Appendix E.
Portugal: bogged down in recession

In the second quarter of 2012, Portugal experienced its third consecutive quarterly decline in GDP. Since the start of 2008, the country's GDP has fallen 6.4%, battered by the effects of the 2008 crisis coupled with the fiscal tightening imposed on the country beginning in mid-2010. Employment has fallen by 9% over the same period, with the unemployment rate standing at 15.5% of the active population during the second quarter of 2012. Exports alone are driving growth. But Portuguese exports have not been sufficient to counteract the recessionary impact of an extremely negative fiscal impulse (-3.5% and -2.9% of GDP in 2012 and 2013 respectively), and the recession is expected to persist until at least the start of 2013. GDP will fall by 2.8% in 2012 and by another 2.2% in 2013 (see Table E). Portugal will not be able to report a budget deficit of less than 3% of GDP anytime before 2014. The European Commission confirmed in early September 2012 that the 2013 deficit target of 3% was not feasible given current economic conditions, and gave the country an additional year to meet its target.

The decline in GDP encompasses every aspect of domestic demand. Private consumption has dropped 9.2% in four years. Employment has been falling since 2009. Moreover, nominal wage growth per worker was gradually slowing before finally turning negative in 2011 (-0.9%). Accordingly, real per capita wages fell by 4.4% in 2011. The extremely sharp increase in the unemployment rate (from 8.4% to 15.5% in four years) has decisively weakened workers' bargaining power , particularly given that public-sector wages have been cut by an average of 5%. At the same time, household debt levels have stabilised at about 140% of disposable income. For businesses, the dislocation has been even more acute: investment has fallen 35% since 2008, affecting construction and the rest of the productive sector in equal proportions. The rate of investment is down 7 points over the period.

Given the fall-off in domestic demand (with a contribution to GDP of -6.7 points in 2011), the significant positive impact of foreign trade (up 5.1 points) has helped to mitigate the downturn in GDP. This improvement is attributable to both the fall in imports and the buoyancy of exports. There has been only moderate improvement in price competitiveness, but Portuguese companies have gained market share since the start of 2011. Accordingly, the deficit in the balance of goods and services has fallen by 10 percentage points, from 10% of GDP in 2008 to 0.2% as of mid-2012.

Meanwhile, the country's total debt mounted significantly between 2009 and 2011: whereas private debt fell by 6 points, to 181% of GDP, public debt grew by more than 24 points (of which 11.8 points is attributable to capital transactions) to 107.8% of GDP.

Contrary to what the “positive” budget results of 2011 might suggest (with a deficit equivalent to 4.2% of GDP, compared to 9.8% of GDP in 2010), the situation remains extremely difficult. This deficit reduction was only achieved at the price of one-off measures amounting to 3.5% of GDP[5], notwithstanding a very negative fiscal impulse (-3.4 points).

In spite of substantial fiscal tightening[6], results for the first seven months of 2012 have been disappointing, with a deficit equivalent to 6.3% of GDP. Spending was down more than projected (by 0.5 point), but unexpectedly low tax revenue and social security contributions (2.1%) have ruled out meeting the public deficit target of 4.5% of GDP in 2012[7].

In early September 2012, during its fifth review mission since the adoption of the aid package in May 2011, the troika (the European Commission, the ECB and the IMF) acknowledged that the deficit forecasts were untenable given the economic climate. The deficit target has been revised not only for 2012 (from 4.5% to 5% of GDP[8]) but for 2013 as well (from 3% to 4.5%). In the Commission's view, Portugal will not fall back below the 3% threshold until 2014 (with a target of 2.5%), and the public debt-to-GDP ratio (expected to peak at 124%) will not see a turnaround until 2015. In addition, disbursement of 4.3 billion euros in aid has been agreed for October[9], with the next review mission scheduled for November.

To reduce the deficit in 2013, the government is once again relying on reductions in public-sector employment and in investment (0.5% of GDP) and cuts in spending on healthcare (lower reimbursement for medicines in particular) and social services (1% of GDP). With regard to revenue, the government plans to raise income tax, *via* an exceptional general tax of 4% and 2.5% on the top income bracket, and revise the tax schedule to reduce the number of brackets from eight to five. Higher taxes on capital and assets will be imposed, along with a tax on financial transactions. In all, these measures will provide the government with additional revenue equivalent to 1.3% of GDP.

Despite the mixed fiscal results in recent months, Portugal still hopes to make a gradual return to the financial markets. Although the long-term maturities remain guaranteed by the EU institutions and the IMF at a rate of 3.5%, Portugal's Debt Management Agency has been extending the maturity of its short-term debt issues since the start of 2012 (to 18 months as of last April). The most recent issues carry

5. This involved the transfer of pension funds held by banks to social security. In return, the government must now assume responsibility for the pensions paid out to the fund beneficiaries.
6. This was applied to both spending (job losses and reduced public investment, cuts in social services) and revenue (an increase in the number of goods subject to standard VAT; taxes on energy, tobacco, alcohol and automobiles; taxation of capital income and reductions in various tax exemptions).
7. The government will, however, be able to count on one-off measures equivalent to 1% of GDP, including the concession for operating Portugal's airports (ANA), accounting for 0.7%.
8. Even though the 2012 target has been revised, new austerity measures will be needed in order to reach it. We have assumed that, despite these measures, the deficit will climb to 5.5% of GDP, *i.e.* 0.5 point higher than the European Commission's forecast.
9. Of the projected 78 billion euros in the aid package, 61.4 billion—about 80% of the total—has already been paid.

lower rates than in the past, a sign of renewed investor confidence: the six-month issues in September 2012 had a yield of 1.7% (compared to 2.3% in July), while the yield for 18-month issues was 3% (compared to 4.5% in April)[10]. These rates remain high, as do those on the secondary market: 10-year bond rates stood at about 8.9% at the end of September (a drop of nearly 6 points from January 2012 levels), compared to 5.1% in Ireland and 6% in Spain. However, Portugal has successfully swapped its debt maturing in September 2013 for debt maturing in October 2015, in order to limit the amount of issues needed in late 2013 for the country's projected return to the markets.

Given the climate of fiscal tightening, GDP will fall in both 2012 and 2013 (by 2.8% and 1.2% respectively). The decline in investment and consumption is likely to continue. Portugal cannot really count on support from exports. The negative impact of widespread belt-tightening in the major developed countries will amount to 1.9% of GDP in 2012 and 1.7% in 2013. Demand for Portuguese goods and services will grow by an average 0.1% per quarter in the second half of 2012 and by 0.4% per quarter in 2013. Exports will rise at a somewhat faster pace, with Portuguese firms continuing to gain export market share between now and end 2013. Imports are likely to show a downturn as a result of the country's economic recession, while foreign trade will have a positive impact on growth, but to a lesser degree than in the past.

Table E. OFCE, ECLM, IMK macroeconomic forecasts

Portugal

%	2010	2011	2012	2013
GDP	1.4	-1.7	-2.8	-2.2
Private consumption	2.1	-4.0	-5.6	-2.4
Investment	-4.1	-11.3	-15.2	-12.1
Public consumption	0.9	-3.8	-2.3	-1.3
Exports	8.8	7.5	4.3	1.6
Imports	5.4	-5.3	-6.6	-2.5
Contribution to growth				
Internal demand	0.7	-5.8	-7.0	-3.8
External trade	0.6	5.1	4.6	1.7
Inventories	0.1	-0.9	-0.4	-0.1
Unemployment rate	12.1	12.9	15.4	16.0
Inflation	1.4	3.6	2.9	1.4
Public deficit % GDP	-9.8	-4.2	-5.5	-5.0
Fiscal impulse % GDP	-0.6	-3.4	-3.5	-2.9
Public debt % GDP	93.3	107.2	119.1	128.0
Current account % GDP	—	—	—	—
Unit labour costs	—	—	-0.9	-1.0

Source: National accounts, Eurostat, OFCE, ECLM, IMK.

10. By way of comparison, France and Germany recently issued six-month securities at negative rates (-0.01% and -0.02% respectively) and 12-month securities at rates close to zero (0.02% and -0.02%). Germany is issuing two-year securities at a rate of 0.06%.