Quarterly: The Portuguese Economy—Respite unlikely to last

GDP stagnated in the second quarter, probably due to a pause in fiscal tightening. The new fiscal measures announced and the global slowdown will likely throw the economy in recession again in the third quarter.

GDP stagnated in the second quarter

Portuguese GDP was flat qoq and –0.9% yoy in the second quarter of 2011. These data were surprisingly benign but may result from the lack of fiscal tightening in the period between the resignation of PM Sócrates and the formation of the new government led by Passos Coelho.

GDP and demand components, %qoq

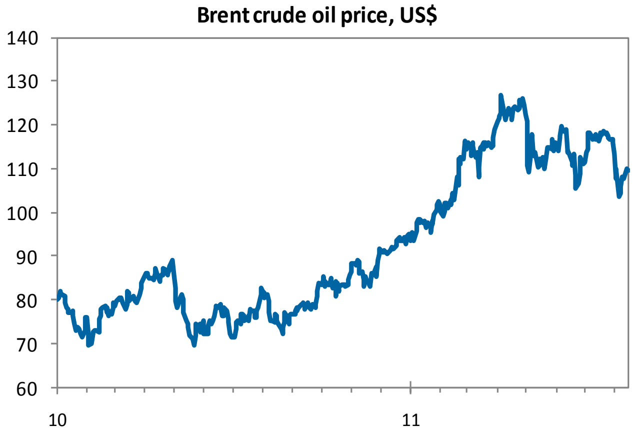
	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2
GDP	0.4	0.3	-0.5	-0.6	0.0
Private consumption	0.5	0.4	-0.2	-2.9	-0.7
Public Consumption	3.1	-5.1	4.0	-5.0	1.8
GFCF	-2.6	-0.3	-3.1	-1.2	-6.0
Exports	3.9	5.0	-0.9	0.2	4.0
Imports	4.5	0.8	1.8	-7.6	-0.2

On the domestic demand side, private consumption fell only 0.7%qoq, compared with –2.9% in the first quarter while public consumption actually rose 1.8% after a 5% fall in the first quarter. GFCF (Gross Fixed Capital Formation) was down for the 5th consecutive quarter, declining by 6% after –1.2% in the first quarter. On the external front, exports were a positive surprise, rising 4.0%qoq, probably reflecting firms' efforts to compensate for declining domestic demand. Imports fell slightly by 0.2% after collapsing 7.6% in the first quarter.

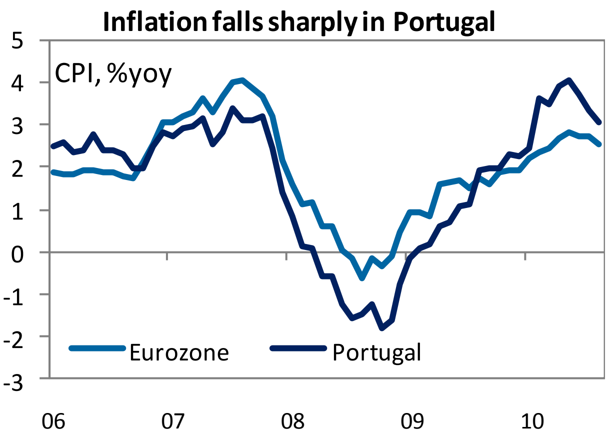
The prospects for the third quarter are dire. According to the European Commission survey, consumer confidence fell to -50.2 in July, slightly above its record low of -53.5 in April but about 28 points below its long-term average of -21.8. In the Eurozone this indicator fell to -11 in July but remains in line with its historical average. Industrial confidence rose to -11 in July after -14 in June. The indicator is about five points below its historical average. In the Eurozone, the indicator fell from fourth to first in June in July, mainly due to declines in Germany and France. This cooling of the European economy will affect Portugal significantly, which, in the context of shrinking the fiscal and monetary policy depends crucially on exports to avoid a prolonged recession.

Inflation high but falling

According to Eurostat, Portugal recorded an inflation rate of 3.0% in July, 0.5 percentage points



Fonte: BP



Fonte: Eurostat

above the Eurozone average, but lower than the 3.3% recorded in April. The inflation differential with the Eurozone is mainly due to successive increases in the VAT rate in the past twelve months while the negative trend since May reflects the impact of the downturn in consumer prices and the decline in oil prices after the peak reached in April. Brent crude fell from 1.26$/bl to 105$/bl in late August.

In the next few months inflation is likely to fall. First, the expected fall in domestic demand will have a disinflationary effect throughout 2011 and 2012. Second, the global slowdown is likely to affect oil prices. Finally, fiscal policy will have a crucial role to play. If VAT rates remain unchanged, then January 2012 will see a drop in inflation as the effects of the VAT top rate rise from 21% to 23% fall off the yoy rate. If, however, the government decides to raise the VAT rate to finance the reduction in employers' social security contributions, Portuguese inflation will jump up again, though only temporarily.

Labour market set to deteriorate further

The unemployment rate fell from 12.4% in the first quarter to 12.2% in the second quarter, though it remains 0.1 percentage point higher than in the second quarter of 2010. In the next months, the unemployment is likely to rise further due to the introduction of measures to facilitate the dismissal and to the expected downturn in the second half of the year.

Expectations for the Portuguese Economy

The expectations for the Portuguese economy remain extremely unfavourable. First, **fiscal policy** is likely to tighten considerably. On the top of the measures introduced by the previous government, the finance minister has already announced a special one-off tax on the employees' year-end one month's salary worth bonus and other measures, to ensure that the deficit target of 5.9% of GDP will be met. Recent estimates suggest that in absence of these extra measures the deficit target would be missed by 1.5% of GDP, due to two failing companies in Madeira and a softer than expected decline in the number of employees in the first semester. This one-off tax, which will only apply in 2011 will be equivalent to 50% of the bonus over and above the minimum wage. In 2012, the Government plans to further reduce the deficit to 4.5% of GDP.

Second, **monetary policy** will remain very constrained. Though expectations are the ECB will keep rates unchanged in the next few months, banks' recapitalization requirements negotiated between the previous government and the European Commission, the ECB and the IMF will further undermine lending to households and firms.

Third, the **slowdown** that starts being felt around the world is likely to have a significant impact on the economy, as it diminishes hopes that the crisis may be somewhat softened by external trade.

Inês Domingos

Table: Forecasts for the Portuguese Economy

	Bank of Portugal (July 11)			European Commission (May 11)		
	2010	2011	2012	2010	2011	2012
Real GDP	1.3	-2.0	-1.8	1.3	-2.2	-1.8
Private consumption	2.3	-3.8	-2.9	2.2	-4.4	-3.8
Government consumption	1.2	-6.3	-4.4	1.8	-6.1	-4.6
Gross fixed capital formation	-4.9	-10.8	-10.0	-5.0	-9.9	-7.4
Exports	8.8	7.7	6.6	8.8	6.2	5.9
Imports	5.1	-4.0	-1.2	5.2	-5.3	-2.8
Unemployment rate	na	na	na	11.0	12.3	13.0
Inflation	1.4	3.4	2.2	1.4	3.4	2.0