Executive Summary

Public Finances: Position and Constraints 2019-2023

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The CFP projections point to a gradual slowdown in Portugal´s economic growth over the projection horizon (2019-2023). The decrease in the rate of real GDP growth already recorded in 2018 should continue**, with an annual rate of change of 1.6% for 2019,** while the rate of growth of the Portuguese economy can be expected to stabilise at around 1.5% in the medium-term. With the exception of the Ministry of Finance (MF), whose latest macroeconomic scenario suggests a real output increase from 2.1% in 2018 to 2.2% in 2019, all international institutions foresee real GDP growth remaining broadly constant or even falling in the same period.

In 2018, the Portuguese economy recorded a slowdown: real GDP growth rate dropped to 2.1% (0.7 p.p. less than in the previous year), thus halting the upward trend witnessed between 2014 and 2017. This change was brought about by both internal and external factors. Analysis of the intra-annual real GDP dynamics in 2018 reveal a downward profile, as year-on-year real GDP growth fell from 2.3% in the 1st half of the year to 1.9% in the 2nd half, in line with the trend that began in the second half of 2017. **Net external demand's performance was the deciding factor**, as there was a substantial decline in the contribution of this component to the year-on-year change in real GDP over the course of 2018 (-0.4 p.p. in the 1st half and -1.0 p.p. in the 2nd half).

Based on data published by the International Monetary Fund (IMF) in the *World Economic Outlook* (WEO) of October 2018, **the CFP projects that the rate of growth in external demand for Portuguese goods and services will steadily decrease over the projection horizon,** reaching 2.8% in 2023. Moreover, the latest IMF and Organization for Economic Co-operation and Development (OECD) forecasts point to a slowdown in the global economy, as well as to geopolitical risks stemming from international trade tensions. For the Euro Area, the latest Eurosystem forecast points to a sharp slowdown in growth – from 1.9% in 2018 to 1.1% in 2019 – while the OECD foresees it to be at 1% in 2019. This slowdown will be a decisive factor influencing the expected performance of the Portuguese economy over the medium-term.

In the labour market, the positive developments recorded in the key indicators since 2014 continued their positive developments in 2018, as there was a considerable decrease in the unemployment rate and a significant increase in employment, although at successively slower rates. According to the current projections, **labour market indicators are expected to continue to recover over the entire projection horizon**. In 2019, the unemployment rate is projected to reach 6.1% (down 0.9 p.p. from the 2018 level), and this downward trend is expected to continue in the coming years at a successively lower rate, until it stabilises at around 5.6% of the working population from 2021 onwards.

According to the agreed methodology of the European Union **potential output should increase by 0.1 p.p. per year starting in the first year of the projection horizon, following a growth rate of 1.7% in 2018, potential growth should increase to 1.9% in 2020, before gradually dropping to 1.6% in the medium-term**. The increase in potential growth projected up to 2020 reflects the increase in the positive contribution of total factor productivity and the increase in the capital input, which jointly more than offset the decline in the contribution of labour input. From 2021 onwards, the slowdown in potential growth is determined by the stabilization of the contribution of both total factor productivity and capital input, combined with the gradual decrease in the contribution of labour input.

Consequently, it appears that the Portuguese economy's expansion phase has come to an end and the downward phase of the cycle has begun within an international setting marked by greater downside risks which can have important repercussions, at a time when the economy still has several internal weaknesses and a limited fiscal space. The worsening of the outlook for the global economy and in particular for the Euro Area, in both the short and medium-term, sets a less favourable framework for the Portuguese economy, particularly with regards to risks for exports and investment, both of which are key to a solid and sustained economic growth in the medium and long-term. Therefore, on the external level, attention must be drawn to the following factors: the increase in trade protectionism, the United Kingdom's no-deal withdrawal from the EU, and the high levels of both public and private global indebtedness.

Recently, the re-establishing of consumer confidence and bank liquidity has led to an **increase in credit granted to households**, in particular home loans. Since private sector and general government indebtedness are still high, this risk carries extra importance given the greater vulnerability high debt stocks are subjected to when faced with potential increases in sovereign interest rates.

In the absence of new policy measures, the General Government budget deficit will stand at 0.3% of GDP in 2019, 0.1 p.p. bellow the MF forecast. The CFP estimate points to a budget deficit of 0.5% of GDP in 2018, while public debt amounted to 121.5% of GDP, according to the Bank of Portugal's preliminary estimate. Compared to the CFP´s estimate released in September 2018, it now points to a similar budget deficit but to a lower public debt ratio (down 0.7 p.p. compared to the 122.2% of GDP previously estimated).

In the coming years, the CFP projection points to a steadily improvement of the budget balance path up to 2021, achieving a surplus in that year (0.4% of GDP), greatly anchored in the revenue component of the budget (in particularly, the return of the prepaid margin from the European Financial Stability Facility (EFSF) in 2021, which represents 0.4% of the projected GDP for that year). **In the years that follow (2022-2023), the outlook for the budget balance is one of a deterioration**, and the projection is for a budget deficit of around 0.1% of GDP, the same as that for 2020. Excluding the effect of temporary and one-off measures, there will be no improvement in the balance over the projection horizon and it is expected to stabilise at a value of deficit equal to 0.1% of GDP. **This projection exercise assumes, nonetheless, that primary balances record surpluses over the forecast horizon**, although it foresees a less favourable path than the ones released in September 2018.

The CFP medium-term projection, from 2019 to 2023, points to a decline in total General Government expenditure's weight in GDP of 1.5 p.p., which is mainly explained by the expected decrease in current primary expenditure (revised downwards by 1.3 p.p. of GDP) and the reduced spending in interest payments (revised downwards by 0.3 p.p. of GDP). Over the same period, capital expenditure is expected to move in the opposite direction and it is expected an increase of 0.2 p.p. of GDP, which is associated with a greater use of Community funds.

The decrease in expenditure is due to the downward trend in current primary expenditure, which is mainly explained by the fall in the weight of compensation of employees (down 0.8 p.p. of GDP), social transfers (down 0.4 p.p. of GDP) and intermediate consumption (down 0.1 p.p. of GDP). The CFP has assumed the average number of General Government employees will remain constant from 2020 onwards, as forecasted in the most recent Stability Program and State Budget, despite that number having grown regularly between 2016 and 2018. Spending on social transfers in cash fall 0.3 p.p. of GDP when updated in line with the CPI, which grows at a slower rate than nominal GDP. Intermediate consumption should remain relatively stable in percent of GDP, reflecting the decline in the cost of Public-Private Partnerships, recorded since 2017.

Capital expenditure is expected to grow, as public investment recovers, through measures encouraging full use of European structural funds, the rebuild of part of General Government´s capital stock and the greater public investment in physical infrastructure, making it the only expenditure component that sees positive change.

The decrease in spending on interest is brought about by the projected public debt stock developments, by the prospects for interest rates (which are based on ongoing favourable market conditions that will bring about some additional savings) and by growth in nominal GDP. Under the assumptions made, the interest payments´ weight in GDP should record a drop of 0.3 p.p., to reach 3% of GDP at the end of the period under review.

Total General Government revenue is likely to decrease of 1.2 p.p. of GDP over the five-year period, reflecting decreases in both current revenue (-1.2 p.p. of GDP) and capital revenue (-0.1 p.p. of GDP). The 0.3 p.p. of GDP decrease in tax revenue reflects the contribution from indirect taxes, which should see its weight in GDP fall by 0.1 p.p. (slightly larger than the -0.1-p.p. contribution from direct taxes).

The CFP projects the public debt-to-GDP ratio to follow a downward path, going from 121.5% of GDP at the end of 2018 to 104.1% of GDP by 2023 (Chart 20). From the end of 2018 to 2023, the debt ratio is expected to fall by 17.5 p.p. of GDP, which compares against the 7.5 p.p. decrease observed in the last five years.

The projection points to a budget deficit below the 3% of GDP limit therefore preserves the fiscal safety margin. **However, this projection postpones the compliance with the MTO compared to the September 2018 exercise**, which continues to remain outside of the projection horizon. The rate of adjustment remains insufficient to achieve the annual minimum structural adjustment laid down in the Budgetary Framework Law and required under the Stability and Growth Pact (0.6 p.p. of GDP per year).

The CFP projection points to a public debt path that complies with the excessive debt correction rule over the 2019-2023 period.

Risks relating to the budget scenario presented stem from essentially four factors: (i) a stronger deterioration expected for the world economy, negatively impacting Portugal's economic growth and, consequently, having detrimental consequences for both public revenues and expenditures; (ii) the impact of the new support for the domestic financial sector; (iii) the materialization of budget pressures on the more rigid components of public expenditure (namely social transfers and compensation of employees); and (iv) the ability to keep control over the growth in intermediate public consumption expenditure.