Conselho das Finanças Públicas

# ECONOMIC AND FISCAL OUTLOOK 2023-2027 (UPDATE)

## EXECUTIVE SUMMARY

*September 2023*

Report NO.

08/2023

# EXECUTIVE SUMMARY

*Macroeconomic outlook*

This projection exercise is carried out at a time when there is a general slowdown in the growth of Portugal's main trading partners, not yet fully reflected in the underlying assumptions regarding external demand for this year based on forecasts by international organizations in June/July. The transmission of restrictive monetary policy decisions in Europe and the USA is subject to variable time lags depending on the characteristics of the economies, with significant differences in the fixed or variable regime of housing loans and refinancing of companies interest rates. Moreover, the economic impact of the ongoing war in Ukraine is felt more intensely in Europe than in the US, including a greater exposure to the still prevailing energy market volatility. Thus, in the short term, particularly for 2024, there is a risk that the external environment becomes worse than assumed. Conversely, an acceleration in RRP, PT2020 or PT2030 implementation stronger than the one assumed in the exercise could have a positive impact on GFCF.

Thus, based on the available information, the CFP projects a real gross domestic product (GDP) growth of 2.2% for 2023 and a slowdown to 1.6% in 2024, followed by a gradual recovery to 2.0% by the end of the projection's time horizon.

**CFP macroeconomic scenario** (change, %)

| | 2022 | 2023 | 2024 | 2025 | 2026 | 2027 |
|---|---|---|---|---|---|---|
| GDP | 6,7 | 2,2 | 1,6 | 1,8 | 1,9 | 2,0 |
| Private consumption | 5,8 | 1,5 | 1,2 | 1,5 | 1,8 | 2,0 |
| Public consumption | 1,7 | 1,2 | 1,1 | 1,1 | 1,0 | 1,0 |
| Investment (GFCF) | 3,1 | 0,6 | 3,7 | 4,7 | 3,9 | 2,9 |
| Exports | 16,6 | 5,4 | 2,5 | 2,9 | 2,8 | 2,7 |
| Imports | 11,1 | 2,8 | 2,9 | 3,4 | 3,2 | 2,8 |
| Domestic demand contribution (p.p.) | 4,7 | 1,1 | 1,8 | 2,0 | 2,1 | 2,1 |
| Net exports contribution (p.p.) | 2,0 | 1,1 | -0,2 | -0,2 | -0,2 | -0,1 |
| Unemployment rate (% labour force) | 6,0 | 6,4 | 6,3 | 6,2 | 6,1 | 6,0 |
| Employment | 2,0 | 1,2 | 0,3 | 0,1 | 0,0 | 0,0 |
| Net lending | -0,6 | 3,0 | 2,5 | 1,9 | 1,5 | 1,3 |
| Trade balance | -2,6 | 1,0 | 0,9 | 0,7 | 0,5 | 0,5 |
| GDP deflator | 4,4 | 7,1 | 2,7 | 2,2 | 2,1 | 2,0 |
| HCPI | 8,1 | 5,2 | 2,8 | 2,2 | 2,0 | 2,0 |

Sources: CFP projections (2023-2027) and Statistics Portugal (2022).

Given the scenario underlying the Economic and Budgetary Outlook (EPO) 2023-2027 Report of March 2023, the current growth projections for the Portuguese economy in 2023 are more favourable (+1.0 p.p.). This revision is mainly based on the robust performance observed in private consumption and exports during the first half of the year. In turn, the projection for 2024 constitutes a downward revision of the value presented in the previous year, based on the downward revisions in the pace of growth of exports and GFCF, as a result of the deterioration of the economic outlook for Portugal's main trading partners and the uncertainty and worsening of the financing costs of the economy, respectively.

For the labour market, the present scenario revises upwards the outlook for job creation in 2023 by 1.0 p.p., estimating a growth of 1.2%. The estimate for the unemployment rate remains unchanged at 6.4% of the working population. The following years are already conditioned by the unfavourable demographic outlook and the pace of job creation is expected to approach zero, while the unemployment rate is expected to gradually decrease to 6.0%.

Despite the persistence in 2023 of relevant inflationary pressures, the projection for the inflation rate, as measured by the pace of growth of the Harmonised Index of Consumer Prices (HICP), is revised downwards over the entire projection horizon. The most significant revisions concern 2023 (0.7 p.p. to 5.2%) and 2024 (-0.3 p.p. to 2.8%). This revision reflects the projected downward profile for the price of food and energy in international markets. Over the medium term, the pace of HICP growth is expected to decelerate gradually to 2.0%.

### *Fiscal outlook*

The fiscal projection assuming no policy changes presented here, although favourable, is subject to the downside risks evidenced in the macroeconomic projection. A stronger slowdown in the economy would automatically translate into less revenue than projected, more cyclical spending and, keeping the bulk of rigid spending , it would deteriorate the projected balance. In the current situation of monetary policy restriction, these effects, usually referred to as automatic stabilizers, are compounded by an increase in the interest burden on public debt. Contrary to the recent past, in which, despite a relatively high debt, Portugal benefited successively from clearly decreasing interest charges, which contributed significantly to the reduction of the budgetary imbalance, this will not be repeated in the projection horizon. In 2014, at the end of the adjustment programme period, the share of interest in GDP amounted to 4.9% of GDP, in 2019 it corresponded to 3% of GDP and in 2022 to 2% of GDP. In the projection horizon between 2023 and 2027, the interest charge is projected to increase 0.5 p.p. of GDP.

Thus, considering the likely evolution of budgetary variables, in a no policy change scenario, the update of the medium-term budgetary scenario points to a budget surplus of 0.9% of GDP already in 2023, more than two-thirds of which are explained by the favourable economic environment. This is an upward revision of the projected budget balance for this year by 1.4 p.p. of GDP, mainly explained by the contribution of tax and contributory revenue (1.2 p.p. of GDP).

Reflecting this evolution, in 2023 the primary balance, which excludes interest charges, will present a surplus position similar to that verified in the last two pre-pandemic years (around 3% of GDP). The stabilisation of this indicator over the projection horizon is important to sustain the path of budget surpluses until 2027, although its gradual reduction reflects the lower contribution of the economic situation (decrease in the cyclical component of the budget balance) and the greater weight of interest charges.

**CFP fiscal scenario** (in % of GDP)

| | 2022 | CFP Projection | | | | |
|---|---|---|---|---|---|---|
| | INE | 2023 | 2024 | 2025 | 2026 | 2027 |
| **Total Revenue** | 44.4 | 44.2 | 44.5 | 44.4 | 43.8 | 42.6 |
| Tax and contributions revenue | 38.2 | 37.9 | 38.1 | 37.9 | 37.7 | 37.4 |
| Tax Revenue | 25.9 | 25.6 | 25.8 | 25.7 | 25.6 | 25.4 |
| Social Contributions | 12.4 | 12.4 | 12.4 | 12.2 | 12.1 | 12,0 |
| Non tax and non contributions revenue | 6.1 | 6.3 | 6.3 | 6.5 | 6.1 | 5.2 |
| **Primary Expenditure** | 42.8 | 41.2 | 41.4 | 41.4 | 40.9 | 39.8 |
| Current primary expenditure | 38.8 | 37.3 | 37.3 | 37.1 | 36.8 | 36.4 |
| Capital expenditure | 4,0 | 3.9 | 4.1 | 4.3 | 4.2 | 3.4 |
| **Primary balance** | 1.6 | 3,0 | 3,0 | 2.9 | 2.8 | 2.8 |
| Interest | 2,0 | 2.1 | 2.3 | 2.3 | 2.4 | 2.5 |
| **Total Expenditure** | 44.8 | 43.3 | 43.7 | 43.8 | 43.4 | 42.2 |
| **Headline Budget balance** | -0.4 | 0.9 | 0.8 | 0.6 | 0.4 | 0.3 |
| Adjusted budget balance from one-offs | -0.3 | 1.1 | 0.8 | 0.6 | 0.4 | 0.3 |
| **Public debt** | 113.9 | 104.7 | 100.3 | 96.5 | 93.1 | 89.4 |

Sources: Statistics Portugal, 1st notification of March 2023 of the Excessive Deficit Procedure, CFP projections and calculations.

In the present projection, the debt ratio is expected to decrease by 24.6 p.p. over the next five years, reaching 89.4% of GDP in 2027. This trajectory will be determined by primary surpluses and a favourable dynamic effect. A sensitivity analysis increasing the costs of new financing by 50 basis points per year in this period points to an impact on the public debt ratio at the end of the projection's time horizon of 0.4 p.p. of GDP. This is a contained impact due to the relatively long maturity of the stock of public debt, which in July 2023 had an average residual maturity of 7.5 years.

### *Risks*

As in the latest reports, the current macroeconomic scenario of the CFP is guided by a framework of high uncertainty, with risks tilted to the upside on price developments and downside on economic activity. Thus, the entrenchment of underlying inflation in high values, the de-anchoring of medium-term inflation expectations and the eventual upsurge in the price of energy commodities could lead to a higher and more persistent inflation rate than currently projected by the CFP. Consequently, the maintenance or even intensification of the degree of monetary policy restraint could penalise both domestic economic activity and external demand.

Concerning the budgetary scenario, the main risk is associated with this high uncertainty regarding macroeconomic projections. If these turn out to be less favourable, this will lead, by effect of the automatic stabilizers, to an unfavourable deviation from the projected trajectory for the balance of the PAs. In addition to this, the following are less favourable risks than projected in the budgetary scenario: (i) the level of existing contingent liabilities, including, inter alia, ongoing legal proceedings; (ii) budgetary pressures regarding social benefits and public expenditure on health, in a context of structural ageing of the Portuguese population; (iii) impact of extreme weather events and the need for climate change mitigation and adaptation measures. In the opposite direction, that is, implying a more favourable trajectory compared to the anticipated, the following risks are identified: (i) a greater elasticity of tax and contributory revenue; (ii) a more moderate increase in social benefits and (iii) a lower execution of nationally funded public investment.

Since this is an exercise in the hypothesis of a no policy change scenario, which cannot under any circumstances be interpreted as if it were a forecast, there is the additional risk concerning the adoption of new economic policy measures or extending measures that have been announced as being delimited in time. If this were to happen, it would have implications for the evolution of budgetary variables and possibly for the macroeconomic scenario itself.