INFOCUS

MACRO COMMENT

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The Portuguese economy looks forward

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With the macro-economic effects of the Covid pandemic receding and Russia's invasion of Ukraine still impacting the global economy, it is a good time to review economic developments in Portugal. In this Issue of *Infocus*, EFG Chief Economist Stefan Gerlach looks at the state of the Portuguese economy and the outlook for growth and inflation. Overall, Portugal appears to have weathered the recent economic turbulence well and seems well positioned for the future.

The economy slows and inflation declines

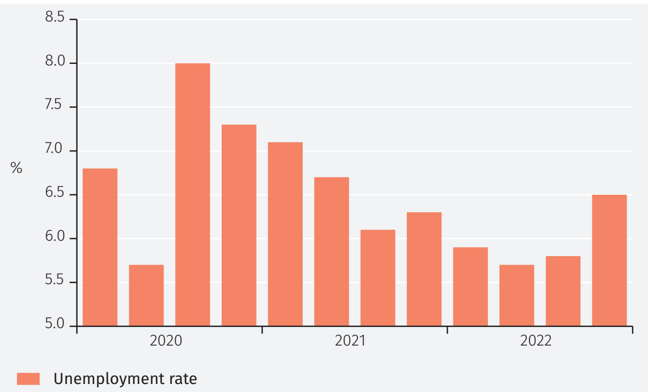
After having collapsed at the start of the Covid crisis in Q2 2020, the Portuguese economy grew rapidly from Q1 2021 onwards as the country reopened. Naturally, growth rates fell during 2022 from 11.9% year-on-year in Q1 to 3.2% year-on-year in Q4 (see Figure 1). Overall, real GDP growth in 2022 was 6.7%.

1. Real GDP growth

Source: INE. Data as at 27 March 2023.

These developments are reflected in the unemployment rate, which surged after Covid struck, then gradually declined but rose again in the second half of 2022 as economic growth slowed towards more sustainable levels.

2. Unemployment rate

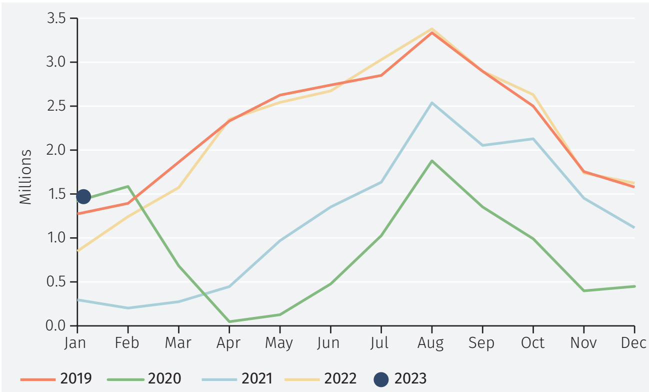


Source: INE. Data as at 27 March 2023.

An important driver of economic growth has been the tourism sector. Tourism collapsed because of Covid in the spring of 2020 but recovered during the summer. Overall, however, the number of nights spent in tourist accommodation fell by 62% between 2019 and 2020. While tourism rose in 2021, it was still 47% below the level of 2019.

In 2022 tourism recovered to the level of 2019. However, before Covid tourism grew by roughly ten percent per year, implying that the 2022 level was much below trend. In January 2023, the number of nights spent in tourist accommodation was about 15% higher than in January 2019, suggesting that tourism growth has returned.

3. Tourist accommodation



Source: INE. Data as at 27 March 2023.

As in most other countries, inflation remained low in 2020 despite Covid, but rose in 2021 and surged in 2022. Most recently, it has declined but headline and core inflation are both high, indicating that inflation is broad based and not solely due to rising energy and food prices. Given its sluggishness, it will take some time before inflation has returned to levels generally associated with price stability.

Lending slows as rates rise

The slowing of the economy is also apparent from loan growth. As in many other countries, loans to non-financial corporations grew very rapidly following the start of the Covid crisis as firms sought to bridge what they expected to be a temporary period of very low or zero cash flow. Loan growth peaked in February 2021 and has since been slowing, turning negative in January and February 2023.

4. HICP inflation

Source: INE. Data as at 27 March 2023.

Loan growth to households for consumption and house purchases has also fallen recently as the economy has slowed.

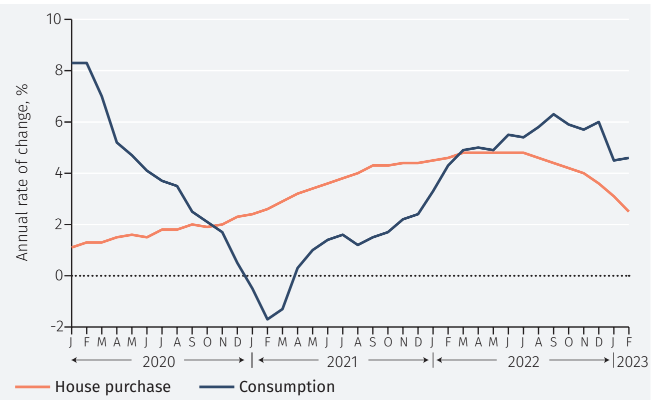
Mortgage interest rates rising, property price growth slowing

A second factor contributing to reduced lending growth is the ECB's tightening of monetary policy. Rising interest rates have translated into higher borrowing costs borne by non-financial corporations and households.

5. Loans to non-financial corporations

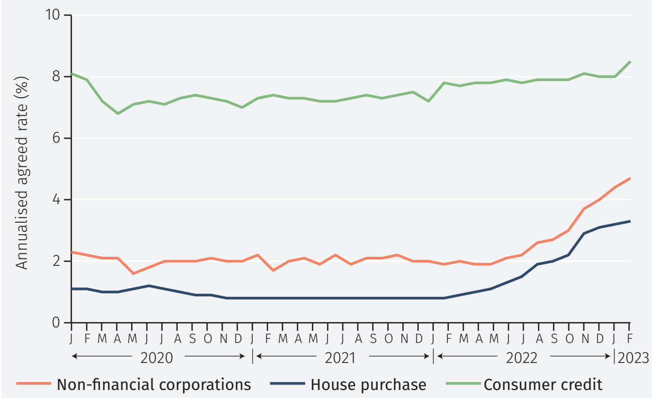
Source: BdP. Data as at 28 March 2023.

6. Loans to households



Source: BdP. Data as at 28 March 2023.

7. Interest rates



Sources: BdP and BIS. Data as at 28 March 2023.

Mortgage interest rates on new lending have tripled since March 2022. Unsurprisingly, one result has been that the rate of increase of residential property prices has started to decline although remains positive. It should be noted that property prices tend to be inertial and further reduction in their growth rate seems likely.

8. Residential property prices

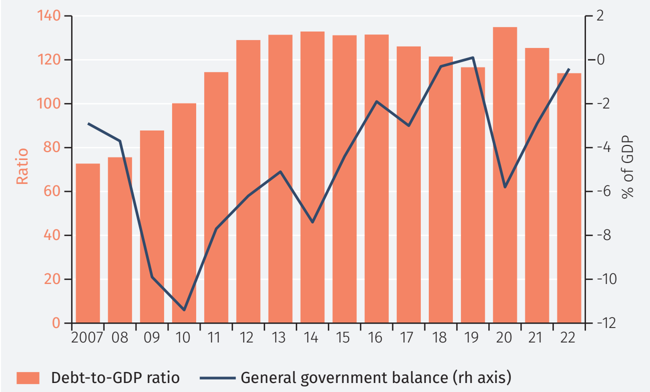
Sources: BdP and BIS. Data as at 28 March 2023.

Public debt declining and yield spread unaffected

In Portugal as elsewhere, Covid was associated with a surge in the debt-to-GDP ratio. The ratio initially rose after the Global Financial Crisis (GFC) in 2008 as the general government deficit spiralled out of control, reaching 11% in 2010. It continued to rise during the eurozone debt crisis despite the measures taken to reduce fiscal deficits and reached 133% in 2014. Concerted efforts and the return to economic growth lowered it to 117% in 2019.

After the start of Covid in 2020, public debt surged to 135% as the general government deficit rose to 6%. The debt ratio has since fallen relative to GDP, reaching 114% in 2022 as the deficit was reduced to 3% of GDP in 2021 and to 0% in 2022.

9. Fiscal indicators



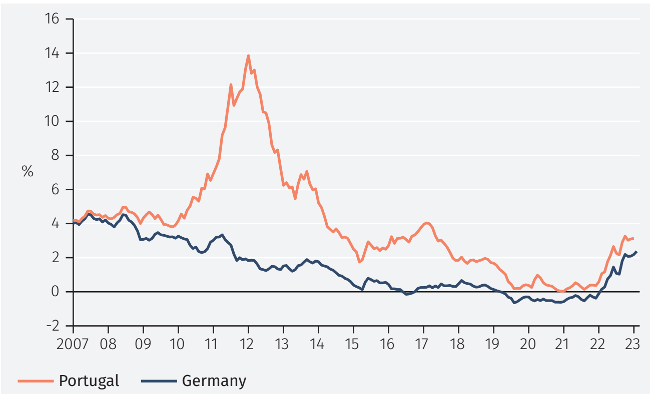
Sources: BdP and FRED. Data as at 29 March 2023.

This strong recent fiscal performance is evident from the behaviour of the spread between Portuguese and German 10-year yields. While the spread rose sharply during the GFC and the eurozone debt crisis as investors worried about the sustainability of Portugal's public finances, it has been well contained since 2020. Notably, it has not risen materially despite the dramatic increase in the ECB's policy rate since July 2022. This is evidence that the credibility of Portuguese fiscal policy has not been an issue.

Lower growth and inflation forecasted

To conclude and looking ahead, real GDP growth is projected to slow in 2023 as the surge in growth after the post-covid reopening of the economy fades. The large macroeconomic shocks triggered by Russia's invasion of Ukraine – in particular rising energy and food prices – and rising interest rates as the ECB seeks to combat high inflation will dampen growth.

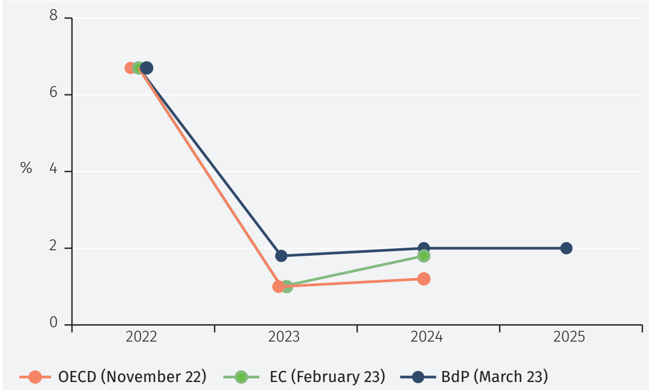
10. 10-year yields



Sources: BdP and FRED. Data as at 29 March 2023.

Furthermore, fiscal policy is likely to turn more restrictive as support measures intended to mitigate energy price shocks are phased out. The same considerations suggest that inflation is likely to fall sharply.

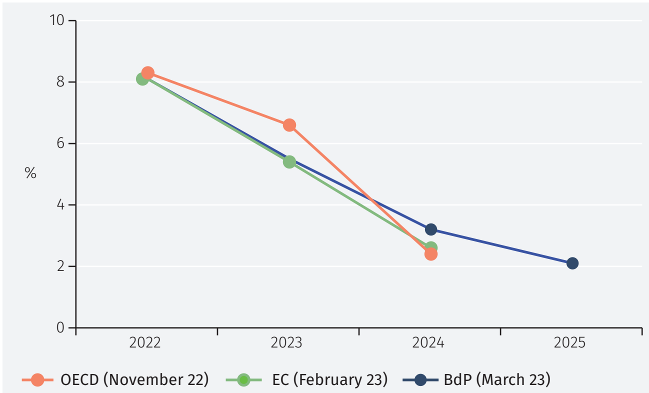
11. Real GDP growth



Sources: OECD, European Commission, and BdP.

This is illustrated by recent forecasts for the Portuguese economy by the OECD[1] in November 2022, the European Commission[2] in February 2023 and the Banco do Portugal[3] in March 2023, all of which point to a sharp reduction in growth from the exceptional level of 2022 and to inflation falling towards 2% from its current very high rate.

12. HICP inflation



Source: OECD, European Commission, and BdP.

[1] See OECD *Economic Outlook*, Volume 2022 Issue 2, 22 November 2022.
[2] See European Commission, *Economic forecast for Portugal*, Latest update 13 February 2023.
[3] See Banco do Portugal, *Boletim Económico*, 24 March 2023

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