, such as stronger growth in actual social contributions and more favourable performance of indirect taxes vs. MF forecast and a lower increase in social transfers other than in kind than expected by the government. As regards debt, although the CFP estimate for the debt ratio was based on financial statistics published before the update conducted by the national statistics authorities (for 2016 and 2017) and the MF (for 2018) under the 2nd EDP notification, the CFP estimate for the decrease in the public debt ratio in 2018 (3.4 p.p. of GDP) is in line with the MF new estimate for the decrease in that ratio (3.5 p.p.).