Notes on the State Budget Report for 2018

- **On October 13th, the Government submitted to Parliament the State Budget Report for 2018, anticipating a deficit of 1.4% of GDP this year (the lowest since 1974) and a reduction to 1.0% in 2018**
- **The macro scenario points to a sustained recovery, with GDP growing 2.2% in 2018 after 2.6% in 2017 (the highest since 2000), mainly on the back of a strong performance of both exports and investment**
- **These developments support a solid decline of the public debt, from slightly over 130% of GDP in 2016 to 126.2% in 2017 and 123.5% in 2018**
- **In 2018, the State's gross financing needs should stand at around €19 bn, to be mainly financed by the issuance of MLT debt of about €15 bn (in line with that expected in 2017)**
- **IGCP will sustain a strategy aimed at maintaining a comfortable cash position and gradually pre-paying the IMF loan (about €3 bn until year-end and €1.4 bn projected in 2018)**

Macro scenario foresees a sustained recovery of GDP

On the 13th of October, the Government submitted to Parliament the 2018 Budget Report. The macroeconomic forecast includes an expected GDP growth of2.6% in 2017, up from 1.5% in 2016, and a deceleration to 2.2% in 2018. The forecasts for both 2017 and 2018 reflect upward revisions when compared with the Stability Program's 2017-2021 figures (released on April 13th) and should be consistent with progressive economic convergence to the Euro Area.

GDP is projected to grow 2.6% in 2017 and 2.2% in 2018, in line with the most recent projections from other institutions

Domestic demand will provide an important contribution to GDP growth, 2.7pp and 2.2pp in 2017 and 2018, respectively. Both private consumption and investment are expected to continue growing steadily in 2018 (1.9% and 5.9%, respectively).

Macroeconomic Scenario

	INE - Statistics Portugal		2018 State Budget Report		Banco de Portugal		Portuguese Public Finance Council		IMF		European Commission	
			October 2017		October 2017	June 2017	September 2017		October 2017		May 2017	
	2015	2016	2017e	2018p	2017p	2018p	2017p	2018p	2017p	2018p	2017p	2018p
Real GDP (yoy%)	**1.8**	**1.5**	**2.6**	**2.2**	**2.5**	**2.0**	**2.7**	**2.1**	**2.5**	**2.0**	**1.8**	**1.6**
Private Consumption	2.3	2.1	2.2	1.9	1.9	1.7	2.2	2.1	2.2	1.8	1.9	1.3
Public Consumption	1.3	0.6	-0.2	-0.6	0.3	0.6	0.7	0.0	0.6	0.5	0.4	0.5
GFCF	5.8	1.6	7.7	5.9	8.0	5.3	9.1	5.2	6.9	5.7	5.4	4.7
Exports	6.1	4.1	8.3	5.4	7.1	6.8	7.9	4.0	7.6	5.2	4.4	4.2
Imports	8.5	4.1	8.0	5.2	6.9	6.9	7.6	4.1	7.3	5.1	5.2	4.5
Contributions to GDP growth (pp)							-	-	-	-	-	-
Domestic demand	2.8	1.6	2.7	2.2	2.5	2.2	2.8	2.3	2.6	2.2	2.1	1.7
Inventories	0.1	0.0	-	-	-	-	-	-	-	-	-	-
Net exports	-1.1	-0.1	-0.1	0.0	0.0	-0.2	0.0	-0.1	-0.1	-0.1	-0.3	-0.1
External sector (% GDP)							-	-	-	-	-	-
Current account	-0.9	0.1	-0.1	0.1	-	-	0.3	0.3	0.4	0.3	0.5	0.5
of which Goods and Services	0.6	0.9	0.9	1.0	1.7	2.2	0.9	0.7	-	-	0.8	0.7
Capital account	1.2	0.9	0.9	0.9	-		1.0	1.0	-	-	-	-
Unemployment (% labor force)	**12.4**	**11.1**	**9.2**	**8.6**	**9.0**	**8.2**	**9.2**	**8.5**	**9.7**	**9.0**	**9.9**	**9.2**
Prices (yoy%)							-	-	-	-	-	-
GDP deflator	2.0	1.4	1.3	1.4	-	-	1.3	1.8	2.2	1.7	1.4	1.4
HICP	0.5	0.6	1.2	1.4	1.6	1.4	1.6	1.9	1.6	2.0	1.4	1.5

Source: Statistics Portugal, Ministry of Finance, Banco de Portugal, Portuguese Public Finance Council and European Commission.

The contribution of net exports is expected to be marginally negative in 2017 and neutral in 2018, with the acceleration of exports being offset by an equivalent increase in imports (following the revival in investment). Notwithstanding, the external accounts will remain in surplus for the 7th consecutive year in 2018, with net external financial capacity expected to stand at 0.8% of GDP in 2017 and 1% of GDP in 2018.

External accounts in surplus for the 7th consecutive year

According to the most recent data, both exports and imports are increasing at a double-digit rate year-on-year, as the exports-to-imports ratio (coverage ratio) stood at 103.4% between January and July 2017 (below the 105.5% figure in the same period of 2016).

The positive developments in the labor market are expected to continue supporting economic growth. According to the State Budget Report for 2018, the unemployment rate is forecasted to reach 8.6% in 2018, the lowest annual average since 2008. The most recent figure published by Statistics Portugal points to 8.8% in 2017Q2 (1.3pp below 2017Q1 and 2pp below 2016Q2).

Labor market is expected to continue contributing positively to economic growth…

The Portuguese Authorities foresee the continuation of the contribution of job creation to the labor market recovery — 2.7% in 2017 and 0.9% in 2018 —, as the economy converges to full employment. Accordingly, productivity growth is expected to contribute more significantly to economic expansion in 2018 (1.2% in 2018, as opposed to -0.1% in 2017 and +0.3% in 2016).

…as employment productivity growth is also set to increase in 2018

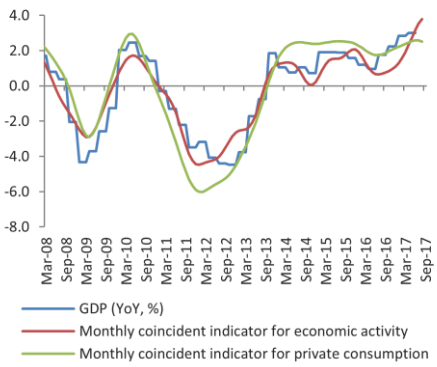
Harmonized Consumer Price Inflation (HICP) is expected to progressively accelerate in both 2017 and 2018, from an average annual growth rate of 0.6% in 2016 to 1.2% in 2017 and 1.4% in 2018. Between January and September 2017 the HICP grew at an average of 1.5% yoy, above the average figure of 0.6% in 2016 over the same period, consistent with that of the Euro Area. The Core HICP presented a similar trend, averaging 1.2% in the first seven months of the year (0.9% in the same period of the previous year).

Inflation is expected to increase in 2018, in tandem with that of the Euro Area

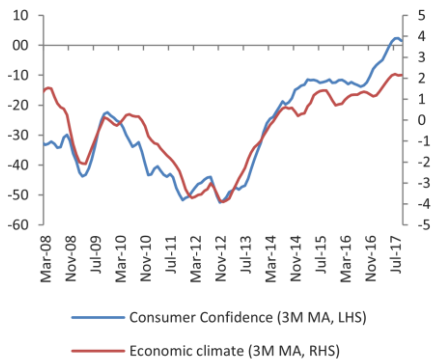
The GDP deflator is forecasted to grow at a similar pace between 2016 and 2018, with the acceleration of the private consumption deflator being offset by a deceleration of the public consumption deflator and by a slight deterioration of the terms of trade in 2017.

Overall, the macroeconomic scenario is consistent with the general consensus and with that of other national and international institutions. On the other hand, high frequency indicators also suggest the continuation of a steady economic recovery.

GDP and coincident indicators
(%)



Consumer and economic climate
(balance between positive and negative assessment)



High frequency indicators continue to signal a robust growth environment

Source: Statistics Portugal and Banco de Portugal

In 2017, the budget deficit is expected to stand at 1.4% of GDP and to decline to 1.0% in 2018

In 2017, the general government deficit is expected to decrease to 1.4% of GDP, an adjustment of 0.6pp relative to the previous year, as a result of an increase in revenue (+0.3pp of GDP) along with a reduction in expenditure (-0.2pp of GDP).

In 2018 the headline deficit will reach 1.0% of GDP and the primary balance shall maintain a surplus of more than 2.5%

For 2018, the fiscal consolidation strategy should allow a budget deficit reduction of 0.4pp, to 1.0% of GDP, achieved through a reduction of total expenditure by 0.3pp (to 44.5% of GDP), coupled with an increase of the weight of the revenue on GDP (by 0.1pp, to 43.5% of GDP).

The primary balance is expected to keep a positive trajectory, achieving a surplus of about 2.5% of GDP in 2017 and 2.6% of GDP in 2018.

The structural overall balance is expected to improve by 0.2pp of potential GDP, to -1.8% in 2017. In 2018, the Government foresees a structural adjustment of 0.5pp of potential GDP, to -1.3% of GDP.

The structural deficit will post an adjustment of 0.5pp of potential GDP, reaching a minimum of 1.3%

OVERALL BALANCE	2010	2011	2012	2013	2014	2015	2016	2017[e]	2018[p]
Overall balance	-11.2	-7.4	-5.7	-4.8	-7.2	-4.4	-2.0	-1.4	-1.0
Structural overall balance	-9.0	-6.1	-3.4	-2.9	-1.7	-2.3	-2.0	-1.8	-1.3

PRIMARY BALANCE	2010	2011	2012	2013	2014	2015	2016	2017[e]	2018[p]
Primary balance	-8.2	-3.1	-0.8	0.0	-2.3	0.2	2.2	2.5	2.6
Structural primary balance	-6.0	-1.8	1.5	1.9	3.2	2.2	2.2	2.1	2.3

Source: Statistics Portugal and Ministry of Finance

In 2018, and taking into account the headline figures, the weight of current revenue is expected to increase 0.1pp of GDP, to 42.8%, while capital revenue share on GDP will remain unchanged (at 0.7%).

Increase in total revenue and decrease of expenditure weight on GDP explain fiscal consolidation

The weight of current taxes on income and wealth on GDP will decrease 0.4pp in 2018, mainly reflecting a reduction of revenues from the Personal Income Tax, on the back of the gradual removal of the extraordinary surcharge (€-260 mn) and a new structure of the tax brackets (€-230 mn) that imply a tax relief for lower and medium-income taxpayers.

In the case of taxes on production and imports there will be an increase of 0.1pp, reflecting the increase in the taxation of products with high salt content (€30 mn) and adjustments on special taxes on consumption (€150 mn).

The weight of other current revenues on GDP will rise by 0.4pp, due to the evolution of revenue sources other than taxes and contributions, namely the expected increase of dividends received from *Banco de Portugal* (€148 mn) and the revenue review (€50 mn).

The capital revenue item includes the recovery of the BPP guarantee in 2017 (€450 mn) and the figure for 2018 takes into consideration an acceleration of revenue from European funds (€167 mn).

On the expenditure side, the weight of current expenditure is estimated to decrease by 0.7pp of GDP (to 41.8%), while capital expenditure will increase by 0.4pp (representing 2.8% of GDP at the end of 2018).

Despite the negative impact stemming from the gradual unfreezing of career progression (€211 mn), the weight of the compensation of employees is expected to continue declining in 2018. The control of public employment, by hiring only one employee per two leaving, in place in 2017, will be replaced by a new rule in 2018 that allows hiring two employees for every three leaving the public workforce (€-23 mn).

The expenditure behavior is influenced by the decrease of the interest expenditure and the compensation of employees

Interest expenditure is expected to keep the downward trend observed over recent years and contract 0.4pp of GDP in 2018, on the back of a lower implicit interest rate and a declining trend of the debt stock. This significant reduction includes estimated savings of €307 mn related with IMF loan early repayments.

The weight of social benefits will diminish 0.1pp of GDP in 2018 (to 18.6pp of GDP), explained by the improvement in the labor market, which will reduce the spending on unemployment benefits and other cyclical measures. These effects are expected to partly compensate the increase with pensions, mainly explained by the pensions update (€154 mn) and early retirement for workers with very long contributory careers (€48 mn), and the increase of expenditure of other social benefits, namely social inclusion income (€79 mn).

In what regards intermediate consumption, its weight is expected to remain unchanged, due to the improvement in public services efficiency and the ongoing spending review (€-287 mn), especially in the health and education sectors, State Owned Enterprises and internal administration. Capital expenditure is projected to increase 0.4pp of GDP through public investment growth, which is expected to more than compensate the decrease in other capital expenditure.

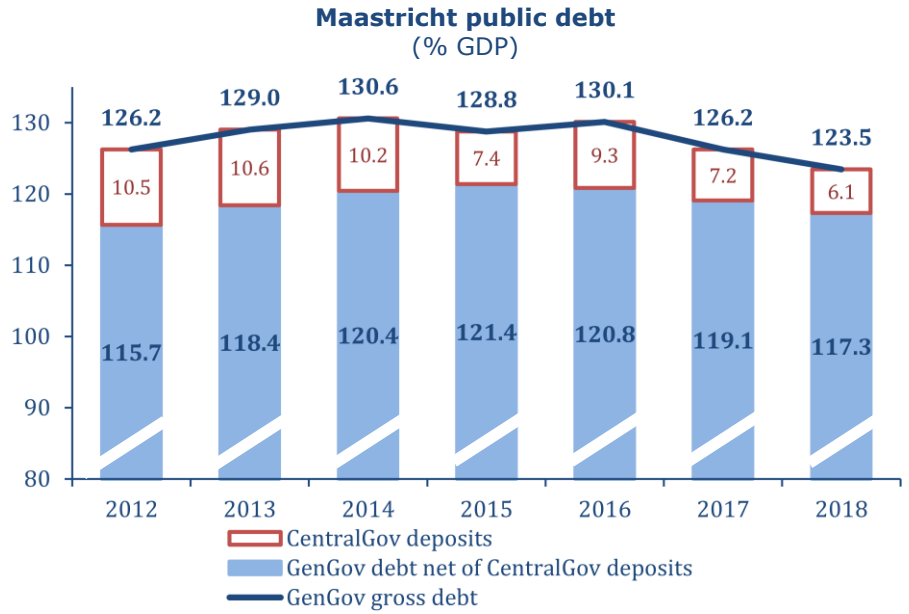
General Government Account (accrual basis)										
(% GDP)	2010	2011	2012	2013	2014	2015	2016 P	2017 E	2018 P	2018 vs 2017
Total revenue	**40.6%**	**42.6%**	**42.9%**	**45.1%**	**44.6%**	**43.8%**	**43.0%**	**43.4%**	**43.5%**	**0.1pp**
Current revenue	39.4%	41.5%	41.1%	44.0%	43.6%	43.0%	42.6%	42.7%	42.8%	0.1pp
Current taxes on income and wealth	8.5%	9.5%	9.0%	11.4%	11.0%	10.9%	10.3%	10.2%	9.8%	-0.4pp
Taxes on production and imports	13.2%	13.9%	13.9%	13.7%	14.2%	14.5%	14.8%	15.0%	15.1%	0.1pp
Social contributions	11.9%	12.0%	11.4%	12.0%	11.8%	11.6%	11.7%	11.7%	11.7%	0.0pp
Other revenue	5.8%	6.2%	6.9%	6.8%	6.6%	6.1%	5.9%	5.8%	6.2%	0.4pp
Capital revenue	1.3%	1.1%	1.8%	1.1%	1.0%	0.8%	0.4%	0.7%	0.7%	0.0pp
Total expenditure	**51.8%**	**50.0%**	**48.5%**	**49.9%**	**51.8%**	**48.2%**	**45.0%**	**44.8%**	**44.5%**	**-0.3pp**
Current expenditure	44.6%	45.6%	45.3%	46.8%	45.6%	43.9%	43.1%	42.5%	41.8%	-0.7pp
Social benefits	18.6%	18.9%	19.6%	20.4%	19.7%	19.3%	19.0%	18.7%	18.6%	-0.1pp
Compensation of employees	13.7%	12.8%	11.7%	12.5%	11.9%	11.3%	11.3%	11.1%	10.8%	-0.4pp
Interest (EDP)	2.9%	4.3%	4.9%	4.9%	4.9%	4.6%	4.2%	3.9%	3.6%	-0.4pp
Intermediate consumption	5.9%	6.0%	5.8%	5.6%	5.7%	5.6%	5.6%	5.6%	5.6%	0.0pp
Subsidies	0.7%	0.7%	0.6%	0.6%	0.7%	0.6%	0.5%	0.5%	0.5%	0.0pp
Other current expenditure	2.8%	2.9%	2.7%	2.7%	2.7%	2.6%	2.5%	2.5%	2.6%	0.1pp
Capital expenditure	7.2%	4.4%	3.3%	3.2%	6.2%	4.3%	1.9%	2.4%	2.8%	0.4pp
Gross fixed capital formation	5.3%	3.5%	2.3%	2.3%	1.9%	2.4%	1.5%	1.7%	2.3%	0.6pp
Other capital expenditure	1.9%	0.9%	1.0%	0.9%	4.2%	1.9%	0.4%	0.7%	0.5%	-0.2pp
Overall balance	**-11.2%**	**-7.4%**	**-5.7%**	**-4.8%**	**-7.2%**	**-4.4%**	**-2.0%**	**-1.4%**	**-1.0%**	**0.4pp**
Memo items										
Primary expenditure	**48.9%**	**45.7%**	**43.6%**	**45.1%**	**46.9%**	**43.6%**	**40.8%**	**40.9%**	**40.9%**	0.1pp
Primary balance	**-8.2%**	**-3.1%**	**-0.8%**	**0.0%**	**-2.3%**	**0.2%**	**2.2%**	**2.5%**	**2.6%**	**0.1pp**

Source: Statistics Portugal and Ministry of Finance

Public debt projected to decline 6.5pp of GDP between 2016 and 2018

The Maastricht gross debt is expected to stand at 126.2% of GDP at the end of 2017, 3.9pp lower than in 2016 – the largest reduction in 19 years. For 2018, in line with the previous year, the debt-to-GDP ratio is expected to maintain a downward trajectory, reaching 123.5% by the end of the year.

Net of Central Government deposits, public debt is projected to stand at 119.1% of GDP in 2017, declining to 117.3% in 2018.



Source: Banco de Portugal and Ministry of Finance

Public debt is projected to maintain a declining trend in 2018, on the back of a strong primary surplus of 2.6% of GDP and nominal GDP growth of 3.6%

The decomposition of debt dynamics shows that the reduction expected for 2017 and projected for 2018 is achieved through a strong primary surplus of about 2.5% of GDP, as well as from the snowball effect, projected to have a favorable contribution of -1.0pp and -0.8pp of GDP, respectively.

Public debt dynamics (pp GDP)

	2015	2016	2017 P	2018 P
Maastricht debt (% GDP)	**128.8**	**130.1**	**126.2**	**123.5**
Change (pp GDP)	-1.8	1.4	-3.9	-2.8
Primary balance effect	-0.2	-2.2	-2.5	-2.6
Snowball effect	-0.3	0.5	-1.0	-0.8
Interest	4.6	4.2	3.9	3.6
Nominal GDP	-4.9	-3.7	-4.9	-4.4
Other stock-flow adjustments	-1.3	3.1	-0.4	0.6

Source: Ministry of Finance

The snowball effect benefits from a strong nominal GDP performance (especially in 2017), but also from the steady decline of interest costs. This reduction stems from a substantial reduction of the implicit interest rate on General Government debt (from a peak of 4.4% in 2011 to a historical minimum of 2.9% in 2018).

The steady reduction of the implicit interest rate is expected to be sustained in the coming years

This trend is projected to be sustained even if marginal interest rates increase, as the bonds maturing in the coming years have an average cost of more than 4%, well above the current market interest rates.

2018 borrowing needs expected to be funded in 40% by the end of 2017

The State's net financing needs in 2017 have been substantially revised down, in line with the better budget execution on a cash basis observed until August. This has been reflected both in a lower State deficit and lower net acquisition of financial assets, as well as on a significant surplus of other public entities (see below a decomposition of the deficit by subsector, on a cash and accrual basis, in 2016-18). This surplus will expectedly increase the amount of funds centralized in the Single Treasury Account, which justifies the positive amount of "Other flows" currently projected in the following table.

IGCP will reimburse an additional tranche of the IMF loan in 2017, amounting to €3 bn, on the back of a stronger budget execution

For this reason, the Government has decided to anticipate additional early reimbursements of the IMF loan amounting to roughly €3 bn until the end of the year. This, however, has no impact on the funding programme for 2017.

State Treasury borrowing needs and sources (€ billion)

	2016	2017 P	2018 P	2019 P	2020 P	2021 P
State borrowing requirements	**22.5**	**25.7**	**19.0**	**16.2**	**13.4**	**20.4**
Net financing needs	**8.3**	9.5	10.8	5.4	3.1	1.4
Overall deficit *	6.2	5.2	5.4	1.6	0.5	-1.5
Other net acquisitions of financial assets **	2.1	4.3	5.3	3.8	2.5	2.8
MLT Redemptions	**14.2**	**16.2**	**8.2**	**10.8**	**10.3**	**19.0**
Tbonds (PGB + MTN)	9.7	7.8	6.7	9.7	10.3	13.7
FRN/*OTRV*						3.5
IMF (executed)	4.5	5.3				
IMF (to be executed)		3.1	1.4	1.0	0.0	1.8
p.m. IMF (original maturity of outstanding loan)		*0.0*	*0.0*	*0.0*	*3.4*	*4.0*
State financing sources	**22.5**	**25.7**	**19.0**	**16.2**	**13.4**	**20.4**
Use of deposits	**-3.6**	2.2	1.5	0.0	-3.5	6.0
Financing in the year	**26.1**	23.5	17.5	16.2	16.9	14.4
Executed	**26.1**	**20.3**				
Tbonds (PGB + MTN)	17.4	13.6				
FRN/*OTRV*	3.5	2.2				
Retail debt (net)	3.5	2.2				
Tbills (net)	0.1					
Other flows (net) ***	1.7	2.3				
To be executed		**3.2**	**17.5**	**16.2**	**16.9**	**14.4**
Tbonds (PGB + MTN)		1.4	15.0			
Retail debt (net)		0.3	1.8			
Tbills (net)						
Other flows (net) ***		1.5	0.7			
State Treasury cash position at year-end ****	**10.2**	**8.0**	**6.5**	**6.5**	**10.0**	**4.0**

* State sub-sector cash deficit in 2016-18. Projection for GG deficit (excl SS) in 2019-21 (Stability Program, Apr 2016).

** Includes refinancing of other public entities (namely SOEs and regions), as well as the direct capitalization of CGD, reimbursement of CoCos and credit line to the Single Resolution Board.

*** Includes centralization of funds of other public entities in the Single Treasury Account.

**** Excluding cash-collateral.

Source: IGCP

Gross borrowing needs in 2018 are estimated at €19 bn (or about €17.6 bn excluding the repurchase of IMF loan), of which €15 bn to be sourced through MLT debt financing

In 2018, the State's net financing needs are projected to stand at €10.8 bn, about €1.3 bn higher than in 2017. This evolution is mainly explained by the higher net acquisition of financial assets, but also by a slight increase of the State deficit on a cash basis.

Gross borrowing requirements shall stand close to €19 bn, given MLT debt redemptions of €6.7 bn (PGB maturing in June) and assuming €1.4 bn redemptions of IMF loans.

IGCP plans to sustain a strategy of pre-emptively covering the funding needs of upcoming years

The financing needs will be covered by MLT debt market issuance (€15 bn) and retail debt net issuance (€1.8 bn), which is sufficient to maintain a cash position that covers roughly 40% of the borrowing needs of the following year.

Annex 1: General Government Accounts on cash and accrual basis

(EUR million)	2016	2017	2018
General Government Balance on a cash basis	**-4,219**	**-2,470**	**-3,353**
Central Government (CG)	-6,377	-4,468	-5,256
State subsector	**-6,132**	**-5,196**	**-5,438**
State Owned Enterprises (SOE)	-1,052	-1,022	-1,288
Other CG entities excl SOE	805	1,750	1,470
Local and Regional Government	599	461	930
Social Security	1,559	1,538	974
Cash-accrual adjustments	**554**	**-280**	**1,320**
Regularization of trade credits		180	421
Tax and SS contributions accruals	-125	192	336
Guarantees	-22	415	-79
Pension funds	459	525	547
Difference between interest paid and accrued	126	-162	234
National Health Service and pensions accruals		-619	-444
SOE accruals	247	-308	730
EU funds neutrality	-28	-465	-877
Other adjustments	-103	-39	450
General Government Balance on accrual basis (ESA 2010)	**-3,665**	**-2,750**	**-2,034**
Central Government	-6,081	-4,826	-4,089
Local and Regional Government	855	490	1,020
Social Security	1,561	1,586	1,036

Source: Ministry of Finance

2018 Budget report (in Portuguese only):

- http://www.dgo.pt/politicaorcamental/Paginas/OEpagina.aspx

2018 Draft Budgetary Plan:

- https://ec.europa.eu/info/sites/info/files/2018_dbp_pt.pdf

Further information on the Portuguese economy can be obtained from:

- **Ministry of Finance** http://www.portugal.gov.pt/pt/ministerios/mf.aspx
- **Banco de Portugal** www.bportugal.pt
- **Statistics Portugal** www.ine.pt
- **Public Finance Council** www.cfp.pt
- **UTAO (only in PT)** Website
- **Portugal Economy Probe** www.peprobe.com

Disclaimer:

Tel: +351 217923300
Fax: +351 217993795
E-mail: info@igcp.pt

Web site: www.igcp.pt
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