Portugal

The European Commission shows some flexibility

■ **Portugal's budget proposal, presented in mid-October, considers that it responds to the EC's demands, by aiming to reduce the budget deficit to 2.4% of GDP this year. Moreover the government is forecasting to reduce it to 1.6% of GDP in 2017.**

■ **Yet the draft budget's growth assumptions are more favourable than those of the European Commission. The Commission is also less optimistic than the government concerning the expected impact of certain measures on the budget balance.**

■ **While pointing out the risk that Portugal might fail to meet its commitments in 2017, the Commission nonetheless approved its budget proposal.**

Last July, the European Commission opted not to sanction Portugal for failing to sufficiently reduce its deficit in 2015, on condition that the country fulfils its deficit reduction targets this year. In the budget proposal presented to the European Commission in mid-October, Portugal considers that it responds to the EC's demands. Indeed, the draft budget calls for a budget deficit of 2.4% of GDP in 2016 (down from 4.4% of GDP in 2015). Moreover the government is forecasting to reduce it to 1.6% of GDP in 2017.

Overly optimistic growth assumptions

Even so, the European Commission issued a few reserves. Indeed, the government's budget outlook must be treated with caution as it is based on more optimistic growth assumptions than those of the European Commission. The Portuguese government is forecasting GDP growth of 1.2% in 2016 and 1.5% in 2017, compared to the Commission's estimates of 0.9% and 1.2%, respectively (see table and chart 1).

The Portuguese economy should benefit from a slightly stronger global economy and a bigger increase in exports next year. The European Commission and the government both expect investment to accelerate despite troubles in the banking sector.

Yet the assumptions from the government and the European Commission differ concerning the size of this increase. The European Commission foresees a bigger increase in investment expenditure. It expects the use of European Structural and Investment funds (ESI) to carry over to the rest of the economy. For the Commission, however, this growth will be accompanied by a bigger increase in imports, which means that foreign trade would make a negative contribution to growth.

The European Commission also expects private consumption's contribution to growth to be smaller than the government's forecast. Both expect private consumption to grow at a slower pace in the months ahead due to the upturn in inflation, but the European Commission is more cautious than the government when it comes to wage trends. Also, according to the EC, the especially high level of

The recovery is still mild

Contribution to annual growth (points of GDP)

Change in inventory | Net exports | Domestic demand excluding inventory | — GDP

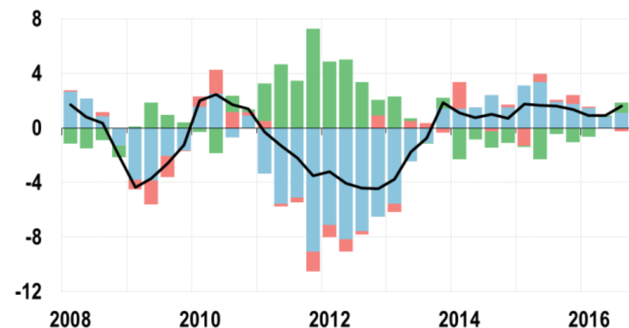

Chart 1 Source: INE

Budget forecast

	2015	2016		2017	
		Draft Budgetary Plan	European Commission	Draft Budgetary Plan	European Commission
GDP (y/y, %)	1.6	1.2	0.9	1.5	1.2
% of GDP					
Primary balance	0.2	1.9	1.7	2.8	2.2
Structural balance	-2.3	-2.2	-2.4	-1.9	-2.4
General government balance	-4.4	-2.4	-2.7	-1.6	-2.2
Gross debt ratio	129	129.7	130.3	128.3	129.5

Source: European Commission

household debt (75.7% of GDP in Q2 2016) should place a bigger strain on consumer spending.

Insufficient fiscal efforts

For the European Commission, this growth differential results in fewer revenues and more spending. The European Commission is also less optimistic than the government concerning the expected impact of certain measures on the budget balance.

In its budget proposal, the government calls for discretionary revenues to increase by 0.3% of GDP in 2017. Next year, the government intends to levy a 0.3% real-estate tax on "luxury" residences valued at more than EUR600,000, and to introduce a soda tax. Transferring the gasoline tax to diesel is also expected to bring in additional revenues. The government will also benefit from one-off revenues, including the recovery of the Banco Privado

Português (BPP) bank guarantee (0.2% of GDP) and higher dividend payments by the Banco de Portugal (0.2% of GDP).

According to the government, these additional revenues should offset the reduction in the VAT rate on food services (from 23% previously to 13% since July 2016), as well as certain spending increases, notably for public sector wages, since Q2 2016. The government also plans to increase state pensions for low-income households, to index pensions and new social welfare benefits for persons with disabilities, and to return to a 35-hour workweek in the healthcare sector.

The Commission is taking a more cautious approach. The replacement of only one public sector worker for every two would have a smaller impact on spending than the government expects.

The European Commission and the government have also made different forecasts for the deficit as well. Let us first look at the structural deficit[1], which reached 2.3% of GDP in 2015. The European Commission expects the structural deficit to widen by 0.1 points this year before levelling off in 2017, unlike the government, which is looking for reductions of 0.1 points and 0.3 points of GDP, respectively, in 2016 and 2017. All in all, the Commission expects Portugal's budget deficit to come to 2.7% of GDP in 2016 and 2.2% in 2017, compared to the budget proposal's figures of 2.4% and 1.6%, respectively.

The same can be said about the outlook for the public debt. According to the European Commission, primary surpluses and one-off revenues on the disposal of certain financial assets will be smaller than the government's forecasts. From 129% of GDP in 2015, it expects the public debt ratio to peak at 130.3% in 2016 before levelling off at 129.5% in 2017 (see chart 2).

Portugal is spared the suspension of structural funds

Portugal did not meet the European Commission's demands, notably in terms of reducing the structural deficit. This one would like Portugal to reduce its structural deficit by 0.6 points of GDP a year between 2016 and 2020, and to generate a medium-term structural surplus of at least 0.3% of GDP. The budget deficit, which is to be reduced primarily via ongoing growth, is unlikely to fall below the Commission's target of 2.5% of GDP which it set this summer. The Commission also pointed out the risks for public finances of the uncertainty surrounding the recapitalisation of the public bank Caixa Geral Depositos (CGD)[2]. Portugal is still vulnerable to any new shocks, especially those arising from its banking system, which remains fragile given the high stock of non-performing loans.

Despite these reservations, the European Commission nonetheless approved Portugal's draft budget proposal. It took into account the efforts Portugal has made in recent years and its capacity to reduce the budget deficit below the Stability and Growth Pact's threshold of 3% of GDP this year. The Commission mainly wants to avoid weakening a country that has already undertaken major fiscal adjustment efforts.

Portugal is weakened by a heavy debt burden

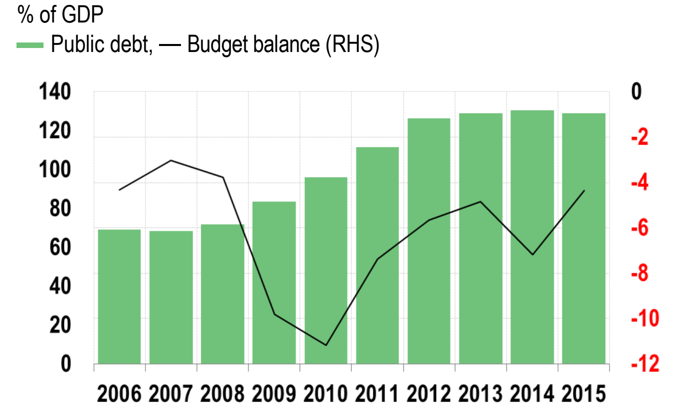

Chart 2 Source: Ameco

This decision bolsters the minority government that has been in power for almost a year. Prime Minister Antonio Costa's Socialist government must work with political parties openly hostile to further austerity measures, namely the Portuguese Communist Party (PCP), the Greens (PEV) and the radical Left Block (BE).

Portugal has been spared any sanctions and the suspension of European structural and investment funds, which are vital for its development. Between 2014 and 2020, the overall ESI funds will account for nearly 15% of 2015 GDP.

[1] *The structural balance equals the balance that would be reached if GDP equalled its potential, adjusted for exceptional measures.*

[2] *In late August, the European Commission approved a EUR 2.7 bn injection in CGD by the Portuguese government in exchange for a restructuring plan and the disposal of EUR 1 bn in debt instruments on the market.*